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Creditors' Rights Against Participants in a Leveraged Buyout

Emily L. Sherwin*

INTRODUCTION

The purchase of a controlling interest in a corporation is often accomplished by a *leveraged buyout*, in which the buyers borrow a large part of the purchase price of controlling shares and secure their borrowing with assets of the business they acquire. A transaction in this form can be prejudicial to creditors of the acquired corporation, and participants in the buyout may face challenges by creditors on various grounds if the business later fails. This Article reviews the approaches courts have taken to creditors' rights in leveraged buyouts and similar transactions and suggests several changes.

Leveraged buyout transactions can take a variety of forms.¹ The common feature is that assets of the acquired corporation are used to finance the acquisition. For the purposes of this Article, it is helpful to distinguish between two categories of buyouts—those financed by selling shareholders and those financed by an independent lending institution.²

In the first category, selling shareholders finance the buyout by accepting the buyers' note for most or all of the purchase price of the shares. Simultaneously with the

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1. See generally P. BLUMBERG, *THE LAW OF CORPORATE GROUPS: PROBLEMS IN THE BANKRUPTCY OR REORGANIZATION OF PARENT AND SUBSIDIARY CORPORATIONS, INCLUDING THE LAW OF CORPORATE GUARANTIES* § 5.01 (1985). Choice of form may depend on tax considerations, the presence of minority shareholders, or other circumstances, as well as concern over potential challenges by creditors. See J. MCGAFFEY, *BUYING, SELLING AND MERGING BUSINESSES* 205-10 (1979).

2. For a discussion of buyouts financed by an independent lender, see Carlson, *Leveraged Buyouts in Bankruptcy*, 20 GA. L. REV. 73, 80-83 (1985). Professor Carlson's article discusses the application of fraudulent conveyance laws to buyouts, focusing on the fraudulent conveyance provisions of the federal Bankruptcy Code. The opening sections of his article describe six possible structures for leveraged buyouts financed by outside borrowing. See *id.* His conclusions are discussed *infra* notes 10 and 244.

purchase, the buyers cause the corporation to endorse the note or guarantee its payment and to grant the sellers a security interest in corporate assets. Corporate assets and earnings are expected to be the primary source for repaying the acquisition debt.³

Within the second category, buyouts financed by an independent lender, a further distinction should be made between two methods of outside financing. First, a lending institution may advance the funds required for the acquisition to the buyers. Typically, the buyers give the lender their unsecured note. In a simultaneous transaction, the buyers acquire the shares, assume control, and cause the corporation to endorse or guarantee their note and to secure the obligation with a lien on corporate assets. This is similar to the buyout financed by selling shareholders except that an independent party receives corporate obligations and security.⁴

Second, in an effort to reduce the risk of a challenge by creditors, the parties may structure the transaction so that the lender advances funds directly to the acquired corporation. There are several ways to do this. The corporation may borrow from the lender and then reloan the proceeds on an unsecured basis to the buyers or a parent corporation formed by the buyers.⁵ Another possibility is to complete the buyout through a

3. See *Credit Managers Ass'n v. Federal Co.*, 629 F. Supp. 175, 177-78 (C.D. Cal. 1986) (corporation executed mortgage to sellers to secure buyers' note); *Cate v. Nicely (In re Knox Kreations)*, 474 F. Supp. 567, 569 (E.D. Tenn. 1979) (corporation endorsed note to selling shareholders), *aff'd in part, rev'd in part*, 656 F.2d 230 (6th Cir. 1981); *Steph v. Branch*, 255 F. Supp. 526, 528-30 (E.D. Okla. 1966) (same), *aff'd*, 389 F.2d 233 (10th Cir. 1968); *Hartwell v. Hartwell Co.*, 167 N.J. Super. 91, 94, 400 A.2d 529, 531 (Super. Ct. Ch. Div. 1979) (corporation gave mortgage to sellers to secure buyers' debt); *Sharrer v. Sandlas*, 103 A.D.2d 873, 873, 477 N.Y.S.2d 897, 898 (App. Div.) (corporation gave mortgage to sellers to secure buyers' note), *appeal denied*, 63 N.Y.2d 610, 473 N.E.2d 1190, 484 N.Y.S.2d 1024 (1984). In some cases corporate assets are employed by more indirect methods to secure or repay a loan to the buyers. See *In re Atlas Foundry Co.*, 155 F. Supp. 615, 616 (D.N.J. 1957); *Dale v. Thomas H. Temple Co.*, 186 Tenn. 69, 75-76, 208 S.W.2d 344, 347 (1948).

