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Leveraged Buyouts in Bankruptcy

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LEVERAGED BUYOUTS IN BANKRUPTCY

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INTRODUCTION

Leveraged buyouts (LBO's) have become a popular method of corporate acquisition.[1] Managers make fortunes from LBO's by investing comparatively little and reaping prodigious returns. So far, relatively few of these LBO's have gone bankrupt, suggesting that they have been judiciously chosen and financed by lenders.[2] But financial fashion has a cyclical quality to it. Some LBO's will certainly end in bankruptcy,[3] and many general creditors will challenge the

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[1] The momentum of LBO's continues unabated. In 1984, there were 245 LBO transactions worth over $18.6 billion, a slight increase over the dollar volume in 1983. 19 MERGERS & ACQUISITIONS 7, 25 (1984).

[2] *See* Deveny & Ehrlich, *Leveraged Buyouts: There's Trouble in Paradise*, BUS. WK., July 22, 1985, at 112.

[3] Williams, *Fearing New Loan Troubles, Banks Start to Sour on Leveraged Buyouts*, Wall St. J., May 8, 1984, at 37, col. 4 (banks financing fewer LBO's for fear of failures). LBO's result in highly leveraged companies, which have less margin of error in case of economic downturn. John Shad, Chairman of the SEC, has said that increased leverage as a means of investment is a matter of national concern. John Shad, The Leveraging of America, Statement before the New York Financial Writers Association (June 7, 1984), *quoted in* CONGRESSIONAL RESEARCH SERVICE, SUBCOMM. ON TELECOMMUNICATIONS, CONSUMER PROTECTION, AND FIN. OF THE HOUSE COMM. ON ENERGY AND COMMERCE, 98TH CONG., 2D SESS., MERGER ACTIVITY AND LEVERAGED BUYOUTS: SOUND CORPORATE RESTRUCTURING OF WALL STREET ALCHEMY? 5 (Comm. Print 1984) ("the more leveraged takeovers and buyouts today, the more bankruptcies tomorrow.") [hereinafter cited as CONGRESSIONAL RESEARCH SERVICE]; *see also* CONGRESSIONAL RESEARCH SERVICE, *supra*, at 16 (LBO's are increasingly risky as more marginal deals are made); 29-31 (banks reluctant to finance buyouts because of increasing riskiness); Lowenstein, *Management Buyouts*, 85 COLUM. L. REV. 730, 758 (1985) (LBO's represent a trend toward greater reliance on debt rather than

financing lender's security interests, mortgages, and guaranties as fraudulent conveyances.[4]

An LBO refers to the acquisition of a company ("target company") where a significant portion of the purchase price is borrowed and where the loan is secured by the target company's assets. The structure of an LBO can vary considerably and may include the acquisition of the target company's stock or assets[5] and may also include the

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equity financing); Lipton, *Takeover Abuses Mortgage the Future*, Wall St. J., Apr. 5, 1985, at 16, col. 4.

The success of cautious LBO lenders may lead to increasing excesses by those unable to discriminate between companies with and without the ability to operate while saddled with enormous debt. Blind pools of funds involving hundreds of millions of dollars have started to appear, reflecting a "can't lose" attitude that may lead to injudicious choices of LBO's. Sloane, *Luring Banks Overboard*, FORBES, Apr. 9, 1984, at 39-40.

[4] Fraudulent conveyances are described in 11 U.S.C. § 548(a) (1982). *See infra* notes 7, 15-16 and accompanying text.

[5] This article focuses on leveraged buyouts in which the target company is acquired through the acquisition of its stock. While it is possible to consummate a leveraged buyout through the acquisition of a target company's assets, asset acquisitions are often disfavored for tax reasons. When asset acquistions are financed by a secured loan, the financial dynamic is sufficiently different that fraudulent conveyance concerns are far less likely to exist. If a subsidiary buys assets with the proceeds of a secured loan, the subsidiary retains the value given by the lender. If the stock of the subsidiary is purchased, the subsidiary often does not retain this value. Hence, exclusion of asset purchases from this article is justified.

Some other underlying limitations in the analysis should be disclosed. First, this article is about bankruptcy risks to LBO lenders and the rights of creditors of the acquired company. I will not deal with any securities issues involving fairness to minority shareholders, or any other related issues. Nor will I discuss the tax aspects of LBO's. For the tax aspects of LBO's, see generally, *supra* note 3, at 22-26; Lowenstein, *supra* note 3, at 759-64.

Second, I will be dealing with fraudulent conveyance concepts as set forth in § 548 of the Bankruptcy Code. *See* 11 U.S.C. § 548 (1982). Other fraudulent conveyance concepts are relevant, of course. For instance, the trustee may have the power to assert fraudulent conveyance rights of actual creditors under state law. 11 U.S.C. § 544(b) (1982). Section 548 duplicates many of the provisions of the Uniform Fraudulent Conveyance Act, which is the foundation of much state fraudulent conveyance law.

Another underlying concept within § 548 is that it avoids both transfers and obligations. I will not focus on this distinction.

In addition, corporate law contains restrictions similar to fraudulent conveyance restrictions, such as those restricting dividends and stock redemptions by insolvent debtors. It will be assumed that the parties to an LBO have made sure that the LBO will comply with these corporate law restrictions. *But see In re* Process-Manz Press, Inc., 236 F. Supp. 333, 348 (N.D. Ill. 1964) (although not strictly speaking merger of the target company and a holding company set up to effectuate the acquisition.

A common characteristic of LBO's is that the selling shareholders receive cash for their shares from the proceeds of the LBO loan. Therefore, the target company, whose assets have been pledged to secure repayment of this loan, does not beneficially receive the loan proceeds. This disparity—that the target company may appear to suffer a burden without any commensurate benefit—raises the question whether the security interests, mortgages, and guaranties executed by the target company and its subsidiaries in connection with an LBO may constitute fraudulent conveyances.[6]

The purpose of this article is to suggest which LBO's should be deemed fraudulent in bankruptcy and which should not. The classification is based upon two premises. First, transfers to the LBO lender should not, in retrospect, be deemed fraudulent conveyances simply because the target company subsequently required protection from creditors. Rather, a bankruptcy court should assess the LBO from the perspective of the time the lender transfer was made, without allowing itself to be influenced by subsequent history. Second, valuation hearings to determine solvency are difficult and costly, and should be avoided to the extent legal doctrines permit. The trustee's prima facie case[7] against LBO loans is largely dependent upon difficult

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an LBO case, the transaction was both a fraudulent conveyance and a violation of Illinois law governing stock redemptions), *rev'd on other grounds*, 369 F.2d 513 (7th Cir. 1966), *cert. denied*, 358 U.S. 957 (1967).

[6] *See* Congressional Research Service, *supra* note 3, at 8.

[7] The trustee has two different prima facie cases he or she could make under 11 U.S.C. § 548(a). First, the trustee could prove that the LBO is an intentional fraud on creditors. As will become clear, the meaning of intentional fraud is highly dependent on the financial condition of the target company. The company probably must be valued as of the time of the LBO. Even so, the LBO lender has an independent chance for a defense under § 548(c).

The second prima facie case that the trustee might prove is that the target company did not receive a reasonably equivalent value in exchange for creating rights in the LBO lender. § 548(a)(2). Such a showing must be supplemented with further proof that the target company:

(i) was insolvent . . . or became insolvent as a result of such transfer valuation estimates. Some of these valuation hearings might be avoided if bankruptcy courts first looked to see whether the LBO lender had a valid defense against fraudulent conveyance liability.

Part I explores fraudulent conveyances in general and Part II describes the financial environment and possible forms of LBO's. By focusing on the lender's defense to the trustee's prima facie case for fraudulent conveyance liability, Part III distinguishes LBO loans that are fraudulent conveyances from those that are not. The basis of the lender's defense is that it believed the target company had a decent chance to survive economically. The easiest case for a nonfraudulent LBO is one in which the lender reasonably believed that, at the time of the LBO, the target company would emerge as a solvent company (whether or not this in fact turned out to be the case). If the LBO lender has such a belief, none of the lender's rights should be avoided as fraudulent conveyances. This approach should be easier than a full valuation hearing required by the trustee's prima facie case. Furthermore, lenders would find such an approach to be a relatively safe harbor for insuring that their transfers would survive a fraudulent conveyances challenge in a subsequent bankruptcy.

More controversial are LBO's in which the lender knows the target is or will be insolvent. Since the lender realizes that such an LBO depletes the assets for existing creditor claims, some have asserted that the lender's rights are per se fraudulent.[8] Such a conclusion is not required. Insolvency does not necessarily imply that the target company cannot survive as a viable entity. If the lender reasonably believes that the target company has a fair chance to survive financially, even admittedly insolvent LBO's should be deemed nonfraudulent. Only when the lender anticipates an upcoming liq-

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or obligations;

(ii) was engaged in business . . . for which any property remaining was unreasonably small capital; or

(iii) intended to incur . . . debts that would be beyond the debtor's ability to pay as such debts matured.

11 U.S.C. § 548(a)(2)(b). All of these insolvency definitions require valuation of the target company, to some degree. If the LBO lender's defense were considered before the trustee's prima facie case, the valuation hearing could be avoided in many cases.

[8] *See* United States v. Gleneagles Inv. Corp., 565 F. Supp. 556, 576 (M.D. Pa. 1983). For a discussion of the *Gleneagles* case in this context, see *supra* notes 96-105 and accompanying text.

uidation that is prejudicial to general creditors should the LBO lender's rights be subject to fraudulent conveyance liability.

Finally, Part IV of this article reviews some of the consequences of declaring an LBO to be fraudulent. One issue is whether honest portions of a partly fraudulent LBO loan could survive avoidance by the trustee or whether courts must follow an "all or nothing" approach to fraudulent conveyance liability. Also, the trustee will often have the power to avoid transfers to parties in addition to the LBO lender. The effect that these alternative recovery rights may have on the LBO lender's liability will be reviewed. LBO loans are frequently assigned or refinanced. The legal position of assignees and refinancers will also be explored in Part V. The article concludes with a discussion of whether estoppel or assumption of the risk by creditors should be a defense to attacks on LBO's.

I. Fraudulent Conveyance Law in General

There are two conflicting goals in debtor-creditor law. On the one hand, debtors have freedom to administer their assets without interference by creditors. If a creditor wishes to restrict the debtor's behavior, the creditor has the drafting burden to set forth those restrictions in covenants.[9] Another goal of debtor-creditor law, however, is to protect creditors when a debtor becomes or is about to become insolvent. In such a case, the debtor, to some extent, is required to assume the role of a fiduciary of his property on behalf of his creditors. Fraudulent conveyance law responds to this latter goal.

The term "fiduciary" does not inherently suggest what the debtor's duties ought to be.[10] Rather, case law defines what acts are "creditor abusive":[11] those acts connected with the disregard of the creditors'

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[9] For a skeptical review of this tradition, see Bratton, *The Interpretation of Contracts Governing Corporate Debt Relationships*, 5 Cardozo L. Rev. 371 (1984); McDaniel, *Bondholders and Corporate Governance*, 41 Bus. Law. 413 (1986).

[10] *See* SEC v. Chenery Corp., 318 U.S. 80, 85-86 (1943) ("[T]o say that a man is a fiduciary only begins the analysis: it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary?").

[11] "Creditor-abusive" simply means acts that violate an insolvent debtor's duties toward creditors other than the lender. This term has been chosen to capture the notion that the insolvent debtor has a wide berth in conducting its affairs and may engage in considerable self-dealing without causing transferees to incur fraudulent conveyance liability. Only inconsistent with the debtor's own welfare as a surviving economic entity should be fraudulent conveyances.

welfare and characterized by some degree of self-dealing by the debtor. Robert Charles Clark, in a much cited article, has attempted to identify standards of insolvent debtor behavior.[12] The standards he draws from a sporadic and diverse case law include: (a) the duty to tell creditors the truth; (b) the duty to be even-handed among competing creditors; (c) the duty to refrain from hindrance or delay; and (d) the duty to pay debts before making gifts or dividends.[13] Beyond this, debtors may take actions that the creditors could not possibly approve of.

A number of developments in the law of creditor rights have displaced some of these categories. For example, secret liens are now voidable by judgment creditors under Section 9-301 of the Uniform Commercial Code (UCC) and under some real estate recording acts.[14] These provisions have reduced the importance of category (a) in modern commercial litigation. Preference law prohibits paying creditors outside the ordinary course of business ninety days before bankruptcy, thereby vitiating category (b).[15] Article 6 of the UCC, governing the bulk sale of inventory, now supplements category (c).[16] The remaining category represents the principal utility of fraudulent conveyance law today: preventing insolvent debtors from making gifts or paying dividends. It is upon this perspective that LBO's should either rise or fall.

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[12] Clark, *The Duties of the Corporate Debtor to its Creditors*, 90 HARV. L. REV. 505 (1977).

[13] *Id.* at 508-17.

[14] *See, e.g.*, 4 AMERICAN LAW OF PROPERTY § 17.29, at 609 & n.1 (A. Casner ed. 1952). Professor Clark uses a slight variation on the secret lien to illustrate his first category of fraudulent conveyances: a mortgagee who perfects and falsely indicates the amount of the loan in his financing statement. Clark, *supra* note 12, at 508-09. This variation (involving perfected security interests) is one for which fraudulent conveyance law is still quite useful.

[15] 11 U.S.C. § 547(b)(4)(A). Voidable preferences grew out of fraudulent conveyance concepts. But in recent times, voidable preference rules have become formalized in a set of relatively predictable rules. I assume that a preference that escapes voidability under § 547 of the Bankruptcy Code faces no further risk of avoidance under § 548 solely because the creditors have been preferred. On the troublesome relation between voidable preferences and fraudulent conveyance liability under state law, see Note, *Good Faith and Fraudulent Conveyances*, 97 HARV. L. REV. 495 (1983).

[16] Fraudulent conveyance law still remains useful for bulk sales to the extent that they are excluded from Article 6 coverage. For a review of the limited coverage of Article 6, see Rapson, U.C.C. *Article 6: Should It Be Revised or "Deep-Sixed"?*, 38 BUS. LAW. 1753 (1983).

II. The Financial Environment and Forms of LBO's

A. The Financial Environment

Among the potential virtues claimed for corporate mergers and acquisitions are sizable economies of scale, tax benefits, and the reduction of agency costs.[17] Many assume that merger activity is rationally conducted and operates in perfectly competitive markets, with companies being bought by those who can extract the most value from them.[18] Although attractive and straightforward in theory, acquisitions in practice have proven to be treacherous. During the past decade there was an expansion of merger activity, but the trend today in some industries is toward decentralization.[19] Particularly common has been the tendency of large conglomerates to shed small-sized subsidiaries with mundane product lines and slack earning patterns.[20]

The LBO has been used as a de-conglomeration technique because unattractive products and low earnings are the very features that make the acquisition of subsidiaries appealing to certain buyers and secured lenders. The class of buyers has tended to include managers already in the business who have confidence in their ability to lower expenditures and to increase profitability.[21] The secured lender looks

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[17] *See generally* P. Steiner, Mergers, Motives, Effects, Policies 58-69 (1975).