In all cases discussed, this Article assumes that corporate liabilities survive the buyout. A buyout agreement, however, may provide for payment of existing debts by the sellers.

4. See, e.g., *In re Venie*, 80 F. Supp. 250, 252 (W.D. Mo. 1948) (partner purchasing interest of another partner gives mortgage of partnership property to independent lender). This form of buyout is described and discussed in *Couillette, Guaranty of and Security for the Debt of a Parent Corporation by a Subsidiary Corporation*, 30 CASE W. RES. 433, 436 (1980).

5. See *United States v. Gleneagles Inv. Co.*, 565 F. Supp. 556, 569-70 (M.D. Pa. 1983), *aff'd sub nom. United States v. Tabor Court Realty Corp.*, 803 F.2d 1288 (3d Cir. 1986), *cert. denied*, 107 S. Ct. 3229 (1987); *In re Process-Manz*

merger. To do this the buyers form a new corporation to purchase the shares of the existing corporation they wish to acquire. In a simultaneous transaction, the new corporation borrows from a lender and delivers the proceeds to the sellers in return for the shares of the acquired corporation, the acquired corporation is merged into the new corporation, and the combined entity grants a security interest in its assets to the lender to secure repayment of the loan.⁶

Whatever its form, a leveraged buyout reduces the assets available to general creditors of the corporation. The sellers' equity interest, which is subordinate to creditors' claims, is replaced with secured debt. Often, the purchase price in a buyout approximates the net worth of the corporation,⁷ and a highly leveraged transaction may threaten the creditors' ability to col-

Press, 236 F. Supp. 333, 336-39 (N.D. Ill. 1964), *rev'd on jurisdictional grounds*, 369 F.2d 513 (7th Cir. 1966), *cert. denied*, 386 U.S. 957 (1967); *Roxbury State Bank v. The Clarendon*, 129 N.J. Super. 358, 365, 324 A.2d 24, 27 (Super. Ct. App. Div.), *certif. denied*, 66 N.J. 316, 331 A.2d 16 (1974). In these cases it appears that the acquired corporation, having borrowed money from an outside lender, simply paid the proceeds to the sellers in satisfaction of the purchase price for its shares.

6. One author, after considering the fraudulent conveyance problems raised by a guaranty transaction, proposed a merger form of buyout as a possible solution. See Rosenberg, *Intercorporate Guaranties and the Law of Fraudulent Conveyances: Lender Beware*, 125 U. PA. L. REV. 235, 263-64 (1976). Apart from concern over potential fraudulent conveyance problems, parties might choose a merger form to "cash out" minority shareholders. See, e.g., *Weinberger v. UOP, Inc.*, 457 A.2d 701, 703 (Del. 1983); MODEL BUSINESS CORP. ACT § 75 (1979) (authorizing merger of subsidiary into parent without approval of subsidiary's shareholders, and conversion of subsidiary's shares to cash, when parent owns at least 90% of the shares). See generally Brudney & Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354 (1978); Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 723-31 (1982).

Any reference made to the acquired corporation in connection with a merger form of buyout encompasses both the new corporation formed by buyers and the preexisting corporation. Due to the merger, which takes place simultaneously with the borrowing and acquisition, the rights of creditors apply to the combined entity, and it is fair to view the actions of the old and new corporations as actions of a single corporation. See MODEL BUSINESS CORP. ACT § 76(d) (1979) (surviving corporation liable for all debts).

7. See, e.g., *Credit Managers Ass'n v. Federal Co.*, 629 F. Supp. 175, 177 (C.D. Cal. 1986) (book value). Net worth is a natural starting point to calculate the value of shares because it represents the interest of shareholders in the event of liquidation. Other considerations, particularly expected earnings, are also important in determining a price. For a general discussion of pricing shares, see J. MCGAFFEY, *supra* note 1, at 6-10. However measured, the price will reflect a determination of the potential value of the business in excess of present and expected debts. In a leveraged transaction, the only margin to protect creditors will come from the amount of the acquisition price paid by

lect.⁸ If the corporation is left with a positive net worth and sufficient funds to pay debts and continue in business, the buyout does not harm the creditors' reasonable expectations of an adequate source of payment. But if the corporation is left insolvent or without the resources it needs to sustain its business, the buyout conflicts with the creditors' legally protected rights.

When a corporation is left in inadequate financial condition following a buyout and later fails, unpaid creditors may assert claims against parties who participated in the buyout. Although several grounds are available, the most effective remedy is provided by fraudulent conveyance statutes. These statutes enable creditors to set aside certain transfers or obligations defined by statute as fraudulent against creditors. In a number of cases, creditors have used fraudulent conveyance law successfully to avoid corporate obligations and security given to selling shareholders in buyout transactions.⁹ In several notable decisions, courts have also applied fraudulent conveyance law to set aside obligations and security in the hands of independent lenders who financed the buyouts.¹⁰ The best known of

the buyers (if any) and any additional capital they contribute to the corporation.

8. As an illustration of the economic effect of a buyout, assume that buyers, sellers, and an outside lender agree to a buyout in merger form. The buyers form a corporation with initial capital of \$100,000. This entity has no other assets or source of income, having been organized specifically for the buyout. The corporation to be acquired has assets of \$2,000,000 and liabilities of \$1,000,000. Buyers and sellers agree that the new entity will purchase the shares of the existing corporation for \$1,000,000. To finance the purchase, the new corporation borrows \$1,000,000 from a bank. It then merges the acquired corporation into itself and grants a mortgage of all its assets to the bank to secure repayment of the loan. The shares of the acquired corporation are cancelled in the merger.

The combined entity now has a net worth of \$100,000 (the new corporation's capital of \$100,000, plus the acquired corporation's assets of \$2,000,000, less the original liabilities of \$1,000,000 and the new secured debt of \$1,000,000). Although the corporation's assets still exceed existing claims, the transaction reduces the protective margin for creditors and the cash or assets available for operation of the business by \$900,000.

9. See *infra* notes 109-12 and accompanying text.

10. See *infra* notes 122-59 and accompanying text. Two recent articles have addressed the application of fraudulent conveyance statutes to avoid interests obtained by an independent lender in a buyout. One article, by Professors Baird and Jackson, discusses the general objectives and limits of fraudulent conveyance law. See Baird & Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829 (1985). The authors suggest that too great a restriction on debtors' freedom of action is not in creditors' best interests and that the creditors' remedy under fraudulent conveyance statutes should therefore be confined to transactions most creditors would

these cases is *United States v. Gleneagles Investment Co.*,¹¹ which recently was affirmed in favor of the creditors.

Part I of this Article begins with a brief survey of the legal theories, apart from fraudulent conveyance law, that creditors have used to challenge leveraged buyouts. The following sections describe how fraudulent conveyance statutes operate, giving examples of their application to three-party transactions generally, to shareholders in connection with buyouts, and to outside lenders who have financed buyouts. Part II is a critical analysis of the application of fraudulent conveyance laws to leveraged buyouts. Part III concludes that fraudulent conveyance law may usefully be applied to buyouts but makes some proposals for interpretation in this context.

I. APPLICABLE LAW PROTECTING CREDITORS

Creditors have used a variety of legal theories to challenge the validity of buyouts or claim compensation from participants. In addition to fraudulent conveyance law, these include lack of corporate power, equitable subordination, and breach of fiduciary responsibility by corporate insiders.

A. THEORIES OTHER THAN FRAUDULENT CONVEYANCE LAW

1. Ultra Vires Doctrine

In older cases courts often addressed the validity of corporate obligations and security interests given to finance a lever-

seek to prevent by advance agreement if they negotiated the point with their debtors. *See id.* at 831-36. With respect to buyouts, the authors conclude that creditors would not oppose a buyout in most cases and so should not be able to challenge the transaction after it has proved undesirable. *See id.* at 850-55.

Another article, by Professor Carlson, specifically addresses the problem of leveraged buyouts. *See Carlson, supra* note 2, at 73. Carlson focuses on the fraudulent conveyance provisions of the federal Bankruptcy Code, particularly the saving provision protecting a transferee who gave value for the transfer in good faith. He proposes that a lender who has financed a leveraged buyout should be protected if it reasonably believed at the time of the buyout that the acquired corporation would generate enough cash flow to survive. *See id.* at 92, 95. For further discussion of Carlson's analysis, see *infra* note 244.