[18] Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 Harv. L. Rev. 1028, 1030-34 (1982) (discussing the motives for takeovers); Easterbrook & Fischel, *Corporate Control Transactions*, 91 Yale L.J. 698, 705-08 (1982) (discussing potential gains from control transactions); Jensen & Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. Fin. Econ. 5, 6 (1983) (describing the takeover market as one in which "managerial teams compete for the rights to manage corporate resources"); Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. Chi. L. Rev. 499, 510 (1976) (giving reasons for corporate affiliations).

[19] O'Connell, *Do Mergers Really Work?*, Bus. Wk., June 3, 1985, at 88; Wayne, *Buyouts Altering the Face of America*, N.Y. Times, Nov. 23, 1985, at 1, col. 1.

[20] Golden, *Management Buyouts: An Attractive Divestiture Option*, 3 J. Buyouts & Acquisitions 3 (Jan. 1985); Congressional Research Service, *supra* note 3, at 9-11; Lowenstien, *supra* note 3, at 749 n.70 (such as retailing, textiles, and bottling), 754-57 (discussing gains in management buyouts). Professor Lowenstein, however, discounts better management as a motive for going-private transactions and blames tax avoidance opportunities. *Id.* at 748-54.

[21] Credit Managers Ass'n v. Federal Co., No. CV 84-3098 ER(Tx), slip op. at 4 (C.D. Cal. Dec. 6, 1985) (company sold to its management in an LBO); *A Leveraged Buyout: What It Takes*, Bus. Wk., July 18, 1983, at 194 (some of the best LBO's take place when confident managers are willing to take high risks to buy divisions of their own company); Ferenbach, *LBOs: A New Capital Market*, 18 Mergers & Acquisitions 21, 24 (1983).

for reliable earnings to finance debt service. If, given reasonable business projections, the earnings do not dip below debt service, the secured lender will have confidence that it will be repaid.[22] When the above factors—entrepreneurial buyers, advantageous price, and a disillusioned conglomerate—are all present, an LBO is a popular mode of financing the transfer of corporate ownership.

Disaggregation is not the only purpose of an LBO. LBO's are also useful whenever corporate owners desire to leave the business. Additionally, LBO's are useful in "going private" transactions, which can have as motives the avoidance of SEC compliance burdens or a belief that an enterprise is undervalued by the market.[23]

B. *Forms of LBO's*

There are several ways to structure an LBO, each generating its own manifestation of the same legal issue: whether the lender knows or should know that it is financing a voidable transfer by a company that cannot survive. Although individual circumstances and layers of shell corporations can give the appearance of creating numerous different structures, the six structures that follow represent the most common LBO's and reflect the major legal issues encountered in even the most complicated of LBO transactions.

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[22] Ross, *How the Champs Do Leveraged Buyouts*, FORTUNE, Jan. 23, 1984, at 70, 74 (good cash flow and increasing earnings help prompt debt repayment). *See* CONGRESSIONAL RESEARCH SERVICE, *supra* note 3, at 12. LBO lenders frequently require floating interest rates, which add an additional vulnerability if interest rates are generally on the rise. *Id.* at 30.

Sometimes, the buyers in an LBO cannot raise the equity capital necessary to cover the difference between what a secured lender is willing to lend (based on asset strength) and what the sellers are demanding as a price. The extra money is often supplied by venture capitalists who extend subordinated loans to the buyers. These subordinated loans are called "mezzanine financing." *Id.* at 14. Subordinated loans have an advantage over straight equity investments: if the buyers do not own 100% of the company's equity, their incentive to push for the maximum income over debt service is reduced. *Id.* at 31-32.

[23] Brudney & Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354, 1365 (1978) (market may undervalue shares); Lowenstein, *supra* note 3, at 759-64 (tax avoidance). Professors Easterbrook and Fischel are loathe to admit that the market could ever undervalue stock. They do mention another source of value in a going-private transaction. Easterbrook & Fischel, *supra* note 18, at 706. If a would-be lender will insist on a downstream guaranty, a majority shareholder simply enriches the minority if it grants such a guaranty. Eliminating the minority therefore reserves 100% of the value of the downstream guaranty for the majority shareholder.

Structure I. A management group forms a wholly owned shell corporation.[24] The lender makes its loan to the shell corporation, which simultaneously uses the loan proceeds to purchase the stock of the target company. At the same time, the shell corporation also pledges the target's stock to the lender to secure the loan.

This structure does not raise any fraudulent conveyance issues. It is little more than a purchase money security interest in stock. Structure I contains a basic flaw, however. Because the lender is not a direct creditor of the target, the lender's claim against the target's assets is no better than a stockholder's claim. As such, the claims of all existing and future creditors of the target have priority over the lender's claim, a risk that may not be acceptable to the lender.[25]

Structure II. The parties start with Structure I, but the shell corporation, instead of using the target's stock as security, causes the target, once acquired, to grant an upstream secured guaranty[26] to the lender. In this context, upstream secured guaranties may be subject to legal attack as fraudulent conveyances. The theory is that such guaranties are transfers for which a target company receives no reasonably equivalent value in return. If the target company becomes insolvent, such a lack of reasonably equivalent value may render the upstream secured guaranty voidable.[27]

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[24] In all of the following LBO forms, I will assume that the buyer will form a holding company that officially owns the stock of the acquired company. This tactic is designed to protect the buyers from personal liability for the loan or perhaps other liabilities of the acquired company (which will be a subsidiary of this shell corporation). The lender, however, often insists that the buyer contribute capital to the shell corporation or agree to some sort of "downstream guaranty" to insure the lender of the buyer's economic commitment to the success of the enterprise. *See* Congressional Research Service, *supra* note 3, at 15.

[25] For an illustration of what a corporate debtor can do to lenders who do not take security interests in the subsidiary's assets, see *In re* Association Gas & Elec. Corp., 61 F. Supp. 11, 28-29 (S.D.N.Y. 1943), *aff'd*, 149 F.2d 996 (2d Cir. 1944). In this case, a parent corporation had made anti-pledge covenants with its creditors. The parent traded its assets to a subsidiary for the subsidiary's stock. Since the subsidiary also had plenty of creditors, the parent's creditors were instantly subordinated to the subsidiary's creditors.

[26] The term "upstream" refers to benefits (guaranties or cash advances) flowing from a subsidiary to its shareholders. For a more complete discussion of issues relating to upstream transfers, see the authorities cited *infra* note 27.

[27] *See* 11 U.S.C. § 548(a)(2) (1982). A further problem with upstream guaranties

Structure III. The third structure also begins with Structure I, but after the shell corporation acquires the target company, the two merge. The merged entity then mortgages its assets to secure the loan. While the merger eliminates the upstream guaranty, it raises another legal issue: does the assumption by the target corporation of the shell corporation's debt obligations (as a result of the merger) and the concurrent mortgage of assets violate any fraudulent conveyance principles? The effect of a merger on preexisting creditors of the target company seems similar to the effect of an upstream guaranty. Courts could develop a similar fraudulent conveyance analysis for both mergers and upstream guaranties.

Structure IV. The management group already owns shares in the target company. To obtain full control, the owners secure a loan to the target by the target's assets. The target then uses the loan proceeds to redeem its outstanding shares, leaving the management group as the sole remaining shareholders. In this manner, the lender obtains a direct claim against the target's assets without creating the appearance of an upstream guaranty and security interest.

This structure assumes, as a matter of corporate law, that the target may redeem its own shares.[28] If it may, the structure raises the issue of whether the target receives "value" when, with the lender's knowledge, it uses the loan proceeds to repurchase its own shares. If the target does not ultimately retain the value, there may be a fraudulent conveyance problem.

A variant of Structure IV occurs when the target advances the loan proceeds in the form of a dividend to a shell corporation controlled by the new management group, which then uses the proceeds to acquire the target. This variant raises the same "value" issue as the structure described in the preceding paragraph.[29]

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is that they may be ultra vires acts under the corporate law of many states (though they are proper under the Model Business Corporation Act). *See* MODEL BUSINESS CORP. ACT § 4(h) (1979). The issue of corporate guaranties is beyond the scope of this article. *See generally* Kreidmann, *The Corporate Guaranty*, 13 VAND. L. REV. 229 (1959); Note, *Upstream Financing and Use of the Corporate Guaranty*, 53 NOTRE DAME LAW. 840 (1978); Note, *The Corporate Guaranty Revisited: Upstream, Downstream and Beyond—A Statutory Approach*, 32 RUTGERS L. REV. 312 (1979).

[28] *See, e.g.*, DEL. CODE. ANN. tit. 8, § 160a (1974 & Supp. 1984).

[29] Just as corporate law restricts stock redemption on behalf of creditors, it likewise restricts dividends. *See, e.g.*, DEL. CODE ANN. tit. 8, § 170 (1974 & Supp. 1984). The nature of dividend restrictions is beyond the scope of this article. It will

Structure V. In this structure, the target company also obtains a loan, but the target then re-lends the proceeds to the shell corporation that is controlled by the management group. The management group uses the loan proceeds to buy out the other owners of the target company. In Structure V, contrary to the second variant of Structure IV, the parent corporation promises to repay the loan from the target company. The claim by the target company against the parent may have substantial value.[30]

Structure VI. This structure is really a variant of any of the foregoing structures. Where the target company has one or more subsidiaries with significant assets, the potential management group will use the assets to induce a lender to make the loan. The lender will want to take a security interest in these assets, either by having the subsidiaries execute upstream guaranties and security interests, or by making a secured loan directly to the subsidiary. In the latter case, the subsidiary advances the loan proceeds to its corporate parent, which in turn uses the proceeds to redeem its own stock.[31] Therefore, the issue arising in Structures II, III, IV, and V is present here as well, namely whether the subsidiary receives "value" when it upstreams the loan proceeds to the corporate parent. As before, the claim by the subsidiary against its corporation parent does constitute potential economic value.

C. *The Trustee's Prima Facie Case Against LBO's*

All of the preceding LBO forms end with the target company's former shareholders taking the proceeds of the LBO loan. All of the forms except Structure I end with the target company retaining the obligation to repay the LBO loan. Only Structure I—the purchase money security interest in the target company's stock—avoided burdening the target company itself. But Structure I leaves the LBO

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be assumed that any LBO using Structure IV will comply with either stock redemption or dividend restrictions.

[30] As a practical matter, buyers of companies on an LBO basis often keep their holding companies practically without assets, in which case the target company's right to recover would be relatively valueless. Sometimes, however, the lender will insist that the buyer contribute some personal assets (including downstream guaranties) to the holding company, in which case the target company's right of recovery will have some affirmative value at the time the LBO is made. *See supra* note 24.

[31] *See, e.g.*, Greenbrook Carpet Co. v. Jones, 722 F.2d 659 (11th Cir. 1984).

lender subordinated to the target company's creditors, a risk that may be unacceptable to the lender.[32] Since the end result of Structures II through VI is the same, the form of the LBO should not particularly matter (without further explanation) in considering whether the LBO involves fraudulent conveyances. Two further points need to be made about the differences between the structures, however.

First, as a purely formal matter, the LBO's structure determines the statutory language under which the trustee brings a prima facie case.[33] In Structure II and perhaps III or VI, for example, the debtor never receives the loan proceeds, even for a moment. These forms involve upstream guaranties. The trustee could therefore proceed under section 548(a)(2),[34] which strikes down transfers if an insolvent debtor has not *received* a reasonably equivalent value in return. In Structures IV and V, and perhaps Structures III and VI, the loan is nominally made directly to the target, in exchange for which the target transfers a security interest to the lender. The exchange of a cash advance for a security interest is an equivalent exchange of values.[35] Under these forms, the debtor has received but has not retained loan proceeds. Therefore, the trustee must shift to section 548(a)(1)[36]—intentional frauds on creditors.

In either case, however, the LBO lender has a potential good faith purchaser defense under section 548(c).[37] The analysis in this article, which focuses on the lender's defense, does not depend on which section the trustee chooses as the basis of his or her prima facie case. Furthermore, it will be assumed that the gravamen of the harm is

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[32] Even if the LBO lender is willing to lend on the strength of Structure I, its bankruptcy worries are not over. If the lender later makes advances directly to the subsidiary, the lender may be an "inside creditor" by virtue of the stock pledge. If, upon default, the lender assumes control of the target and engages in self-serving preferential actions, the preferences themselves could be grounds for equitable subordination or fraudulent conveyance liability. *See generally* DeNatale & Abram, *Doctrine of Equitable Subordinations as Applied to Nonmanagement Creditors*, 40 Bus. Law. 417 (1985) (discussing equitable subordination as applied in bankruptcy cases to the claims of nonmanagement creditors).

[33] *See supra* note 7.

[34] 11 U.S.C. § 548(a)(2) (1982).

[35] That is, the debtor admittedly received (if not retained) x dollars in loan proceeds in exchange for the right to recover x dollars from the sales proceeds of the collateral.

[36] 11 U.S.C. § 548(a)(1) (1982).

[37] *Id.* § 548(c).

the same under either section 548(a)(1) or 548(a)(2): an LBO is fraudulent when, in anticipation of a liquidation, shareholders extract value from the company at a time when the general creditors have not been paid.

A second and genuinely substantive difference between the LBO forms should be mentioned. In most of the forms, the buying parent is obligated to repay the target company for any upstream benefits passed on from the target to the parent. For example, in Structure II, involving upstream guaranties, the target is subrogated to the LBO lender's rights against the buying parent if the LBO lender calls upon the target for payment. Structure III, involving a merger between parent and subsidiary, permits the subsidiary's creditors to reach the parent's assets, if any. In Structure V, the buying parent directly promises the target to repay a loan. Each of these legal rights against the parent's assets provides a modicum of value received in exchange for the upstream benefit. The existence of value received in return will be directly or indirectly relevant to both of the trustee's prima facie cases.[38] In Structure IV, however, the shareholders receive direct dividends or stock redemptions with no contractual obligations to repay. If Structure IV is chosen, no right of recovery exists to constitute partial value.

The existence of an upstream right of recovery is a relevant but not determinative factor in considering the LBO lender's fraudulent conveyance. In some cases the upstream right of recovery has not defeated the trustee's prima facie case.[39] The right of recovery was a value but not by itself a reasonably equivalent value. There have also been cases in which the absence of an upstream right of recovery has not established the trustee's prima facie case. Other reasonably

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[38] If the trustee claims that a Structure II LBO involves conveyances to the lender that are void under section 548(a)(2) of the Bankruptcy Code, the buying parent's promise to repay the target could constitute value to some degree, although not necessarily a reasonably equivalent value. If the trustee claims that a Structure V LBO involves conveyances that are void under section 548(a)(1), the existence of a valuable contract right against the parent must inevitably color the judgment on whether the debtor intended to defraud creditors with an LBO. The nature of the intentional fraud is borrowing for the sole purpose of allowing shareholders to extract value from the company on the eve of liquidation at a time when the creditors have not been paid. If the upstream loan is consistent with survival of the target company, the accusation that the *debtor* intended a fraud is partially rebutted.