11. 565 F. Supp. 556 (M.D. Pa. 1983), *aff'd sub nom.* *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288 (3d Cir. 1986), *cert. denied*, 107 S. Ct. 3229 (1987). Decisions on related aspects of the same case are *United States v. Gleneagles Inv. Co.*, 571 F. Supp. 935 (M.D. Pa. 1983) (*Gleneagles II*), *aff'd sub nom.* *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288 (3d Cir. 1986), *cert. denied*, 107 S. Ct. 3229 (1987), and *United States v. Gleneagles Inv. Co.*, 584 F. Supp. 671 (M.D. Pa. 1984) (*Gleneagles III*), *aff'd in part, vacated in part sub nom.* *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288 (3d Cir. 1986), *cert. denied*, 107 S. Ct. 3229 (1987).

aged acquisition in terms of corporate power.¹² The ultra vires doctrine allows a corporation, its shareholders, or its creditors to set aside corporate action that exceeds the powers of the corporation as defined by its articles of incorporation and governing law.¹³ Applying this doctrine in buyout cases, courts have reasoned that a transfer of corporate assets for the benefit of shareholders, without consideration to the corporation, does not further proper corporate purposes.¹⁴ Therefore, creditors could avoid the obligations and security interests a corporation gives to obtain financing for a purchase of shares.¹⁵

The ultra vires doctrine lost force as views of corporate powers and business expediency expanded, and it is not often

12. See *Schloss Bros. & Co. v. Monongahela Nat'l Bank*, 60 F.2d 365, 366 (3d Cir.), cert. denied, 287 U.S. 661 (1932); *Pantaze v. Murphy (In re Nugrape Bottling Co.)*, 54 F.2d 895, 896 (5th Cir.), cert. denied, 287 U.S. 599 (1932); *First Savings & Trust Co. v. Romadka (In re Romadka Bros. Co.)*, 216 F. 113, 116-17 (7th Cir. 1914); *Steph v. Branch*, 255 F. Supp. 526, 530-31 (E.D. Okla. 1966), aff'd, 389 F.2d 233 (10th Cir. 1968); *In re Stucky Trucking & Rigging Co.*, 243 F. 287, 288 (D.N.J. 1917); *Pratt v. Valliquette*, 338 Mich. 397, 399, 61 N.W.2d 648, 649 (1953); *Payne v. White Swan Auto Co.*, 126 Wash. 550, 552-53, 219 P. 32, 33 (1923); *Washington Mill Co. v. Sprague Lumber Co.*, 19 Wash. 165, 173-74, 52 P. 1067, 1070 (1898); Annotation, *Validity of Obligation Given by Corporation Incident to Purchase of Entire Stock by Sole Shareholder*, 71 A.L.R.3d 639, 643, 650-61 (1976).

13. See P. BLUMBERG, *supra* note 1, §§ 6.02-.04, 6.07.2; 7A W. FLETCHER, *CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* §§ 3399, 3406, 3444, 3446, 3452-3453 (1978); Coquillet, *supra* note 4, at 438-46.

14. See *Schloss Bros.*, 60 F.2d at 366; *Nugrape Bottling Co.*, 54 F.2d at 896; *Romadka Bros.*, 216 F. at 116-17; *Payne*, 126 Wash. at 552-53, 219 P. at 33.

15. Between the corporation and its shareholders, corporate obligations might be enforced on grounds of estoppel. See *Shumpert v. National State Bank*, 231 F. 82, 86 (4th Cir. 1916); *Miller's Shoes & Clothing v. Hawkins Furniture & Appliances*, 300 Minn. 460, 464-66, 221 N.W.2d 113, 116-17 (1974); *Pine v. Hyed Realty Corp.*, 145 N.Y.S.2d 548, 549-50 (Sup. Ct. 1955), aff'd mem., 1 A.D.2d 952, 151 N.Y.S.2d 610 (App. Div. 1956); *Haynie v. Milan Exch.*, 62 Tenn. App. 36, 45, 458 S.W.2d 23, 27-28 (Ct. App. 1970); Annotation, *supra* note 12, at 645-50. But if the corporation has creditors whose interests have been harmed, they can set aside the transfer and recover corporate property. See *Steph*, 255 F. Supp. at 530; *Pratt*, 338 Mich. at 399, 61 N.W.2d at 649; *Hess v. Cedarhome Lumber Co.*, 139 Wash. 107, 117-19, 245 P. 753, 757 (1926); *Payne*, 126 Wash. at 553, 219 P. at 33; Annotation, *supra* note 12, at 650-61. Some courts have distinguished between existing and subsequent creditors, holding that only creditors who had claims at the time of the transaction may challenge it. *Id.* at 655-58. Others have extended the doctrine to protect subsequent creditors as well. *Id.* at 658-61.

One authority on corporate law states that corporate creditors who are not parties to a transaction cannot challenge it in the absence of fraud against them. See 7A W. FLETCHER, *supra* note 13, § 3452. Most courts, however, have not insisted that there be a fraud against creditors as defined in fraudulent conveyance statutes.

applied in modern cases to invalidate buyout transactions.¹⁶ Some courts have interpreted broad grants of authority in modern corporate statutes to permit corporations to enter into agreements, such as guaranties, for the benefit of shareholders.¹⁷ Others have found adequate support for corporate obligations in incidental benefits obtained by the corporation in a buyout transaction.¹⁸

2. Equitable Subordination

Equitable subordination is a remedial device by which the claims of certain creditors, and any interests given to secure them, are subordinated to claims of general creditors.¹⁹ The

16. See *Emerald Hills Country Club*, 32 Bankr. at 419; 7A W. FLETCHER, *supra* note 13, §§ 3407, 3410, 3439.

17. See *Emerald Hills Country Club*, 32 Bankr. at 417-18; Cechettini v. Consumer Assocs., 260 Cal. App. 2d 295, 298, 67 Cal. Rptr. 15, 17 (1968); *New England Merchants Nat'l Bank v. Lost Valley Corp.*, 119 N.H. 254, 256-57, 400 A.2d 1178, 1180 (1979). Modern statutes usually recognize a wide range of corporate powers and in some cases expressly limit application of the ultra vires doctrine. See CAL. CORP. CODE § 208 (West 1981); REVISED MODEL BUSINESS CORP. ACT § 3.04 (1984); MODEL BUSINESS CORP. ACT § 7 (1979). See generally 7A W. FLETCHER, *supra* note 13, § 3439 (describing the movement in several states to limit the ultra vires doctrine); Ham, *Ultra Vires Contracts Under Modern Corporate Legislation*, 46 KY. L.J. 215, 246 (1958) (arguing that legislation curtailing the scope of the ultra vires doctrine is proper). For discussions of the Model Business Corporation Act and its application to intercorporate guaranties, see P. BLUMBERG, *supra* note 1, §§ 6.03-04; Coquillette, *supra* note 4, at 438 & *passim*.

18. See *Emerald Hills Country Club*, 32 Bankr. at 412-14, 417 (seller agreed to forgive a loan, convey interests in property, and provide financing for condominium sales by affiliate of acquired corporation); *Widett v. Pilgrim Trust Co.*, 336 Mass. 738, 743-45, 148 N.E.2d 167, 170-71 (1958) (seller agreed to pay certain debts, provide supplies and advertising, refrain from competition, and permit use of a trade name); *Miller's Shoes & Clothing*, 300 Minn. at 468-69, 221 N.W.2d at 118 (seller agreed to lease property to corporation, pay certain debts, remain on board of directors, and refrain from competition); *cf. Haynie*, 62 Tenn. App. at 44, 458 S.W.2d at 27 (incidental conveyance of property from seller to corporation not consideration for note and mortgage given in buyout).

19. See P. BLUMBERG, *supra* note 1, §§ 4.01-03, 4.19-22, 5.01-11; 3 COLLIER ON BANKRUPTCY ¶ 510.05 (15th ed. 1986) [hereinafter COLLIER]; Chaitman, *The Equitable Subordination of Bank Claims*, 39 BUS. LAW. 1561 (1984); Clark, *The Duties of the Corporate Debtor to Its Creditors*, 90 HARV. L. REV. 505, 517-36 (1977); Hackney & Benson, *Shareholder Liability for Inadequate Capital*, 43 U. PITT. L. REV. 837, 879-90 (1982); Herzog & Zweibel, *The Equitable Subordination of Claims in Bankruptcy*, 15 VAND. L. REV. 83 (1961).

Professor Clark notes that in many cases, equitable subordination performs a function parallel to that of fraudulent conveyance law. See Clark, *supra*, at 517-36. For example, in *Pepper v. Litton*, 308 U.S. 295 (1939), it appeared that the dominant shareholder accumulated salary claims against the

subordinated claim or interest is not invalid, but payment of the claim is postponed until other creditors are paid in full.²⁰ The Bankruptcy Code provides specifically for the subordination remedy in bankruptcy proceedings by authorizing bankruptcy courts to alter the priority of otherwise allowable claims "under principles of equitable subordination."²¹ State courts have exercised comparable powers in cases involving assignments for the benefit of creditors or similar arrangements governed by state law.²²

The remedy of subordination depends on broad principles of equity. Nearly all subordination cases refer to *Pepper v. Litton*,²³ in which the Supreme Court recognized the power of bankruptcy courts to "sift the circumstances surrounding any claim to see that injustice or unfairness is not done."²⁴ Rather

corporation to prevent enforcement of other creditors' claims. *Id.* at 297. Thus, the salary obligation could have been viewed as a fraudulent conveyance, intended to hinder, delay, or defraud creditors. Clark, *supra*, at 527. Clark suggests that the remedy provided in fraudulent conveyance laws (which he terms "constructive distribution") is preferable in many cases to subordination of claims, because it is more precise in correcting the harm done to creditors. *See id.* at 518-26.