[39] United States v. Gleneagles Inv. Corp., 565 F. Supp. 556, 582 (M.D. Pa. 1983).

equivalent values might have been received to replace the absence of an upstream contractual right of recovery.[40] Nevertheless, because the existence of an upstream right of recovery is at least relevant to fraudulent conveyance liability, the choice between Structure IV and any of the other forms is at least partially substantive.

D. *The LBO Lender's Defense Under Section 548(c)*

This article proceeds on the theory that, regardless of the structure of the LBO, the LBO lender who acts in good faith should have a defense against fraudulent conveyance attacks. Section 548(c) provides this defense. It states, in relevant part:

> [A] transferee or obligee [the LBO lender] . . . that takes for value and in *good faith* . . . may retain any lien transferred, or may enforce any obligation incurred, as the case may be, to the extent that such transferee or obligee *gave value to the debtor* [the target company] in exchange for such transfer or obligation.[41]

In applying this section to LBO's, there are two critical elements requiring comment. First, the LBO lender must have acted "in good faith"; and second, the LBO lender must have given value "to the debtor."

Regarding the second requirement, clearly an LBO lender gives value when it actually loans funds. The lender gives value "to the debtor" only in Structures IV and V (although arguably in III or VI also). To the extent the LBO involves an upstream guaranty of a loan made to the buying parent, the value (loan proceeds) is not given "to the debtor" but to a third party at the behest of the debtor.

The phrase "to the debtor" seems to be a drafting error. The language did not appear in the predecessor provision, section 67(d) of the Bankruptcy Act of 1898,[42] nor does it appear in the Uniform

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[40] *In re* Royal Crown Bottlers, Inc., 23 Bankr. 28 (Bankr. N.D. Ala. 1982).

[41] 11 U.S.C. § 548(c) (1982) (emphasis added).

[42] *See* Bankruptcy Act of 1898, ch. 541, 30 Stat. 544, 567(d) (1898) ("[L]iens given or accepted in good faith and not in contemplation of or in fraud upon this Act and for a present consideration, which have been recorded according to law, if record thereof was necessary in order to impart notice, shall not be affected by this Act.")

Fraudulent Conveyance Act.[43] There is no legislative history suggesting otherwise.[44] Hence, section 548(c) should be read as if "to the debtor" were omitted. Such a reading allows for the following summary of the interplay between section 548(a) (the trustee's prima facie case) and section 548(c) (the lender's defense): section 548(a) focuses on what the debtor *receives and retains*;[45] section 548(c) focuses on what the lender *gives*, not on what the lender gives *to the debtor*.

The best argument for the above reading of section 548(c) is that lawyers can always guarantee access to the 548(c) defense by shifting from upstream guaranties (Structure II) to loans *received* but not retained by the target company (Structures IV or V). It costs lawyers nothing to make the shift, and it gains the lender a defense under section 548(c) whenever the lender in good faith gives value directly "to the debtor." There is no social utility in favoring one form over another. A literal wording of section 548(c) achieves nothing except establishing a trap for the unwary.

The other requirement of section 548(c) is "good faith." The term "good faith" is not defined in the Bankruptcy Code, nor are there many cases or other authorities interpreting what good faith means in the specific context of LBO's.[46] But one can presume that an LBO

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[43] *See* UNIF. FRAUDULENT CONVEYANCE ACT §§ 3-4, 7A U.L.A. 430, 448-49, 474 (1985).

[44] The "to the debtor" restriction does appear in the proposed Uniform Fraudulent Transfer Act, *see* UNIF. FRAUDULENT TRANSFER ACT § 8(d), 7A U.L.A. 643 (1985), but this new endeavor is influenced by the drafting of § 548. *See id.* (prefatory note). In other parts of the Act, however, the "to the debtor" restriction is left out. *See id.* § 8(a), (e), (f). The arbitrary and unpredictable appearance of the words "to the debtor" suggests that the drafters did not have upstream guaranties in mind when the various lender defense provisions were written.

[45] The trustee would use § 548(a)(1) if the debtor received a reasonably equivalent value but did not retain the value. The trustee cannot proceed at all under § 548(a)(2) if the debtor received a reasonably equivalent value. Hence, the trustee has no prima facie case whenever the defendant can show that the debtor both received *and* retained the value given in exchange for the debtor's transfers.

[46] A typical definition of "good faith" in the general fraudulent conveyance context is as follows:

> [A] person seeking to set aside a conveyance upon the basis of lack of good faith must prove that one or more of the following factors is lacking: (1) an honest belief in the propriety of the activities in question; (2) no intent to take unconscionable advantage of others; and (3) no intent to, or knowledge of the fact that the activities in question will hinder, delay or defraud others. The term "good faith" does not merely

lender acts in good faith where it is not actually aware of circumstances suggesting fraud and where it investigated with the diligence expected from the reasonably prudent lender. While the exact nature of the minimum due diligence required cannot be described precisely,[47] lenders should assume that some duty to investigate will be imposed upon them. Mere absence of actual knowledge will probably not (and should not) suffice.

As for the content of "good faith," a good source of guidance is *Dean v. Davis*,[48] a leading case concerning tripartite loans. In *Dean*, a secured lender refinanced an unsecured loan, knowing that the debtor would immediately file for bankruptcy. Because the secured lender knew he was financing a voidable transaction, the lender's mortgage was declared to be fraudulent. In dictum, however, Justice Brandeis indicated that under certain circumstances some unsecured claims could be refinanced on a secured basis:

> The mortgage may be made in the expectation that thereby the debtor will extricate himself from a particular difficulty and be enabled to promote the interest of all other creditors by continuing his business. The lender who makes an ad-

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> mean the opposite of the phrase "actual intent to defraud." That is to say, an absence of fraudulent intent does not mean that the transaction was necessarily entered into in good faith. The lack of good faith imports a failure to deal honestly, fairly and openly.

Southern Indus. v. Jeremias, 66 A.D.2d 178, 183, 411 N.Y.S.2d 945, 949 (1978). A standard definitional controversy in assessing good faith is whether the transferee has a duty to inquire when presented with reason to do so. Courts routinely insist that the inquiry be made. *See* Chorost v. Grand Rapids Factory Showrooms, 77 F. Supp. 276, 281 (D.N.J. 1948), *aff'd*, 172 F.2d 327, 329 (3d Cir. 1949) ("A man cannot successfully claim that he is acting honestly when he wilfully shuts his eyes for fear that leaving them open will reveal unpleasant facts."). From the standpoint of the debtor, "good faith" has been defined succinctly as "non-abuse of the bankruptcy process." An inquiry as to good faith involves a consideration of the "conduct of a debtor in the context of candor, frankness, sincerity, and willingness to do equity." Ordin, *The Good Faith Principle in the Bankruptcy Code: A Case Study*, 38 BUS. LAW. 1795, 1796 (1983).

[47] Such diligence should be defined by custom and practice. It should at least include an internal review by the lender of the target company's credit and an analysis of the impact of the loan and the consummation of the LBO on the target company. In appropriate circumstances, this diligence may also include receipt of opinions or comfort letters of expert third parties on matters such as solvency, to the extent practicable.

[48] 242 U.S. 438 (1917).

> vance for that purpose with full knowledge of the facts may be acting in perfect "good faith."[49]

This reasoning is equally applicable to LBO's. If the lender in an LBO is financing the target company's fraud on other creditors, the lender should be subject to fraudulent conveyance liability. If, on the other hand, the lender believes in good faith that the upstream benefit is not intended to defraud creditors, then, according to *Dean*, the lender should be permitted to retain the security interest it received.[50]

III. Assessing the Validity of LBO's in Bankruptcy

A. *The Lender Reasonably Believes the Target Company Is Solvent*

Applying *Dean* to LBO's, the easiest LBO's for courts to uphold are those in which the lender reasonably believed, at the time the transfer was made, that the borrower would be solvent after giving effect to the LBO.[51] Fraudulent conveyance law is not intended to limit the right of a *solvent* company to transfer assets or incur obligations.[52] A lender should not be subject to fraudulent conveyance liability where the target company was apparently able to grant upstream benefits, even if the debtor received no value in return.

In assessing the LBO lender's good faith belief in the target company's solvency after the LBO, bankruptcy courts should avoid a

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[49] *Id.* at 444.

[50] *See also* Van Iderstine v. National Discount Co., 227 U.S. 575, 583 (1912) (secured lender who refinanced unsecured debt not liable for fraudulent conveyance since it was without knowledge that the debtor intended not to pay remaining creditors).

[51] *See, e.g.*, Troll v. Chase Nat'l Bank, 257 F.2d 825 (2d Cir. 1958).

[52] Section 548(a)(2)(B) defines fraudulent conveyances as transfers with no reasonably equivalent value given in return at a time when one of three versions of insolvency exists. Therefore, if the debtor is solvent, § 548(a)(2) does not apply. Section 548(a)(1), however, has no express insolvency requirement. If the trustee relies on § 548(a)(1) (intentional frauds on creditors), I am assuming that *Dean* defines the outward limit on fraudulent conveyance liability. There, the gravamen of the wrong was that the debtor definitely intended to file for bankruptcy. The loan in question was for the purpose of effecting a payment on antecedent debt that would have been a voidable preference if the debtor had made the payment directly. This factor obviously implicates the debtor's insolvency to some degree.

serious valuation error that is frequently committed.[53] A court should not compute a contingent liability at face value in measuring solvency. This error is usually made with regard to upstream guaranties (present in LBO Structure II and perhaps VI) and could change results in many LBO cases. A numerical example illustrates the problem.

Prior to its acquisition, a company's assets are valued at $5 million. Creditors' claims against the company are $4 million. The owners decide to sell the company for $1 million. The buyer supplies $200,000 of the purchase price, and a lender supplies $800,000 to the buyer, secured by an upstream guaranty and mortgage. The valuation error consists in the assumption that the $5 million firm now has $4.8 million in debt, perhaps not enough capital to survive the insolvency tests of section 548(a)(2).[54]

In calculating solvency—or to be more precise, the lender's good faith belief in it—the upstream guaranty should be discounted by two factors: (1) the discount that arises when the contract rate of interest is lower than the market rate of interest; and (2) the discount based upon the chance that the guaranty will never be called.

First, as to the face amount of below-market loans, assume the lender gives favorable interest terms on the $800,000 loan. When the market would demand 12% from the target company after the LBO, the lender is willing to lend at 10%. This is especially likely to occur when the creditor is an insider and therefore has informational and transaction cost advantages. Assume further a maturity of ten years with no prepayments. In such a case, the LBO loan could be defeased at the cost of $709,616. Therefore, the true burden on the subsidiary for guarantying the debt should be no higher than this amount.[55] Of

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[53] Authorities that make this error include Steph v. Branch, 255 F. Supp. 526 (D. Okla. 1966), *aff'd*, 389 F.2d 233 (10th Cir. 1968); Ear, Nose & Throat Surgeons, Inc., 49 Bankr. 316 (Bankr. D. Mass. 1985); Baird & Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV., 829, 850-51 (1985); Rosenberg, *Intercorporate Guaranties and the Law of Fraudulent Conveyances: Lenders Beware*, 125 U. PA. L. REV. 235, 255-57 (1976). Sources that avoid this error include Alces, *The Efficacy of Guarantee Contracts in Sophisticated Commercial Transactions*, 61 N.C.L. REV. 655, 679 (1983); Conner, *Enforcing Commercial Guarantees in Texas: Vanishing Limitations, Remaining Questions*, 12 TEX. TECH. L. REV. 785, 807 (1981); Coquillette, *Guaranty of and Security for the Debt of a Parent Corporation by a Subsidiary Corporation*, 30 CASE W. RES. 433, 456-57 (1980); Comment, *Guaranties and Section 548(a)(2) of the Bankruptcy Code*, 52 U. CHI. L. REV. 194 (1985).

[54] *See supra* note 7.

[55] "In substance defeasance" refers to the practice of matching issued debt with

course, this discount might actually be a premium if the LBO lender's contract rate of interest exceeds market. But in light of the competitive advantages of insider credit, discounts would seem to be the more common situation, when good faith insider credit is involved.[56]

The second discount, which should be applied on top of and in addition to the above discount, relates to the probability that the guaranty will never be called. For example, if the buyer in a relatively stable market is reasonably expected to succeed in earning positive income, the chance that the upstream guaranty will be called by the lender is considerably less than 100%.[57] Accordingly, the guaranty of $800,000 in loans to the buyer (already discounted to $709,616) should be further discounted to reflect the true burden of the obligation on the subsidiary.[58]

Similarly, if the target subsidiary has security from the parent for its subrogation rights against the parent, the amount of the LBO debt chargeable against the subsidiary should be reduced pro tanto by the amount of security. In particular, at the time of or subsequent to the LBO, the parent may lend funds to its subsidiary. Such a loan creates a setoff opportunity for the subsidiary, thereby increasing the value of the subrogation rights and decreasing the burden of the LBO debt.[59]

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federal government securities with equal maturities and interest rates. Defeased debt permits the debtor's accountants to eliminate debt from the books in exchange for the federal securities. In the above example, the parent or subsidiary could wipe out the LBO debt immediately by buying $709,616 in federal securities and reserving them for the LBO lender. Since GAAP accounting standards allow such a practice, the true burden of the LBO debt on the subsidiary should represent the cost of defeasance at the time of the LBO. *See generally* Fortgang & Mayer, *Valuation in Bankruptcy*, 32 UCLA L. REV. 1061, 1095-96 (1985) (explaining "in substance defeasance" in the context of bankruptcy).

[56] *See* Credit Managers Ass'n v. Federal Co., Case No. CV 84-3098 ER (Tx), slip op. at 7, 13 (C.D. Cal. Dec. 6, 1985). In this case, the selling shareholder supplied the credit at a below market rate. The court discounted the face amount of the LBO debt from $1.2 million to $900,000. *Id.*

[57] The discounting can be expressed in two ways. First, it can be expressed as a reduced liability on the books of the debtor. Second, it could be expressed as a full liability with the subrogation right as an offsetting asset. *See In re* Ollag Constr. Equip. Corp., 578 F.2d 904, 908 (2d Cir. 1978), *aff'd*, 665 F.2d 45 (1981); Syracuse Eng'g Co. v. Haight, 97 F.2d 573, 576 (2d Cir. 1940).

[58] This principal is recognized for tax purposes. *In re* Barry, 48 Bankr. 600, 605 (Bankr. M.D. Tenn. 1985) (guaranties may not be counted as bad debts for income tax deduction purposes until it is shown that the subrogation rights are worthless).