20. *Pepper*, 308 U.S. at 310; Herzog & Zweibel, *supra* note 19, at 85-88. Some courts subordinate the claim entirely, postponing any payment to the claimant, while others attempt to limit the subordination remedy to what is necessary to correct harm to particular creditors. *See* Chaitman, *supra* note 19, at 1571-72; Clark, *supra* note 19, at 517-19; Note, *The Deep Rock Doctrine: Inescapable Command or Equitable Remedy?*, 47 COLUM. L. REV. 800, 808-09 (1947). *Compare In re Process-Manz Press*, 236 F. Supp. 333, 348-49 (N.D. Ill. 1964) (when loan was made with intent to defraud, lender's entire claim subordinated to all other creditors' claims), *rev'd on jurisdictional grounds*, 369 F.2d 513 (7th Cir. 1966), *cert. denied*, 386 U.S. 957 (1967) with *Miller v. Borton (In re Bowman Hardware & Elec. Co.)*, 67 F.2d 792, 793-95 (7th Cir. 1933) (creditors induced by false statements entitled to priority over creditor responsible for false statements).

21. 11 U.S.C. § 510(c)(1) (1982). Legislative history indicates this provision was intended to incorporate a series of decisions in which federal courts had subordinated claims as an incident of their general equitable powers in the administration of bankruptcy estates. *See* H.R. REP. NO. 595, 95th Cong., 1st Sess. 359, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6315 (citing *Pepper v. Litton*, 308 U.S. 295 (1939), and *Taylor v. Standard Gas & Elec. Co.*, 306 U.S. 307 (1939)); S. REP. NO. 989, 95th Cong., 2d Sess. 74, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5860.

22. *See, e.g., In re Erie Drug Co.*, 416 Pa. 41, 44-46, 204 A.2d 256, 257-58 (1964); *Gelatt v. DeDakis (In re Mader's Store for Men)*, 77 Wis. 2d 578, 600-03, 254 N.W.2d 171, 184-85 (1977).

23. 308 U.S. 295 (1939).

24. *Id.* at 308. In *Pepper* a controlling shareholder caused the corporation to accumulate large debts to himself for overdue salary and to confess judgment. The shareholder then executed on the judgment to shield corporate assets from claims of other creditors. The combination of this and other

than setting specific rules for subordination, the Court stated that a bankruptcy court should subordinate claims according to "rules of fair play and good conscience."²⁵

In most cases subordination is based on abuse of control by an insider.²⁶ The claim of a corporate officer, director, or shareholder is subjected to close scrutiny whenever it competes with claims of other creditors. If the insider obtains the claim fairly, in an arms-length transaction, it is valid and enforceable on the same terms as other claims.²⁷ But if the insider claimant acts inequitably in connection with the claim or the corporation generally, and this conduct harms creditors, the insider is subordinated to general creditors.²⁸

Certain facts or combinations of facts are mentioned frequently in subordination cases and indicate what courts are likely to view as inequitable.²⁹ Typically, these facts relate to

manipulative conduct, by one in a fiduciary relationship to the corporation, led the Court to approve an order subordinating the shareholder's claim. *See id.* at 297-99, 311-12.

25. *Id.* at 310. The Court's only specific guidance was its reference to several sets of circumstances that might support subordination. The Court mentioned "dominancy and exploitation"; use of a business entity as the "corporate pocket of the dominant shareholder"; and a purely "nominal" amount of paid-in capital, "the capital necessary for the scope and magnitude of the operations of the company being furnished by the stockholder as a loan." *Id.* at 309-10.

26. *See Comstock v. Group of Institutional Investors*, 335 U.S. 211, 228-29 (1948); *Pepper*, 308 U.S. at 306-10; *Taylor v. Standard Gas & Elec. Co.*, 306 U.S. 307, 322-23 (1939); 3 COLLIER, *supra* note 19, ¶ 510.05[3]; *Clark, supra* note 19, at 517-18. Courts have not limited subordination and the equitable concepts that support it to insiders. Subordination of the claim of an outside creditor, however, is likely to depend on clear fraud, such as intentional or reckless misrepresentation to other creditors. *See, e.g., Miller v. Borton (In re Bowman Hardware & Elec. Co.)*, 67 F.2d 792, 795 (7th Cir. 1933); *Herzog & Zweibel, supra* note 19, at 93-112 (each category of subordination cases, with the exceptions of fraud and illegality, involves claimants in positions of control).