[59] A pro tanto reduction when the parent lends to the subsidiary more or less

B. *Nonfraudulent LBO's in Which the Lender Knows the Target Company Is Insolvent*

More controversial are LBO's in which the lender knows the target company is or may become insolvent after giving effect to the LBO.[60] In such an LBO, the lender understands that the debtor will grant an upstream benefit.[61] If the target company grants the upstream benefit without receiving a reasonably equivalent value in return, the upstream benefit is a fraudulent conveyance. Nevertheless, *Dean* suggests that if the LBO lender believes in good faith that the target company, though insolvent, will survive as an economic entity, then the lender has not been involved in a fraudulent conveyance, even if the buying and selling shareholders have.

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occurred in Credit Managers Ass'n v. Federal Co., No. CV 84-3098 ER(Tx), slip op. at 15 & n.10 (C.D. Cal. Dec. 6, 1985), although the court's treatment of the reduction in LBO debt burden is confusing.

In *Credit Managers*, the court held the LBO debt burdened the target by $900,000 (discounted from $1.2 million because of a favorable interest rate). The court did not discount the LBO debt burden further by the chance that the guaranty would never be called, as I have suggested. But the parent holding company did lend its subsidiary $189,000. The court was willing to consider this loan as "value," although not enough value to justify the $900,000 burden it felt existed.

In counting the $189,000, the court declared that the loan was not really a loan but was an equity investment because the parent did not require the target to repay the loan. *Id.* at 15 n.10. This reasoning is confusing and is not supported in the opinion. A better way of saying the same thing is that if the parent attempted to demand payment when the subsidiary was insolvent and if the subsidiary filed for bankruptcy within one year of payment, the payment was recoverable as a voidable preference. 11 U.S.C. § 547(b)(4)(B) (Supp. 1985). Once the payment was returned, the $900,000 subrogation right of the subsidiary could be set off against the $189,000 right to payment. The net burden on the subsidiary, therefore, was never more than $711,000.

[60] Some analysts believe that a sound financial condition is no longer a prerequisite to a buyout. Increasingly, the LBO market is absorbing companies with underemployed assets that lack management or financial resources to improve the earnings of their less productive operations. Ferenbach, *supra* note 21, at 21-22.

[61] *See, e.g.*, United States v. Gleneagles Inv. Corp., 565 F. Supp. 556, 582 (M.D. Pa. 1983) (lender knew that debtor would become insolvent through the transaction); *In re* Process-Manz Press, Inc., 236 F. Supp. 333, 346 (N.D. Ill. 1964) (lender had access to debtor's financial records and knew or should have known that debtor would incur debts that it could not repay), *rev'd on other grounds*, 369 F.2d 513 (7th Cir. 1966), *cert. denied*, 358 U.S. 957 (1967). *But see* Greenbrook Carpet Co. v. Jones, 722 F.2d 659, 660 (11th Cir. 1984) (lender ignorant of an important aspect of the transaction).

One concern with this *Dean* defense, however, is whether *Dean*, which involved refinancing debt, is applicable to LBO's, which involve refinancing upstream benefits to shareholders. Some may attempt to argue that in debt refinancing, a creditor obtains the proceeds of the loan. Although value leaves the bankrupt estate, so does a claim against the estate. In an LBO, shareholders (not creditors) get the benefit. Once again, value leaves the bankrupt estate, but this time no creditor's claim is extinguished to offset the loss. Moreover, an inference could be drawn from *Dean* that would call into question its use in the LBO context. The inference is that before the defense is available, there must be the existence of (a) a debtor in a predicament; and (b) a secured refinancing for the purpose of "extricating" the debtor from the predicament.[62] In spite of such an inference, an analogy between *Dean* and a good faith LBO defense seems fair. A numerical illustration demonstrates why.

Assume a debtor has $2 million in unsecured debt and $1 million in unencumbered assets. One institutional creditor who is owed $100,000 threatens to accelerate. The debtor therefore persuades a secured lender that if the unsecured creditor could be paid off, the other creditors would acquiesce for a reasonable period to allow for a possible recovery. Believing that such a recovery is plausible, the lender advances $100,000 in exchange for a floating lien on all the debtor's assets.

This secured refinancing would be upheld under the *Dean* rule. Nonetheless, the instant effect of the refinancing hurts the creditors. Prior to the refinancing, each creditor could expect 50¢ for each dollar in a liquidation. Immediately after the refinancing, each creditor could expect only 47.3¢ on the dollar.[63]

Now suppose that the lender instead decides that the present management of the debtor cannot stave off bankruptcy. The lender agrees to finance an LBO if its exposure is low enough. A prospective buyer approaches the existing board of directors and asks what the price

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[62] This inference could be drawn from Justice Brandeis' language quoted *supra* in the text accompanying note 49.

[63] After the secured refinancing, $100,000 in collateral is reserved for the secured creditor. The bankrupt estate contains $900,000 for $1,900,000 in general claims. The bankruptcy dividend amounts to 47.3% of all claims. For the sake of illustration, we are assuming away the cost of administering the estate, plus any priority claim under 11 U.S.C. § 507(a) (1982).

of this hopelessly insolvent company might be. The board of directors knows that the price will be quite low, but it also perceives that it has some holdout power over the buyer, whereby a positive price for the old shareholders might be extracted from the new buyer.[64] The parties agree on a price of $100,000. At the same time the lender also refinances the accelerating institutional creditor's claim (but does so on an unsecured basis).

As with the secured refinancing, the LBO instantly harms the creditors. Before the LBO, each unsecured creditor could expect 50¢ on the dollar in an immediate liquidation. After the LBO, the creditors could expect only 45¢ on the dollar.[65] Admittedly, the general creditors fared better under the secured refinancing (47.3¢) than under the LBO (45¢). The difference, however, seems trivial from a legal standpoint. Furthermore, it is entirely plausible that the LBO of a troubled company can cost the creditors less than the secured refinancing of unsecured debt. For example, if the board of directors sells the target company for $50,000 cash and $50,000 in subordinated debt, the debt burden from the perspective of the target's old creditors is only $50,000.[66] This form of an LBO (the sellers take part of their price in the form of a modified equity position) reduces creditor claims to 47.5¢ on the dollar.[67] Under this LBO, creditors are actually in a better position (on an asset basis) than they were under the secured refinancing of an unsecured claim, which gave them 47.3¢. Moreover,

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[64] If the buyer has no alternative opportunities, the board of directors, perceiving this, can extract from the buyer a portion of the buyer's projected profit. How much of the profit can be capitalized into the price depends upon the bargaining skill of the board of directors. At a minimum, the board of directors would insist on a price that exceeds the expected holdout value the existing shareholders could extract in a bankruptcy reorganization. The holdout value in a chapter 11 reorganization has a different source. It comes from the ability of junior claimants to insist on a full hearing to determine the value of the enterprise. *See* Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527, 536-48 (1983). The selling shareholders in an insolvent LBO would demand to get at least as much from the buyer.

[65] After the LBO, $900,000 in assets are left for $2 million in claims.

[66] The existence of subordinated debt in LBO (mezzanine financing) has become popular in LBO's. *See supra* note 22. Because the debt is subordinated to the general creditors, it is harder for them to argue that the new debt is a fraudulent conveyance, although subordinated creditors still increase leverage and hence the risk of bankruptcy.

[67] After the LBO, $950,000 in assets are left for $2 million in claims.

the LBO produces new management with a credible chance to increase cash flow, thereby further improving the position of the unsecured creditors.

The above parable illustrates several points. First, the use of the *Dean* principle in the context of LBO's need not prejudice general creditors any more than the secured refinancing of unsecured debt. If the LBO price is less than the amount required to refinance the unsecured debt, the general creditors can be better off with the LBO. This is a reasonable possibility because the price of the stock in insolvent companies is usually low. Second, to the extent courts hold the *Dean* opinion to require a predicament plus a projected extrication, an LBO can qualify as freeing the debtor from a predicament just as a secured refinancing can. The refinancing can dispose of a threatening creditor, but an LBO can provide a better long-term chance for survival.

Thus, as applied to LBO's, *Dean* requires the LBO lender to have a good faith belief that the upstream benefit the lender finances will not be avoided as a fraudulent conveyance. This good faith can be subdivided into two smaller components: (1) the lender reasonably believes that the insolvent target company can generate enough surplus cash flow (after all other creditors are accounted for) to cover the debt service of the LBO loan; and (2) the lender is not an insider of the borrower.

1. *Enough Surplus Cash Flow to Cover the Debt Service of the LBO Loan.* Strictly speaking, solvency is not a necessary condition for corporate survival. What is necessary is a cash flow that exceeds costs of operation, including the cost of servicing outstanding debt.[68] If this surplus cash flow is sufficient to cover the debt service on the LBO loan, then the target company is likely to survive, even if it is insolvent. This test is identical to the test adopted by the Supreme Court for determining whether a chapter 11 plan for a reorganization is feasible.[69]

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[68] LoPucki, *A General Theory of the Dynamics of the State Remedies/Bankruptcy System*, 1982 WIS. L. REV. 311, 327 ("Continued operation will be economically desirable so long as the present value of the future excess of revenues over expenses other than interest on debt already incurred and depreciation on assets already owned exceeds the resale value of the assets.") (emphasis omitted).

[69] "Whether or not the earnings may reasonably be expected to meet the interest and dividend requirements of the new securities [in a chapter 11 reorganization] is

If an LBO meets the above assumption, then it is not abusive of creditors.[70] New management expects to benefit the firm, even though the immediate effect on the value of creditor claims is generally unfavorable.[71] The harm created by such an LBO is increased leverage.[72] Creditors disfavor such increases in risk, but the increase does not mean that the managers cannot generate a surplus cash flow.

For the insolvent LBO to meet the standard for survival—enough cash flow to meet current expenses—the new management is expected to benefit the firm as a whole. As such, the nonfraudulent, insolvent LBO can be analogized to a service contract with a new management team, in the nature of a bonus paid in advance to a new chief executive officer by a company in trouble.[73] The payment instantly

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a sine qua non to a determination of the integrity and practicability of the new capital structure." Consolidated Rock Prods. v. Du Bois, 312 U.S. 510, 525 (1941).

[70] *See* Credit Managers Ass'n v. Federal Co., No. CV 84-3098 ER(Tx), slip op. at 16-17 (C.D. Cal. Dec. 6, 1985).

[71] Easterbrook & Fischel, *Limited Liabilty and the Corporation*, 52 U. CHI. L. REV. 89, 98-99 (1985) (takeovers may hurt creditors in the short run but benefit them in the long run by maximizing the firm's assets); McDaniel, *supra* note 9, at 455 (disagreeing with Easterbrook & Fischel), *supra*, that creditors are benefitted by takeovers as long as the firm's assets are maximized); Prokesch, *Merger Wave: How Stocks and Bonds Fare*, N.Y. Times, Jan. 7, 1986, at 1, col. 1 (shareholders hurt by LBO's in the long run).

[72] For a good discussion on the harmful effect of leverage, see Roe, *supra* note 64, at 549-50.

[73] *Cf.* Easterbrook & Fischel, *supra* note 18, at 734-35 (expropriation of corporate opportunity should be viewed as compensation to management for which management would take a cut in other forms of compensation). Professors Easterbrook and Fischel rely upon the market for corporate control and labor markets to constrain the managers from simply expropriating the corporate opportunity without taking cuts in other benefits. Although this reliance on such markets is controversial, it surely does not work to constrain 100% shareholders from awarding themselves upstream guaranties without giving up other benefits in return. I would therefore distinguish between upstream benefits in LBO's and upstream benefits expropriated after the buyer has control of the corporation. *See, e.g., In re* Ear, Nose & Throat Surgeons, Inc., 49 Bankr. 316 (Bankr. D. Mass. 1985) (upstream guaranty of controlling shareholder's obligation held a fraudulent conveyance); *In re* Complete Drywall Contracting, Inc., 11 Bankr. 697 (Bankr. E.D. Pa. 1981) (payments that lacked fair consideration made by insolvent corporation to its president for personal obligations were found to be fraudulent; other payments in exchange for services were held valid). In the former case, where an LBO lender believes in good faith that future surplus revenue will cover debt service, the buyer has incentives to take smaller salaries in exchange for upstream benefits. The smaller salaries help to

impoverishes the debtor, but it improves creditors in the long run if new management succeeds. Although a bonus or advance in salary is usually in cash, there is no compelling conceptual reason why the price paid to the new manager could not be in the form of an upstream benefit in an LBO.

The above LBO lender's defense does not really depend upon whether the upstream benefits to the buying and (ultimately) the selling shareholders are themselves voidable. The LBO lender's defense is instead based upon the lender's good faith belief that the target company might survive. Nevertheless, digressing on the subject of the shareholders' liability for fraudulent conveyances in an LBO, it ought to follow that if the target company *did* have a decent chance of survival, not even the upstream benefits should be recoverable from the shareholders. The upstream benefit is the price paid for new management. Just because the new management failed to stave off bankruptcy should not by itself prove that the target company received no reasonably equivalent value in return for the upstream benefits.[74] It has been submitted that a nonfraudulent LBO is like a

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guarantee surplus revenue, the existence of which assures that the existing creditors are not being abused. In the latter case—i.e., once the buyer is in control—no such incentives exist. Therefore, fraudulent conveyance liability is a necessary deterrent.

[74] *See* Credit Managers Ass'n v. Federal Co., No. CV 84-3098 ER(Tx), slip op. (C.D. Cal. Dec. 6, 1985) (fraudulent conveyance recovery against selling shareholder denied). In this case, the court used the cash flow approach suggested in the text to show that the target had adequate capital within the meaning of California's version of the Uniform Fraudulent Conveyance Act, which provides: "Every conveyance made without fair consideration when the person making it is engaged or about to engage in a business or transaction for which the property remaining in his hands after the conveyance is an unreasonably small capital is fraudulent . . . ." CAL. CIV. CODE § 3439.05 (West 1970). Because the cash flow was adequate, the court viewed the capitalization adequate as well. *Credit Managers*, No. CV 84-3098 ER(Tx), slip op. at 17-18 (C.D. Cal. Dec. 6, 1985).

A few comments about this use of cash flow are in order. First, in the text, I assume that the company is insolvent under one of the three solvency tests in 11 U.S.C. § 548(a)(2) (1982). Adequate cash flow is therefore proof of the lender's good faith. In *Credit Managers*, cash flow is used as evidence of solvency itself. I would take the position that the cash flows in *Credit Managers* made the valuation exercise useless. Even though the lender in *Credit Managers* was an insider, the cash flow projections were provided by an arm's-length non-LBO lender in the manner described *infra* in the text accompanying note 94. The role of an independent lender entitles the cash flow projections to considerable deference in establishing the lender's good faith.

Second, the case makes clear that, to some degree, the solvency test of inadequate service contract with payment in an unusual form. Those who view an upstream benefit to shareholders in an LBO to be per se fraudulent also must find any service contract a fraudulent conveyance whenever the service fails to preserve the value of a debtor's assets.

Surprisingly, there is some strong doctrinal support for the notion that all service contracts involve fraudulent conveyances, including transfers in LBO's to shareholders. Some prestigious judicial opinions—especially in the upstream guaranty context—have emphasized the requirement that the transferee who received debtor property must return value that can actually be sold. For example, in *Rubin v. Manufacturers Hanover Trust Co.*,[75] Judge Kearse discussed some of the bad motives for transfers that fraudulent conveyance doctrine condemns, and remarked: "Whatever the motivation, the fraudulent conveyance provisions . . . recognize that such transactions may operate as a constructive fraud upon the debtor's innocent creditors, for they deplete the debtor's estate . . . without bringing in property of similar value from which creditors' claims might be satisfied."[76] Thus, Judge Kearse would require leviable property as the only antidote to fraudulent conveyance liability in the case of an upstream guaranty.[77]

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capitalization, 11 U.S.C. § 548(a)(2)(b)(ii) (Supp. 1985), and the test of the lender's good faith, are in fact the same test. The only difference is that "inadequate capitalization" seems to require a positive net worth, whereas the suggested good faith defense for lenders does not.

Even so, parts of the *Credit Managers* opinion seem to discount the importance of any net worth at all. *See Credit Managers*, No. CV 84-3098 ER(Tx), slip. op. at 26 (C.D. Cal. Dec. 6, 1985) (court refuses to look at debt-equity ratios because "it is possible to overcome the negative conclusions of such ratios based on positive cash flow projections").

[75] 661 F.2d 979 (2d Cir. 1981).

[76] *Id.* at 989.

[77] Judge Kearse's definition of value was too narrow, in light of the statutes she applied to the facts in *Rubin*. The former Bankruptcy Act defined "fair consideration" in the following terms: "when, in good faith, in exchange and as a fair equivalent therefor, property is transferred or an antecedent debt is satisfied . . . ." 11 U.S.C. § 107(d)(1) (1976), *amended by* 11 U.S.C. § 548(d)(2) (1982). This definition is the same as the present definition of "value" in 11 U.S.C. § 548(d)(2) (1982) although section 548(d)(2) further provides that satisfaction of *present* debt is also value.

One can (with some resourcefulness) bring service contracts within the definitions of "fair consideration" and "value." Once the service is performed, the debtor owes the servant a debt. The payment to the servant therefore is extinction of a

Moreover, the court in *United States v. Gleneagles Investment Corp.*,[78] ruled directly that, in an LBO, management services could never constitute reasonably equivalent value in exchange for an upstream benefit. In reaching this conclusion, the court relied heavily on the theory that value must be leviable property.[79]

There are contrary cases, however. For example, in *In re Royal Crown Bottlers of North Alabama, Inc.*,[80] a lender conditioned aid on the removal of a shareholder-manager in whom the lender had no confidence. The court seemed willing to consider the stock redemption plan by an insolvent company as an exchange for "reasonably equivalent value," although the court found an alternative way to dispose of the case.[81] In *Telefest, Inc. v. VU-TV, Inc.*,[82] a subsidiary gave an upstream guaranty to help the parent acquire a new subsidiary (a Structure VI transaction). The District Court of New Jersey, interpreting state fraudulent conveyance law, was willing to consider the vertical integration benefits supplied by the corporate acquisition because the parent corporation had acquired a new subsidiary that would buy the services of the old subsidiary.[83] In this

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debt. The former Bankruptcy Act required extinction of antecedent debt, however. Performance of a service when the servant is paid in advance cannot easily be characterized as satisfaction of an *antecedent* debt. Nevertheless, no serious suggestion was ever made that payments in advance for legitimate services could be viewed as a fraudulent conveyance under either definition.

In an LBO, the buying shareholders provide management services that are expected to keep the company alive as a business entity. Although the creditors may view this service as creating risks for them, the management service itself could create the present or antecedent debt for which upstream benefits could be compensation. Therefore, if compensation for other services is sometimes given for value, upstream compensation in a nonfraudulent LBO might be given for value as well.

[78] 565 F. Supp. 556 (M.D. Pa. 1983).

[79] *Id.* at 576; *see also* Credit Managers Ass'n v. Federal Co., No. CV 84-3098 ER(Tx), slip op. at 15 (C.D. Cal. Dec. 6, 1985) (relying on *Gleneagles*). The actual management in the *Gleneagles* case by no means met the standards for valid insolvent LBO's that I propose here. The *Gleneagles* case is discussed at length *infra* text accompanying notes 96-105.

[80] 23 Bankr. 28 (Bankr. N.D. Ala. 1982).

[81] *See also In re* Corporate Jet Aviation, Inc., 57 Bankr. 199 (Bankr. N.D. Ga. 1986) (where a buyer of assets refused to go ahead with the deal unless a dissenting shareholder was removed by a redemption, the court ruled that the redemption was a valid upstream transfer).

[82] 591 F. Supp. 1368 (D.N.J. 1984).

[83] *Id.* at 1379.

case, the leviable benefits standard of *Rubin* was expressly rejected.[84] The removal of an untrusted manager and the economies of scale produced by a merger are close enough to the expectations of surplus cash flow in an insolvent LBO that these two cases can be viewed as authority in support of the proposition that management services can constitute a reasonably equivalent value.

2. *Independence of the Lender.* The second feature that ought to be present for an insolvent LBO to escape fraudulent conveyance attack is that the lender be independent and unrelated to the target company. The independence of the lender adds the arm's-length flavor to the lender transfer that could keep it from being considered a creditor-abusive act. Independent lenders do not frequently lend for the purpose of delaying or hindering the creditors of the debtor. While secured lenders will have a relatively strong position in case of bankruptcy, lenders, if independent, are nevertheless in the business of earning their income from the lending of their assets, not from liquidating collateral. More income is to be earned and fewer transaction costs are involved when the borrower pays voluntarily than when the lender must foreclose. The presence of an independent lender is more likely to signal that LBO financing ought to be respected in bankruptcy.

In the instances where an LBO has been struck down, the lender has often been an insider. In *Reiner v. Washington Plate Glass Co.*,[85] for example, a company purchased a retiring owner's stock. Credit for the purchase was supplied by the owner himself, who took promissory notes instead of cash. After the subsidiary went bankrupt, the court equitably subordinated the former owner's claim on the notes,[86]

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[84] *Id.* at 1378-80.

[85] 27 Bankr. 550 (Bankr. D.D.C.), *rev'd on other grounds*, 711 F.2d 414 (D.C. Cir. 1983).

[86] The bankruptcy court's power of equitable subordination is set forth in 11 U.S.C. § 510 (1982). For our purposes, its restrictions on debtor-creditor conduct are often identical. *See In re* Corporate Jet Aviation, Inc., 45 Bankr. 629, 636 (Bankr. N.D. Ga. 1985); Clark, *supra* note 12, at 517-36 (general discussion on fraudulent conveyances and equitable subordination). The use of the power of equitable subordination in the *Reiner* case might be explained by the fact that the one-year statute of limitations in § 548(a) had already passed, eliminating the use of that section. The trustee therefore had to locate a creditor with a state law fraudulent conveyance claim in order to make a subrogation claim against § 544(b), which the trustee could not or did not do. The equitable subordination provision has no such limitations.

even though the acquired company had been solvent at the time of the purchase.

At first glance, the case seems arbitrary. If the shareholder in *Reiner* had taken cash instead of credit for his stock, the exchange would have been unassailable.[87] But because the shareholder extended credit, he was made fully responsible for subsequent unfavorable events. Although the *Reiner* case and others like it[88] seem to show an irrational prejudice against self-financing,[89] they might be better understood as cases against self-dealing. In each of the cases, the selling shareholder was an insider. No arm's-length bargaining occurred, which the courts could have relied upon to produce an honest price.[90] These cases, then, could be read as attempts to curtail inflated valuations that self-dealing might bring.[91]

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[87] *See* Tracy v. Perkins-Tracy Printing Co., 278 Minn. 159, 153 N.W.2d 241 (1967) (upholding a stock-debt swap on this ground).

[88] *See* Robinson v. Wangeman, 75 F.2d 756 (5th Cir. 1935); *In re* Dawson Constr. Co., 218 F. Supp. 411 (N.D.N.Y. 1963); *In re* Bell Tone Records, 86 F. Supp. 806 (D.N.J. 1949). In addition to straight fraudulent conveyance statutes, some courts have used corporation statutes restricting stock redemption to rule that insolvency should be tested on the date payment is demanded on the debt claim. *See, e.g.*, McConnell v. Estate of Butler, 402 F.2d 362 (9th Cir. 1968). *See generally* Herwitz, *Installment Repurchase of Stock: Surplus Limitations*, 79 HARV. L. REV. 303 (1965).

[89] Insider credit is often the cheapest kind. For criticism of rules that discriminate against insider credit, see Clark, *supra* note 12, at 538-39; Posner, *supra* note 18, at 518.

[90] *See In re* Roco Corp., 701 F.2d 978 (1st Cir. 1983). The result in *Roco* can be explained. There, a father and son were shareholders of Roco Corp. The father wanted to retire. He and his son agreed that Roco Corp. would buy back the father's shares in exchange for the corporation's secured promissory note. The extra debt burden made the company insolvent, and bankruptcy ensued within a year.

As stated, the rationale is not convincing. Retirement per se should not be deemed a fraudulent abuse of creditors. Opportunity for exit is a vital precondition for investing in the first place. We assume that what upset the court of appeals was the inflated price for the stock that father and son agreed to. Because there is no reliable market constraint on the price negotiated between buyer and seller, the exchange deserved special scrutiny in a way that institutional lender financing does not.

[91] Even if so read, the *Reiner* case and others sweep too broadly. The usual instinct in corporate law is to scrutinize self-dealing very carefully. Courts place the burden on the self-dealer and allow no zone of discretion that a "business judgment rule" would permit. If, in the *Reiner* case, the debtor had been clearly solvent when the stock was exchanged for debt, the transaction should have survived in bankruptcy. The problem with self-dealing lies in the unrealiability of valuations, not in the morality of the transaction when the valuation is fair.

In contrast, an insider extended credit in *Credit Managers Association v. Federal Co.*,[92] and the court gave wide deference to the insider's good faith belief that the cash flows would meet debt service requirements. Nevertheless, this deference was well justified. At the same time the selling parent extended LBO credit, a secured lender refinanced debt the target owed its parent. The secured creditor was an independent institutional lender that made extensive cash flow projections, showing the target company to be economically viable.[93] It was these projections to which the deference was given.[94] In *Reiner*, the valuations were prepared by the buying and selling shareholders themselves.

To summarize, this portion of the Article has discussed the circumstances where transfers in LBO's should be valid, even though the LBO resulted in an insolvent target company.[95] There are, how-

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[92] No. CV 84-3098 ER(Tx), slip op. (C.D. Cal. Dec. 6, 1985).

[93] This refinancing of unsecured credit by means of secured credit was not challenged by the assignee for the benefit of creditors, even though it must have burdened the target company more than the LBO debt. The refinanced debt was $7.5 million. The LBO debt was $1.2 million, although this amount was further discounted to $711,000 by the court. *See supra* notes 55-56 and accompanying text. The refinancing, of course, had no contingencies, whereas the LBO debt was a burden only to the extent it was called and only to the extent subrogation rights against the parent were valueless.

[94] Credit Managers Ass'n v. Federal Co., No. CV 84-3098 ER(Tx), slip op. at 19 (C.D. Cal. Dec. 6, 1985) ("The question the court must decide is *not* whether [the secured lender's] projection was correct, for it clearly was not, but whether it was reasonable and prudent at the time it was made.") (emphasis in original). Technically, the cash flows were used to prove that the target company was adequately capitalized after the LBO. I have argued that the same test should have saved the LBO even if it were admittedly insolvent as a result of the LBO. *See supra* note 74.

[95] The only other article to date that takes a generic position on insolvent LBO's is Baird & Jackson, *supra* note 53, but the exact nature of their view is rather hard to extract. They commence by announcing, "Even under the narrowest view of fraudulent conveyance law, the leveraged buyout may be a fraudulent conveyance." *Id.* at 851. But later they express regret at the supposedly inevitable reading of the statutes: "It . . . might seem a good thing that these transactions appear to trigger sections of existing fraudulent conveyance statutes. But we doubt this is the case." *Id.* at 853. The reason for their regret is the possibility that the new buyers are better managers and will lower SEC compliance costs. As a test, they posit that if creditors with antipledge covenants actually do not accelerate their loans following an LBO, "one might infer that the fraudulent conveyance remedy did not advance the interests of all the creditors." *Id.* at 854; *cf.* Farrell, *Takeovers and Buyouts Clobber Blue-Chip Bondholders*, Bus. Wk., Nov. 11, 1985, at 113 (Triple A bond market disrupted because anti-LBO covenants generally do not exist); Hertzberg,

ever, two categories of LBO's in which lender transfers may be subject to avoidance as fraudulent conveyances. These unacceptable LBO's are discussed in the next section.

C. Fraudulent LBO's

The first category of unacceptable LBO's involves those in which the reasonable probability of survival is too low. When the LBO's

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'Poison-Put' Bonds Are Latest Weapon in Companies' Anti-Takeover Strategy, Wall St. J., Feb. 13, 1986, at 6, col. 1 (companies are just now writing covenants that protect against LBO's). But the inference drawn from the failure of institutional creditors to accelerate their loan is to be ignored, apparently. They assert that "[t]he costs of establishing the rights of actual creditors may not be worth the benefits of having a rule that is more finely tuned." Baird & Jackson, *supra* note 53, at 854.

In any case, even if insolvent LBO's are fraudulent because it is too expensive for courts to look into them, the LBO lender, apparently, is free to finance LBO's without fear of losing its security interest in the assets of the subsidiary. This is my reading of the elliptical sentence with which the Baird and Jackson article draws to a close: "When an individual engages in a financial transaction with multiple parties (as in the case of an insider guarantee or a leveraged buyout), the transaction generally should not be viewed as a fraudulent conveyance provided . . . that the transaction was entered in the ordinary course." *Id.* at 855 (footnote omitted). The omitted footnote refers to Comment, *Guarantees and Section 548(a)(2) of the Bankruptcy Code*, 52 U. CHI. L. REV. 194 (1985), which, without dealing with *Dean*, makes the surprising assumption that the LBO lender should never be liable. Baird and Jackson would add that the LBO lender must make the loan "in the ordinary course." Thus, if "in the ordinary course" means "in good faith," Baird and Jackson end up in the same place that I do: from the perspective of the lender, LBO's should rise and fall on the ethical quality of LBO's.

Although Professors Baird and Jackson (arguably) observe that good faith of the LBO lender is relevant, it also would have been useful to supply some content to that concept. I have theorized in this Article that LBO's are in good faith when independent lenders conclude after careful inquiry that the acquired company has a decent chance to escape bankruptcy, even if it is technically insolvent as a result of the LBO.