27. *See Comstock*, 335 U.S. at 229; *Twin-Lick Oil Co. v. Marbury*, 91 U.S. 587, 589 (1875); *R.J. Enstrom Corp. v. Interceptor Corp.*, 555 F.2d 277, 283 (10th Cir. 1977); *Wood v. Richmond (In re Branding Iron Steak House)*, 536 F.2d 299, 301 (9th Cir. 1976); *In re Madelaine, Inc.*, 164 F.2d 419, 420 (2d Cir. 1947); 3 COLLIER, *supra* note 19, ¶ 510.05[3][a]; 12B W. FLETCHER, *supra* note 13, § 5739.

28. *See Comstock*, 335 U.S. at 228-29; *Pepper*, 308 U.S. at 306-10; *Machinery Rental v. Herpel (In re Multiponics)*, 622 F.2d 709, 713 (5th Cir. 1980); *Benjamin v. Diamond (In re Mobile Steel Co.)*, 563 F.2d 692, 700 (5th Cir. 1977).

29. A survey of cases in a leading article on subordination traces recurring patterns likely to result in subordination. *See Herzog & Zweibel, supra* note 19, at 90. The authors list consensual subordination; loans made by shareholders to an undercapitalized corporation; fraud, such as misrepresentations to other creditors; illegality in connection with the claim; breach of fiduciary duty by the claimant; and the claimant's use of the corporate debtor as an instrumentality or alter ego (at least when combined with an elusive additional element of bad faith or mismanagement). *See id.* at 90-112.

mismanagement or bad faith in dealing with other creditors.³⁰ One circumstance courts emphasize is inadequate capitalization of a corporate debtor.³¹ In this situation courts reason that loans made by shareholders to a corporation with only a thin or nominal amount of capital should be treated as capital contributions in a contest between the shareholders and general creditors.³²

If inadequate capital refers to insufficient capital contributions at the time of incorporation,³³ it is not relevant to the problems of most buyout cases. Some courts, however, have found inadequate capital based on a lack of capital assets at the time the debts were incurred.³⁴ On that view, if a buyout leaves the corporation without the resources to sustain its business and pay creditors, a court might subordinate shareholder claims arising from the buyout.³⁵

30. *See id.*

31. *See Pepper*, 308 U.S. at 310; *Multiponics*, 622 F.2d at 716-20; *Mobile Steel Co.*, 563 F.2d at 702-04; *Brown v. Freedman*, 125 F.2d 151, 156 (1st Cir. 1942); 3 COLLIER, *supra* note 19, ¶ 510.05[4][a]; *Hackney & Benson*, *supra* note 19, at 881-83; *Herzog & Zweibel*, *supra* note 19, at 93-98.

32. *See* sources cited *supra* note 31.

33. Some cases suggest that capital in this context refers not to general working capital but to the initial investment made by shareholders. *See Pepper*, 308 U.S. at 310 ("paid-in" capital); *Costello v. Fazio*, 256 F.2d 903, 907 (9th Cir. 1955); *Hackney & Benson*, *supra* note 19, at 898-99 (adequacy of capital generally should be determined as of "the beginning period of corporate existence," but a substantial expansion of the business might require additional capital contributions).

34. *See Multiponics*, 622 F.2d at 717-19; *Mobile Steel Co.*, 563 F.2d at 703; *In re Trimble Co.*, 479 F.2d 103, 116 (3d Cir. 1973). At least in the context of a buyout, when the effect of the transaction is to withdraw capital, it is appropriate to consider the adequacy of capital remaining after the transaction. This does not impose a general duty on shareholders to maintain a certain level of capital or to bail out a failing corporation. In the context of subordination, it means only that shareholders may not deal with the corporation on inequitable terms when it is in precarious financial condition. *See Multiponics*, 622 F.2d at 718-19.