I have more complaints about the Baird-Jackson article on fraudulent conveyances that must be saved in large part for a future endeavor. Briefly, however, they claim in their article that efficiency is the motivating value in fraudulent conveyance law. They reach this conclusion because the debtor and general creditor would agree *ex ante* that the debtor should not make gifts to third parties after the debtor is insolvent. If the parties would have agreed to it, then it is efficient to save them negotiation expense by providing it through positive law. *See* Baird & Jackson, *supra* note 53, at 835-36.

This is all very irrelevant. Such a hypothetical agreement costs neither the debtor nor the creditor anything to make. The person who pays the bill under fraudulent conveyance law is the third party who may not retain a gift or dividend. Why should that party participate in a hypothetical creditor's bargain? An *ex ante* reconstruction of what parties really want is rather worthless when it excludes the very parties who must bear the cost of the agreement.

chances for survival are poor, the lender's secured claims should be struck down. This proposed standard is no more than a reminder that the belief in the debtor's survival must be reasonable. This standard is incapable of any exact quantification and serves merely as a tool for striking down disingenuous claims that the LBO lender expected the acquired company to survive.

The second type of fraudulent LBO includes those intended to loot the company at the expense of the company's existing creditors. LBO's present good opportunities to do so. The lender receives, through its security interest, a priority higher than that of the existing unsecured creditors. The gains from subordinating existing creditors can easily be shared with the debtor, thereby allowing the debtor to extract value from an otherwise insolvent enterprise.

Good evidence of such a scheme might include a lender's inability to show that reasonable projections of income of the target company would cover its debt service, including that of the LBO loan. In such a case, the lender would have a priority over existing creditors in any subsequent liquidation, which would suggest a scheme in the nature of a bulk transfer, a traditional type of fraudulent conveyance.

A prime example of an unacceptable LBO in this vein is *United States v. Gleneagles Investment Corp.*[96] This LBO followed Structure V whereby the LBO loan was made to the target company, Raymond Colliery Co. (Raymond Colliery), and its subsidiaries. Raymond Colliery in turn lent most of the proceeds to the buyer's newly established shell corporation. In this case, the LBO lender, Institutional Investors Trust (IIT), did not expect to recover periodic interest; interest was not even payable until maturity of the loan, at which time IIT expected to recover from the liquidation of assets.[97] In addition, IIT did not

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[96] 565 F. Supp. 556 (M.D. Pa. 1983); *see also In re* Venie, 80 F. Supp. 250, 253-54 (W.D. Mo. 1948) (loan for purchase of insolvent firm secured by firm assets a fraudulent conveyance).

[97] "The loan principal was not amortized and presumably IIT believed that over the next three years [Raymond Colliery] could somehow liquidate enough assets to generate the cash needed to pay off the principal." *Gleneagles*, 565 F. Supp. at 581-82; *see also id.* at 566 (the loans were secured by the company's assets and the initial payments were deferred by a cash reserve established by IIT), 574 (debtor companies received less cash than they were obligated to repay); United States v. Gleneagles Inv. Co., 571 F. Supp. 935, 953 (1983) (court concluded that negotiations between lender and debtor indicated lender's concern that debtors might be forced into bankruptcy prior to liquidation of assets and prior to a recovery by the lender)

expect the target company's surplus revenue to cover the debt service of the LBO loan.[98] Raymond Colliery was insolvent at the time of the LBO.[99] Moreoever, the new manager, James Durkin,[100] had no plan for making the company profitable; in fact, he shut it down within six months of the acquisition.[101] In light of these facts, the motives of Durkin and the other principals seem most questionable.[102]

[hereinafter cited as *Gleneagles II*].

[98] *Gleneagles*, 565 F. Supp. at 568, 579, 581.

[99] *Id.* at 564-65, 567. Raymond Colliery covenanted to IIT that its assets would never be less than 75% of liabilities. But even under this weak covenant, Raymond Colliery was immediately in default. *Id.* at 569.

[100] Durkin's subsidiary, Great American Corporation, received loans from Raymond Colliery to enable Great American to buy Raymond Colliery stock. Durkin also had partners, including his wife, Jimmy Hoffa, and Hyman Green. *Id.* at 565-66.

[101] *Id.* at 572.

[102] At the time of the LBO, Raymond Colliery was one of the largest anthracite coal companies in the United States. *Id.* at 564. Its major competitor was Pagnotti Enterprises, a company with whom Raymond Colliery had quite good relations, including illegal price fixing agreements. *Gleneagles II*, 571 F. Supp. at 939. In 1973, the principals of Raymond Colliery had determined to get out of the business, *Gleneagles*, 565 F. Supp. at 565, and apparently entered into a scheme to sell the assets of Raymond Colliery to Pagnotti. Since such a sale had negative antitrust overtones, the parties pursued an elaborate subterfuge. Durkin was an ancient crony of James Tedesco, a major shareholder of Pagnotti Enterprises and president of Old Forge Bank. *Gleneagles II*, 571 F. Supp. at 938. Tedesco arranged for Durkin to receive a loan from his bank and also from a subsidiary of Pagnotti. *Id.* at 938-39; *Gleneagles*, 565 F. Supp. at 567. The loan was "collateralized" by cash from Jimmy Hoffa, the erstwhile labor union president, *Gleneagles II*, 571 F. Supp. at 940-41, so that the transaction seemed more like a laundering maneuver than a loan. Apparently, Hoffa was anxious to disassociate himself from the LBO.

Whatever motive Durkin had for buying, IIT's motive seems to have been ordinary greed. IIT had no apparent knowledge of Durkin's connection to Pagnotti, its borrower's competitor. *Gleneagles*, 565 F. Supp. at 568-59. But it was to receive interest at five percent over prime; *id.* at 574, an extraordinarily high rate. *See* Fortgang & Mayer, *Valuations in Bankruptcy*, 32 UCLA L. REV. 1061, 1077 (1985) (five percent over prime said to be "in extremis"). Although it does not necessarily reflect on IIT's motive for making the LBO, the subsequent history of Raymond Colliery and IIT is very interesting. In 1976, Durkin (who put none of his own money into the LBO) sold his equity interest in Raymond Colliery to one of his partners, Hyman Green. *Gleneagles II*, 571 F. Supp. at 940. Green then stood by and allowed a nominee corporation of Pagnotti to buy Raymond Colliery's assets at tax sales in which IIT's mortgage was senior. *Id.* at 948-50. For good measure, Pagnotti also purchased the stock of Raymond Colliery in 1978 for one dollar. United States v. Gleneagles Investment Co., 584 F. Supp. 671, 676, 680 (M.D. Pa.

But, whatever the exact motives of all the parties, clearly IIT did not act in good faith. The acquired company was not expected to survive. The LBO seemed close to a looting scheme whereby the company was liquidated not for the benefit of the creditors, but for the benefit of the equity owners and the secured lender. The court did not write down the face amount of Raymond Colliery's LBO obligation, but the promise of Durkin's shell corporation to repay its loan from Raymond Colliery was essentially worthless: the shell corporation had no prospect of income from Raymond Colliery, its only asset.[103]

Nevertheless, LBO's involving a planned liquidation at the expense of the general creditors should not be deemed per se fraudulent, when the creditors are fully provided for. The standard LBO that is used as a defense against hostile takeovers frequently involves partial liquidations of divisions and subsidiaries in order to raise cash to finance the LBO.[104] Whether these are fraudulent conveyances depends on whether the surviving entity meets the tests that have been suggested. A stripped down conglomerate with healthy prospects of survival at the time of the LBO does not become fraudulent simply because its prebankruptcy history included a partial liquidation.[105] Rather, what makes the LBO fraudulent within the meaning of *Dean* is the lender's knowledge that it will take a liquidation preference in a near certain bankruptcy.

IV. THE CONSEQUENCES OF FRAUD

Classifying an LBO as a fraudulent conveyance in the style of *Dean* by no means ends the inquiry. Bankruptcy courts will surely

1984) [hereinafter cited as *Gleneagles III*]. IIT also sold its LBO loan to a subsidiary of Pagnotti at the same time, so that Pagnotti controlled both the assets and chief secured claim against Raymond Colliery. *Gleneagles II*, 571 F. Supp. at 944-46. While it is not clear from the judicial opinions that Tedesco planned in 1973 for Pagnotti to be the owner of Raymond Colliery's assets, this possibility may well have been in the background at the time of the Raymond Colliery LBO.

[103] *Gleneagles*, 565 F. Supp. at 571, 574-75. The court also ignored a $1 million downstream guaranty from Durkin and his partner, Green. *Id.* at 568-69. This guaranty was appropriately ignored if Raymond Colliery had no ability to subrogate itself to IIT in order to enforce this obligation.

[104] *See* Wayne, *Buyouts Altering Face of Corporate America*, N.Y. Times, Nov. 23, 1985, at 1, col. 1, and at 37, col. 2.

[105] *See* Fortgang & Mayer, *supra* note 102, at 1129 (when surplus assets exist, their value should be added to estimates of future income to determine going concern value).

face five additional problems in devising a fraudulent conveyance remedy for lender transfers in LBO's. The first issue arises when the LBO lender advances funds to the target company, but only part of the funds is upstreamed to redeem stock (Structures IV-VI). The balance is used for working capital or retirement of existing debt. To what extent should the fraudulent portion of the loan infect those parts used for more legitimate purposes? Similarly, what if the upstreamed benefits are partly supported by a fair equivalent value, as where the subrogation rights against the parent company have a positive value? These questions are essentially the same, so they will be considered together. Second, suppose the bankruptcy trustee could, if he chose, recover from the buyer or seller of the target company's shares; is this in any sense a defense for LBO lender? Third, what status does an LBO lender's assignee or holder of a loan participation have if the lender transfer is found to be a fraudulent conveyance? Fourth, what is the status of a subsequent lender who refinances the original LBO loan? Fifth, let us assume that none of the creditors represented in the bankruptcy had claims that existed at the time of the LBO, and the LBO is clearly a fraud on creditors. Have these creditors "assumed the risk" of thin capitalization and insolvency of the debtor? The first four of these issues were present in the exceptionally interesting *Gleneagles* case.[106] The fifth theory was endorsed in the equally instructive *Credit Managers* case.[107]

A. Partially Valid LBO Loans

Suppose that the acquired company uses part of the LBO loan for fraudulent upstreaming purposes and part of the loan for working capital. Or suppose the entire loan is upstreamed in a fraudulent LBO. Nevertheless, the debtor's right of recovery against its parent has a positive value at the time the LBO is closed. In both cases, part of the loan is fraudulent and part of the loan is legitimate. Can the LBO lender claim partial credit for the legitimate part of the loan.?[108]

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[106] 565 F. Supp. 556 (M.D. Pa. 1983).

[107] Credit Managers Ass'n v. Federal Co., No. CV 84-3098 ER(Tx), slip op. (C.D. Cal. Dec. 6, 1985).

[108] Chancellor Kent wrestled with the issue of partial versus total avoidance as a result of fraud. He concluded that a partial remedy was to be preferred over total

Section 548(c) is ambiguous. The relevant language states: "[A] transferee . . . that takes for value and *in good faith* . . . may retain any lien transferred . . . *to the extent* that such transferee . . . gave value to the debtor in exchange for such transfer."[109] The italicized language "to the extent" seems to contemplate partial fraudulent conveyance liability. But it is open to argument that "to the extent" does not modify "good faith." Under this view, the transferee need not have paid *full* value to obtain a defense under section 548(c), but all value must have been given in good faith. If any part of the LBO is fraudulent, the entire security interest of the lender is fraudulent.

The *Gleneagles* case was decided under the Uniform Fraudulent Conveyance Act, as enacted by Pennsylvania,[110] not section 548(c). The Uniform Act, however, is equally ambiguous.[111] *Gleneagles*, therefore, may represent a good indication of what a bankruptcy court might do with the issue under section 548(c).[112] In *Gleneagles*, over 41% of the loan stayed with the acquired company, Raymond Colliery. Nevertheless, the LBO loan was declared 100% fraudulent.[113]

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avoidance. Boyd & Suydam v. Dunlap, 1 Johns. Ch. 478, 482-84 (N.Y. Ch. 1815) (citations omitted). For a discussion of this case, see McCoid, *Constructive Fraudulent Conveyances: Transfers for Inadequate Consideration*, 62 TEX. L. REV. 639, 649-52 (1983).

[109] 11 U.S.C. § 548(c) (1982) (emphasis added).

[110] Pennsylvania has codified the Uniform Fraudulent Conveyance Act in 39 PA. CONS. STAT. ANN. §§ 351-363 (Purdon 1954 & Supp. 1985).

[111] The Uniform Fraudulent Conveyance Act is also ambiguous on whether bad faith destroys the entire bundle of rights received by a lender. Section 9(1) of the Act gives the lender a defense if it is a "purchaser for fair consideration without knowledge of the fraud." UNIF. FRAUDULENT CONVEYANCE ACT § 9(1), 7A U.L.A. 430 (1985). Section 3(a) defines fair consideration as "[w]hen . . . in good faith, property is conveyed" to the debtor. *Id.* § 3(a). Clever lawyers had no problem arguing both sides of the question in the *Gleneagles* case.

[112] The only case found construing § 548(c) is *In re* Ear, Nose & Throat Surgeons, Inc., 49 Bankr. 316 (Bankr. D. Mass. 1985). In that case, the lender took an upstream guaranty for a loan to the corporation's only shareholder. Part of the loan was invested back into the subsidiary and part was not. The entire upstream guaranty, however, was avoided, even though a reasonably equivalent value could have been established for the part of the loan reinvested in the subsidiary. The case did not involve an LBO; therefore, *Gleneagles*, an LBO case, will probably be viewed as closer precedent.

[113] *Gleneagles II*, *Gleneagles III*, 584 F. Supp. at 683. Other cases followed the all-or-nothing approach but were decided under the former Bankruptcy Act. *See In re* Roco Corp., 701 F.2d 978 (1st Cir. 1983); *In re* Process-Manz Press, Inc., 236

The court reasoned that the LBO lender had been guilty of an intentional fraud under the state law equivalent of section 548(a)(1)[114] and this fraudulent behavior had infected the nonfraudulent parts of the loan.

The lender in the *Gleneagles* case was an unattractive candidate for sympathy. IIT, the original LBO lender, seemed to have been implacably greedy. But in any case, IIT had assigned its rights to a subsidiary of Pagnotti, the competitor of Raymond Colliery that may have designed the liquidation scheme in the first place. The party that stood to lose was, therefore, the instigator of the entire LBO.[115]

Consequently, it is hard to argue that the LBO lender in *Gleneagles* deserved any better treatment. But more sympathetic cases can be imagined. Suppose that the LBO is only marginally unacceptable and part of the loan is put to good use. Avoiding the entire loan as in *Gleneagles* seems unduly harsh. Perhaps a more flexible approach ought to be preserved for more sympathetic cases.[116]

F. Supp. 333, 346 (N.D. Ill. 1964), *rev'd on other grounds*, 369 F.2d 513 (7th Cir. 1966), *cert. denied*, 358 U.S. 957 (1967).

Although *Gleneagles* purports to take an all-or-nothing approach to the lender's good faith, the LBO lender's assignee (who lost the entire LBO mortgage) was nevertheless given credit for being subrogated to various tax liens satisfied by advances from the assignees. *Gleneagles III*, 584 F. Supp. at 685. These liens, however, were subordinated to all other tax liens, but placed ahead of any other judicial liens that nontax creditors might have. *Id.* at 686, 690. Hence, the court seems to be taking the position that loans advanced at the time of the LBO are void under the all-or-nothing approach, whereas subsequent advances are to be treated with slightly more deference.

[114] 39 PA. CONS. STAT. § 357 (Purdon 1954 & Supp. 1985). *See Gleneagles*, 565 F. Supp. at 586.

[115] IIT, the original LBO lender, advanced $7 million at the time of the LBO, *Gleneagles*, 565 F. Supp. at 568, plus $50,000 to retire tax liens senior to the IIT mortgages, *Gleneagles II*, 571 F. Supp. at 941, for a total of $7,050,000 in advances. Pagnotti paid IIT $3,600,000 for the mortgage. *Id.* at 952. IIT also received $4,589,640 in payments from Raymond Colliery during the years it was Raymond Colliery's creditor. *Gleneagles III*, 584 F. Supp. at 675. Therefore, ignoring compound interest, IIT received a profit of $1,139,000 on the LBO (amounting to an annual interest rate of 4%). Since IIT made no warranties regarding whether the mortgage would survive fraudulent conveyance liability, *Gleneagles II*, 571 F. Supp. at 944, Pagnotti stood to lose its investment in the mortgages.

[116] A proportional recovery rule was apparently approved in Rubin v. Manufacturers Hanover Trust Co., 661 F.2d 979, 994 (2d Cir. 1981) ("If the value received by [the subsidiary] is found to be disproportionately small as compared with its obligation, then *to that extent*, the trustee for that issuer will have proved lack of fair consideration . . . .") (emphasis added). The underscored words seem to call for a pro rata recovery only.

If prorated recoveries are substituted for an all-or-nothing approach to LBO's, several further considerations arise. First, if the target company has made any interest or principal payments on the fraudulent parts of the loan, these payments are affirmative recoveries that the trustee might have against the LBO lender. As such, they should be set off against the legitimate part of the LBO lender's secured claim.[117] Second, if the trustee has recovered from the buyer pursuant to a subrogation or contract right of the debtor, the LBO lender should be given credit for the amounts recovered. Otherwise, the trustee will have received a double recovery.[118] On the other hand, if the value of the subrogation rights at the time of the completion of the LBO has been used to reduce the amount of illicit upstream benefits for which the lender is responsible, courts must be careful that credits for recoveries from the shareholders are not double-counted in the LBO lender's favor.[119]

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[117] This setoff possibility was yet another issue analyzed thoroughly in the *Gleneagles* case and was used as an alternative ground for refusing any recovery to the assignee of the LBO lender. *Gleneagles III*, 584 F. Supp. at 681.

The opinions in *Gleneagles* do not reveal what the countervailing debts in the setoff were. The debtor had apparently paid large amounts of interest to the LBO lender (although not to the lender's assignee). The entire amount of interest was used to set off the 41% of the principal that was still valid. *Id.* at 683. If, however, fraudulent conveyance liability was only partial, 41% of the interest should have been validly paid and should not have been part of the set off.

[118] The *Gleneagles* court refused to give IIT's assignee credit for the fact that substantial recoveries were had from the old shareholders of Raymond Colliery who were bought out by Durkin and Company. *Gleneagles III*, 584 F. Supp. at 682. Its primary excuse was that the old shareholders had paid about $6 million in a universal settlement and other types of liability. *Id.* Because the old shareholders had failed to prorate their settlement, the Pagnotti subsidiary that held the LBO mortgages lost a credit for recoveries actually made. Except that the Pagnotti interests command no sympathy whatsoever, one could view this decision as unfair.

[119] The double-counting problem is quite complex. Suppose that the upstream benefit is a secured guaranty of $1 million. The court is inclined to discount the face value of the upstream guaranty liability to $250,000 because there was a 75% chance the guaranty would never burden the subsidiary. *See supra* notes 53, 57 and accompanying text. The trustee then recovers $1 million from the shareholders. Obviously, the trustee should have no further recovery from the LBO lender. The LBO lender's $1 million mortgage should be reinstated in full. *See* 11 U.S.C. § 550(c) (1982) ("[T]he trustee is entitled to only a single satisfaction . . . ."). In fact, any amount recovered over $750,000 should benefit the LBO lender. Otherwise, the creditors of the debtor will have received a windfall.

A separate issue arises if the trustee has not yet recovered from the shareholders but might do so. In such a case, I think that the LBO loan should be avoided

B. *The Significance of the Trustee's Right to Recover Fraudulent Conveyances from the Buyer or Seller of the Target Company's Shares*

The existence of the target company's contractual right of recovery against its new parent[120] should positively affect the value deemed to have been received. The right of recovery might come from subrogation (in an upstream guaranty in Structure II) or from a direct loan obligation (in Structure V). One place it should not come from is fraudulent conveyance law. If the trustee in bankruptcy of the target company has the right to recover fraudulent conveyances from the buyer or seller in an LBO, this right should not constitute "value" under section 548(a)(2), nor should such a right affect the solvency calculations of the bankruptcy court. The LBO lender's liability should be unaffected by any hypothetical fraudulent conveyance recoveries the trustee might receive.

As a theoretical matter, both the buyer and seller have received fraudulent conveyances if the LBO is in any way fraudulent. Any third party, except a bona fide purchaser for value, must return property that is fraudulently conveyed. In an LBO, it is unlikely that many parties will be bona fide purchasers. The sellers of shares, if the target company was privately held, may be tainted with full insider knowledge of, and perhaps even active participation in, the LBO transaction (although the question of the bona fide purchaser status of public shareholders may have a different answer). If the seller has transferred the stock to the buyer in exchange for tainted

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without regard to hypothetical recoveries (although whether it is avoidable should still be based upon partial subrogation value at the time of the LBO). At issue is who should bear the expense of pursuing the shareholders in some other forum. Since the LBO is a fraudulent conveyance, it is fair for the LBO lender to pursue whatever it can from the principal obligor. I make no "marshalling of assets" argument here, since that doctrine should not be available when the obligor is not also a party to the guarantor's bankruptcy. *See* Note, *Marshalling Assets in Bankruptcy: Recent Innovations in the Doctrine*, 6 CARDOZO L. REV. 671 (1985) (discussing marshalling cases that improperly require this). Rather, I am simply suggesting that the trustee should have the right to avoid an admittedly fraudulent conveyance without regard to hypothetical recoveries that might be had elsewhere.

[120] Under Structure V, the contractual right of recovery is explicit. Under Structure II, the right comes from the doctrine of subrogation, which I take to be an implied term in suretyship contracts. *See* Carlson, *A Theory of Contractual Debt Subordination and Lien Priority*, 38 VAND. L. REV. 975, 987-90 (1985) (explanation of subrogation clauses and their application in bankruptcy).

dollars, the seller is a purchaser for value, but is not a good faith purchaser to the extent it knows that the LBO dollars are tainted. Its good faith defense will be similar to that of the LBO lender. Pertinent inquiries include whether the seller believed the company was solvent and whether the seller believed that the LBO would result in a surviving business entity that would provide for its creditors.[121]

Also, if the sellers have received tainted dollars directly from the acquired company in a stock repurchase (Structure IV), some may take the view that the sellers have a per se fraudulent conveyance liability.[122] It is frequently said that the seller's stock in the hands of the issuing company is never value, so that the seller in a stock repurchase can never be a purchaser *for value*.[123] This view is not compelled by the statute. Even if the *sellers* have given no value, the *buyers* have paid for the transfers to the selling shareholders with their management services and other promises. If the buyers and the LBO lenders have a good faith defense against fraudulent conveyance liability, the selling shareholders (as third-party beneficiaries of the contracts between the target, the buyer, and the LBO lender) ought to have a defense as well. Otherwise, a premium is placed on one LBO form over another when, substantively, they are identical.

Meanwhile, if we stipulate that the LBO is fraudulent, the buyer will have to return the upstream benefits it received. The fact that the buyer is a shell corporation does not remove the possibility of

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[121] Easterbrook & Fischel, *supra* note 18, at 716-19, disfavor any remedy against shareholders who sell to a corporate looter, on the ground that it is too hard to tell in advance who the looters are; fear of false charges will chase sellers from marginal deals that might nevertheless be economically efficient. Easterbrook and Fischel prefer criminal penalties to deter the looters themselves. *Id.* at 719.

I believe that it is easier to tell when the buyer is a looter than Easterbrook and Fischel think. It is simply a matter of comparing the expected income streams of the company before the LBO (figures that are generated by the sellers) with the debt service that the buyer must meet after the LBO. Coupled with a modicum of judgment as to whether the buyer can maintain or increase the acquired company's income, the assessment should not be hard to make at all.

[122] *See* Fisher, *Oops! My Company Is on the Block*, FORTUNE, July 23, 1984, at 16, 21. In World Broadcasting Sys. v. Bass, 160 Tex. 261, 267, 328 S.W.2d 863, 866 (1959), the court went even further, holding the selling shareholders personally liable, without regard to tracing fraudulently conveyed funds.

[123] *In re* Roco Corp., 701 F.2d 978, 982 (1st Cir. 1983); Ballantine, *The Curious Fiction of Treasury Shares*, 34 CALIF. L. REV. 536, 540 (1946). A contrary view is taken in *In re* Corporate Jet Aviation, Inc., 57 Bankr. 195, 198-99 (Bankr. N.D. Ga. 1986).

an upstream recovery, provided corporate veil piercing is appropriate.[124]

While the above theories may be available to the trustee,[125] it is probably much easier for the trustee to recover from the LBO lender, usually a solvent financial institution. But to what extent can the LBO lender use these hypothetical recoveries against the buyers and sellers to reduce its own liabilities?

The better view is not at all. The creditors' right to recover fraudulent conveyances should not be confused with the debtor's contractual right to recover from its parent. The right of the target company to recover from its parent is an asset with a value at the time of the LBO. Like all assets, it may increase or decrease in value

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[124] *See generally* Clark, *supra* note 10, at 541-47. Although I know of no cases in which the veil of a buyer's holding company was pierced in order to recover fraudulent conveyances in an LBO, the generally stated standards of veil piercing would seem to fit in LBO cases. *See* Fisser v. International Bank, 282 F.2d 231, 238 (1960) (piercing requires control of the subsidiary by the parent, use of the control to commit fraud, and proximate causation of the plaintiff's loss).

[125] A further doctrinal impediment to the trustee should be mentioned. This impediment might prevent the trustee from recovering against either the seller or the buyer. I have made much of *Dean* as the basis of my analysis of an LBO lender's liability for fraudulent conveyance. That case had a second important aspect. It will be remembered that a debtor's brother-in-law assumed a bank debt in exchange for a mortgage. The brother-in-law was not liable for a voidable preference because the mortgage was traded contemporaneously with the assumption agreement, *see* 11 U.S.C. § 547(b)(2) (1982) (preferences require transfers on antecedent debt), but he was liable for a fraudulent conveyance because he knew he was helping to finance a voidable transaction. That is, if the debtor had paid the bank directly, the bank would have received a voidable preference.

Curiously, the court held that the bank did not have to return any money it received directly from the brother-in-law. It reasoned that voidable preference liability required the bank to receive property of the debtor. The bank had only received property of the brother-in-law.

This "property of the debtor" principle could shield the buyer and seller in an LBO, if they receive money directly from the LBO lender, as in Structure II. On the other hand, *Dean* is inapplicable if the LBO follows Structure V, where the loan passes through the acquired company to the buyer and seller. In that case, they have indeed received "property of the debtor."

The ability of a purely formal attribute of an LBO to so drastically affect the trustee's rights strongly suggests that *Dean* was wrongly decided on the question of the bank's voidable preference liability. After all, the debtor in that case was buying an assumption of debt with the mortgage and had the power to determine who received the value. This power seems extremely close to property of the debtor. *See* 11 U.S.C. § 541(b)(1) (1982) (powers that could be executed for the debtor's estate are part of the estate).

with the passage of time. General creditors always take this risk. The relevant time period for valuing that asset (to determine the debtor's solvency or to determine if the debtor received reasonably equivalent value for upstream benefits) is the time the LBO is made. The fraudulent conveyance right, however, is not a target company asset. It is a creditor right in property that the debtor has transferred away. As such, it should not affect valuation of the debtor's estate. But, if the trustee actually does recover from the buyer or seller under a fraudulent conveyance theory (or under any theory) the trustee must give the LBO lender credit. According to section 550(c), "[t]he trustee is entitled to only a single satisfaction . . . ."[126] Anything else would constitute a penalty on the LBO lender and a windfall for the general creditors.

C. Assignments and Participations

Lenders do not always retain the entire risk of a large loan, even if it is secured. They routinely sell participations or assign their interest to other investors. It is therefore necessary to consider what effect fraudulent conveyance liability might have on such assignees.

Not all participations are assignments. Sometimes the lender continues to own the claim against the borrower and sells a contractual obligation to pay the participant an amount gauged by the collections from the borrower. If the participation takes this form, the participant has not purchased any of the property that is alleged to be fraudulently conveyed. The participant has no claim against the borrower at all. Fraudulent conveyance liability of the lender reduces the recovery of the lender, however, and thereby the recovery of the participant.[127]

On the other hand, if the LBO lender actually assigns its rights,[128] the assignee might take the secured claims with better title than the

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[126] 11 U.S.C. § 550(c) (1982).

[127] *See* Note, *Classification of Loan Participations Following the Insolvency of a Lead Bank*, 62 TEX. L. REV. 1115, 1120-21 (1984) (lead bank shares loan risks with participants). If a loan participation creates no proprietary claim directly against the borrower, the borrower obviously cannot avoid any obligation to the participant. The participant's rights against the lead lender, in case the loan is avoided, is entirely a matter of construing the participation contract.

[128] *E.g.*, FDIC v. Mademoiselle of California, 379 F.2d 660, 664 (9th Cir. 1967) (lender assigned 80% interest in note to participant); *In re* Alda Commercial Corp., 327 F. Supp. 1315, 1317-18 (S.D.N.Y. 1971) (lender assigned 10% interest to participants).

LBO lender had. The bankruptcy trustee of the target company must pursue lenders under section 550 of the Bankruptcy Code, which establishes liability of the target company's "initial transferee"[129] (i.e., the initial LBO lender) or the "transferee of such initial transferee" (i.e., the LBO lender's assignee). If the trustee pursues the assignee, the assignee has a defense if it "takes for value . . . in good faith, and without knowledge of the voidability of the transfer avoided . . . ."[130] This language establishes an independent opportunity for assignees to prove their own good faith, even if the original lender was guilty of bad faith.[131]

While this opportunity is undoubtedly compelled by the statutory language, it is hoped that courts will impose a duty of inquiry that is as vigorous as that imposed on an LBO lender. An LBO lender who knows that an LBO is unlikely to produce a surviving business entity would have an easy time laundering its rights through innocent assignees if the rule were otherwise. Therefore, if the assignee knows that the loan proceeds were upstreamed to shareholders of the target company, the assignee should be required to make a thorough investigation of the original deal.[132]

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[129] 11 U.S.C. § 550(a) (1982).

[130] *Id.* § 550(b)(1).

[131] *See Gleneagles II*, 571 F. Supp. 935, 952-57 (1983) (assignee accorded independent opportunity to make a good faith purchaser defense but fails to carry it); *see also Gleneagles III*, 584 F. Supp. at 671, 682 (M.D. Pa. 1984) (although assignee was without actual fraudulent intent, it knew or should have known of the fraudulent nature of the mortgages).

The creditors in *Gleneagles* claimed that mere knowledge of the fact that the mortgage was in default at the time of the assignment should prevent the assignee from having a good faith purchaser defense of its own. *Gleneagles II*, 571 F. Supp. at 953. Although the court avoided this question, it cited some authorities that it said were in "modest support" of it. I disagree that such a claim has any merit. The issue is whether the LBO loan was fraudulent in the first place. A valid loan that later goes into default should hardly be declared fraudulent for that reason alone. Otherwise, creditors could never assign bad debts to others for the purpose of collection.

[132] If the trustee defeats the assignee-participant under this standard, the assignee's right to indemnification from the lead bank will depend upon contractual principles. Assignments include the implied warranty that the right, as assigned, actually exists and is subject to no undisclosed defenses, RESTATEMENT (SECOND) OF CONTRACTS § 33(1)(b) (1979), but waivers of such warranties are surely possible. *See Gleneagles II*, 571 F. Supp. 935, 944 (E.D. Pa. 1983) (assignor and assignee agreed to waive warranty in exchange for lower price).

D. *Refinanced LBO Loans*

In the *Gleneagles* case, the target company, Raymond Colliery, was involved in its third LBO-related loan. In 1966, it had purchased a company giving the old owners a promissory note guaranteed by the subsidiary it had just acquired.[133] In 1971, it borrowed from Chemical Bank to retire the LBO debt owed to the former shareholders of its subsidiary. This loan was also secured by an upstream guaranty.[134] In 1983, the buyer of Raymond Colliery caused IIT to advance funds to Raymond Colliery, part of which was upstreamed to the buyer (who then bought out the old shareholders) and part of which was used to retire the Chemical Bank debt.

As already discussed, assignees have a statutory bona-fide-purchaser defense of their own, although they should be held to a strict standard of inquiry. While economically similar to assignments, the refinancing of an LBO loan by an independent new lender is technically in a statutorily distinguishable position. Refinancing lenders are "initial transferees" under section 550(a)(1), whereas assignees of LBO lenders are transferees of transferees within section 550(a)(2).

Nevertheless, refinancing LBO lenders should be liable on principles parallel to those governing the original LBO lender. They should have a similar good faith defense under section 548(c) and should likewise be held to a reasonable duty of diligence. Otherwise, it would be too easy to launder unacceptable LBO's through refinancing tricks.

Thus, although the analysis is conducted under different statutory language, assignees and refinancing lenders should be bound by similar standards. Each has a theoretical good faith defense, but each should be put to a reasonable duty to inquire. These comments must be tempered by an important consideration: if the original LBO lender is protected by a statute of limitations or other principle, the LBO debt cannot be avoided. As such, an LBO loan is then like any other debt. Refinancing of nonvoidable LBO loans should be completely permissible.[135]

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[133] *Gleneagles*, 565 F. Supp. at 563.

[134] *Id.* at 564.

[135] Refinancing can raise subtle issues. In *In re* Process-Manz Press, Inc., 236 F. Supp. 333 (N.D. Ill. 1964), *rev'd on other grounds*, 369 F.2d 513 (7th Cir. 1966), *cert. denied*, 358 U.S. 957 (1957), the court did not treat the lender as a refinancer of a valid LBO debt, but such treatment was appropriate under the circumstances.

E. Laches and Estoppel as a Defense to Fraudulent Conveyance Liability

In *Credit Managers Association v. Federal Co.*[136] the court determined that the LBO involved transfers of the debtor's assets without fair consideration in return, even though cash flows suggested that the new management would take over a viable economic entity. In my view, the cash flows proved that the management services themselves were adequate consideration in exchange for the transfers to the LBO lender. Nevertheless, the court used the very same cash flow evidence as proof that the debtor was adequately capitalized within the meaning of California's fraudulent conveyance statute. Hence, the LBO was not fraudulent.

But even if the LBO was a fraud on creditors, the court was apparently ready to hold that the creditors had no right to challenge the LBO because their claims postdated the LBO. This theory could save otherwise fraudulent LBO's in cases where there has been a complete credit turnover between the LBO closing and the bankruptcy petition.

Credit Managers is not a bankruptcy case. Instead, the insolvent target company's assets had been transferred to an assignee for the benefit of creditors under state law.[137] In a bankruptcy, the court's theory would not work when the LBO survives less than a year. Trustees in bankruptcy are privileged to bring actions under section 548(a) even if no single creditor has fraudulent conveyance rights

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The buyer had purchased the sellers' shares on credit, with the shares themselves as collateral. After this transaction, the acquired company had no LBO liabilities. After the one year federal statute of limitations had passed, the lender refinanced this debt, taking a mortgage in the borrower's subsidiary. If the lender had been refinancing an LBO with an upstream secured guaranty, the lender should have had no liability, since the statute of limitations had passed (at least at the federal level). But the lender was refinancing the parent's own obligation and taking an upstream guaranty for the first time within a year of bankruptcy. As such, the lender was quite clearly within the one year statute of limitations. *See also* Wells Fargo Bank v. Desert View Bldg. Supplies, Inc. (*In re* Desert View Bldg. Supplies, Inc.), 475 F. Supp. 693 (D. Nev. 1978), *aff'd*, 633 F.2d 221 (9th Cir. 1980).

[136] No. CV 84-3098 ER(Tx), slip op. (C.D. Cal. Dec. 6, 1985).

[137] An assignment for the benefit of creditors is a type of state law equivalent of a voluntary bankruptcy. For a description of the rights and powers of the assignee, see Carlson & Shupack, *Judicial Lien Priorities Under Article 9 of the Uniform Commercial Code: Part II—Creditor Representatives, Bank Receivers, Fixtures, Crops, and Accessions*, 5 CARDOZO L. REV. 823, 823-28 & n.1 (1984).

under state law.[138] In contrast, if the transfers in an LBO are over a year old by the time of the bankruptcy, the trustee must rely on his subrogation to the rights that real creditors have under state law.[139] In such cases, the theory of *Credit Manager* is important.[140] And of course, it would be important in any nonbankruptcy fraudulent conveyance context.[141]

The *Credit Managers* court states its theory in terms of estoppel or assumption of the risk:

> These creditors made a post-buyout decision to extend credit on new terms to a new entity . . . . As the creditors plaintiff represents did not have any substantial stake in Crescent at the time of the buyout, there does not appear to be a strong reason to give these creditors the right to attack the buyout as harmful to them. It would seem that if leveraged buyouts are to be susceptible to attack on fraudulent conveyance grounds, only those who were creditors at the time of the transaction should have a right to attack the transaction.[142]

Somewhat inconsistently, however, the court suggests incorporating the one year statute of limitations in section 548(a) of the Bankruptcy

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[138] *See* S. RIESENFELD, CREDITORS' REMEDIES AND DEBTORS' RIGHTS 635 (3d ed. 1979).

[139] *E.g.*, *In re* O.P.M. Leasing Servs., 32 Bankr. 199 (Bankr. S.D.N.Y. 1983).

[140] The court in Credit Managers Ass'n v. Federal Co., No. CV 84-3098 ER(Tx), slip op. (C.D. Cal. Dec. 6, 1985), was ambiguous on whether *all* or *nearly* all the creditors postdated the LBO. *E.g.*, *id.* at 9 ("In fact, most claims arose after the buyout"), 10 ("much of the credit . . . was extended *after* the buyout) (emphasis in original).

In a bankruptcy, if the trustee could subrogate himself to a single creditor with avoidance rights, the trustee could destroy the entire LBO obligation. 11 U.S.C. § 544(b) (1982). This is the rule of Moore v. Bay, 284 U.S. 4 (1931). For a discussion of *Moore* and § 544(b), see Jackson, *Avoiding Powers in Bankruptcy*, 36 STAN. L. REV. 725, 742-50 (1984).

On the other hand, although the *Credit Managers* court talks of an assumption of risk defense, it actually proposes a one-year statute of limitations that starts running at the time of the LBO. This statute of limitations would therefore destroy the bankruptcy trustee's subrogation power, whether or not the trustee can find a creditor who did not assume the risk of the LBO.

[141] It should be noted that the two principal LBO cases—*Gleneagles* and *Credit Managers*—both involved state law proceedings, not bankruptcies.

[142] *Credit Managers*, No. CV 84-3098 ER(Tx), slip op. at 10 (C.D. Cal. Dec. 6, 1985).

Code.[143] The idea of incorporating an analogous statute of limitations is a standard feature of laches.[144] But if assumption of the risk or estoppel is the sin, a one year statute of limitations (as opposed to California's existing three year statute)[145] seems a non sequitur. Creditors who take a conscious credit risk nevertheless have avoidance rights, although they are somewhat narrower in scope. Meanwhile, creditors who existed at the time of the buyout and took no credit risk are denied their avoidance rights when the LBO survives more than a year.

In addition, even on a more sensible basis, I think the *Credit Managers* court is off base in introducing assumption of the risk into fraudulent conveyance law. The Uniform Fraudulent Conveyance Act expressly allows post-conveyance creditors to assert avoidance rights. Section 5 of the Act provides that conveyances without fair consideration are void as against "persons who become creditors during the continuance of such business."[146] This broad language seems inconsistent with the assumption of the risk theory.

The economic case for assumption of the risk also seems indeterminate. It might be true that the post-LBO creditors could raise the price of their loans in response to the riskiness of the debtor's financial structure, but such reasoning is highly circular. If the same creditors have fraudulent conveyance rights, they have an incentive to lower their interest rates. The economic case for favoring the LBO over the trade creditors would then depend entirely upon the comparative costs perceived *ex antecedentibus* by would-be secured LBO lenders and unsecured trade creditors. By no means is it certain that the trade creditors are the most efficient bearer of the risk, if that is what the *Credit Managers* court is implying.[147]

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[143] *Id.* at 12.

[144] *See* Keller v. Standard Sand & Gravel Co., 365 F. Supp. 1 (S.D. Ohio 1973).

[145] CAL. CIV. PROC. CODE § 338(4) (West 1982). The time only starts running, apparently, when creditors reduce their claims to judgment. Pedro v. Soares, 18 Cal. App. 2d 600, 64 P.2d 776, 781 (1937).

[146] UNIF. FRAUDULENT CONVEYANCE ACT § 5, 7A U.L.A. 430, 504 (1985).

[147] The efficiency case for an estoppel principle in fraudulent conveyance law is too complex to take on here, but is a most interesting subject. Some of the elements of the case are as follows: (1) Profit maximizing debtors will not issue secured debt today if they know it raises the price of unsecured debt tomorrow by as much or more than they saved by issuing secured debt. Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEGAL. STUD. 2, 9

Putting aside the difficulties of any economic case for the court's position, there is a moral point to be made here. The assumption of the risk observation, whether it is manifested in the unresponsive short statute of limitations or in some straight estoppel rule, protects LBO's that we have already decided are looting schemes. Between the two classes of creditors, we have secured creditors who know the LBO cannot survive, and trade creditors accustomed to extending easy credit terms to the shakiest of their clients. I see no reason to impose the loss on the trade creditors on the value-laden judgment that these creditors could have protected themselves but preferred the risk instead. Rather, the LBO lender, as deliberate wrongdoer, seems like a more attractive candidate for punishment.

V. Conclusion

In this article, I have attempted to set forth a policy that bankruptcy courts should adopt toward failed LBO's. Obviously, LBO's that were solvent at birth (as broadly defined in section 548(a)(2)(A)-(C)) should be free from challenge. More controversial are LBO's that start off life insolvent.

The bankruptcy policy I have suggested is based on the idea that the form of the LBO should not matter much in determining whether the LBO involved fraudulent transfers to the LBO lender. It is also based on the idea that the LBO lender should have a defense against fraudulent conveyance liability whenever the lender believes in good faith that it is financing a corporate acquisition with a decent chance

(1981). But can we rely on the market to discipline debtors to be profit maximizing? Recall that we are dealing with debtors who have, by definition, already decided to cheat their unsecured creditors by issuing security and liquidating quickly thereafter. (2) In perfect markets, creditors have perfect information. But trade creditors are apparently in the habit of granting credit terms in a rather careless fashion. Rules, such as assumption of risk, may work in perfect markets, where all costs of education and experience are sunk, but in the real world, relieving trade creditors in part from the risk of leverage might be an efficient second-best solution. (3) The increased cost of crooked LBO's probably cannot be counted as a social cost since we presumably would like to make crooked LBO's so costly that LBO lenders are deterred from dishonesty. Rather, the increased costs must be those of honest LBO lenders who fear that they will be erroneously labelled fraudulent. With an assumption of risk principle, more honest-but-marginal LBO's will be done. In a perfect market, more marginal LBO's would produce more social gains. On the other hand, more dishonest LBO's will be done as well, which presumably will produce higher interest rates from general creditors.

of survival. A "decent chance of survival" was defined as sufficient expected surplus cash flow (after all other expenses) to cover LBO debt service, as determined in an arm's-length loan transaction. These standards should distinguish LBO's that are honest but risky from LBO's that are looting conspiracies between secured lenders and shareholders.

Once an LBO is found to be fraudulent, numerous additional issues need to be addressed. I have tried to coordinate the trustee's right to recover fraudulent conveyances from the buying or selling shareholders with the trustee's right to avoid transfers to the LBO lender. My view is that the trustee's hypothetical right to recover from others should be irrelevant, but that the trustee should be entitled to one recovery only. In addition, I have argued that (in appropriate cases) partial avoidance should be used when the LBO loan is partly used for legitimate purposes. Furthermore, assignees of or participants in an LBO loan should be treated on principles roughly analogous to the principles governing the initial LBO loan.

All of these ideas are based upon a certain view of how we should mediate between two conflicting values in debtor-creditor law: (a) debtors should have the freedom to alienate their property, and (b) debtors should not alienate the property in order to defeat their creditors in an impending liquidation. Fraudulent conveyances have been limited in my suggested LBO policy to conveyances that the lender knows to be in anticipation of liquidation. Fraudulent conveyances that are merely risky (without more) would therefore be upheld in bankruptcy under this suggested policy.