35. Some courts have tested the adequacy of capital by reference to the corporation's ability to borrow from other sources. In *Mobile Steel Co.*, for example, the court stated that capital is inadequate if initial capital contributions were insufficient to support the anticipated business, or if, "at the time when the advances were made, the bankrupt could not have borrowed a similar amount of money from an informed outside source." 563 F.2d at 703; *see Multiponics*, 622 F.2d at 719; *Trimble Co.*, 479 F.2d at 116. In the context of a buyout, however, this standard may not adequately protect the interests of general creditors. A corporation heavily indebted to unsecured creditors nevertheless may be able to borrow on a secured basis from outside sources. A loan made in these circumstances would not be prejudicial to creditors if the lender provided cash or property to the corporation. But in the case of a leveraged buyout or stock redemption, when the borrowing produces no new assets

Some courts refuse to subordinate claims solely on the basis of inadequate capital but will do so if the capital deficiency is combined with some further circumstance that makes the claim in question inequitable as against other creditors.³⁶ Several courts have found this additional element of inequity in a conversion of equity to debt.³⁷ Because the principal effect of a leveraged buyout is to substitute a secured debt for the sellers' equity in the corporation, this reasoning applies to shareholders' claims arising from a buyout. Another inequitable circumstance that may be relevant in buyout cases is breach of the fiduciary duties that the insider claimant owes to the corporation, either in connection with the claim or in "reasonable proximity" to financial collapse.³⁸

for the corporation, creditors may be harmed regardless of the availability of outside financing. In these situations a better test of adequate capital is whether the corporation is left with sufficient assets to pay present and anticipated debts.

For discussion of adequate capitalization in connection with shareholders' limited liability, see Campbell, *Limited Liability for Shareholders: Myth or Matter-of-Fact*, 63 Ky. L.J. 23, 39-41 (1975); Hackney & Benson, *supra* note 19, at 891-98 (comparing subordination with disregard of corporate entity).

36. See Wood v. Richmond (*In re Branding Iron Steak House*), 536 F.2d 299 (9th Cir. 1978); *Costello*, 256 F.2d at 908-11; Rego Crescent Corp. v. Tymon (*In re Rego Crescent Corp.*), 23 Bankr. 958, 965-66 (Bankr. E.D.N.Y. 1982); 3 COLLIER, *supra* note 19, ¶ 510.05[4][a]; Clark, *supra* note 19, at 534-36 & n.82; Hackney & Benson, *supra* note 19, at 883-88; Macey, *No Fault Subordination of Loans in Bankruptcy*, 85 COM. L.J. 44, 45-56 (1980); see also Anderson v. A.F. Walker & Son (*In re A.F. Walker & Son*), 46 Bankr. 186, 189-90 (Bankr. D.N.H. 1985). In *A.F. Walker & Son*, the court described the "evolving standard" by which an insider's loan will be treated as a capital contribution: if the insider dominated the corporation and was aware of financial difficulty; if the loan was not likely to be repaid in the ordinary course and payment depended on a business turnaround; and if recognition of the insider's claim would give the insider an unfair advantage. See *id.*

37. In *Costello*, for example, partners dissolved their partnership, withdrew substantial capital contributions, and then incorporated the business with a small amount of capital. The business was in financial difficulty at the time, so that the reduction of capital was prejudicial to creditors. The court found this sufficient to justify subordination, although it implied that it would not subordinate a claim solely on the basis of inadequate capitalization. See 256 F.2d at 908-11; see also Reiner v. Washington Plate Glass Co. (*In re Washington Plate Glass Co.*), 27 Bankr. 550, 551-52 (D.D.C. 1982) (shareholder caused corporation to redeem shares, taking a note for the redemption price), remanded for consideration of state law without discussion of subordination, 711 F.2d 414 (D.C. Cir. 1983); 3 COLLIER, *supra* note 19, ¶ 510.05[4][c].

38. See *Pepper*, 308 U.S. at 306-10 (emphasizing fiduciary relationship and breach of duty); *Mobile Steel Co.*, 563 F.2d at 700 (quoting *Bostian v. Schapiro* (*In re Kansas City Journal-Post Co.*), 144 F.2d 791, 804 (8th Cir. 1944)); *Seder v. Gibbs*, 333 Mass. 445, 452-53, 131 N.E.2d 376, 380-81 (1956). See generally Herzog & Zweibel, *supra* note 19, at 98-102. The possible fiduciary responsibil-

This discussion has focused on subordination of claims acquired by selling shareholders in an internally financed buyout. Because subordination cases typically emphasize abuse of control by insiders and breach of fiduciary duty, it is less likely that a court would subordinate the claims of an outside lender who finances a buyout.³⁹ A passive lender who does not participate in control of the corporation is not among the parties traditionally considered insiders or fiduciaries of a corporation.⁴⁰ In some circumstances, however, it is possible that a court would treat a lending institution as an insider for purposes of subordination. For example, a lender might assume the status of an insider if it obtains a pledge of shares as part of the security for its advances and then exercises rights of control incidental to the shares.⁴¹

ities of shareholders in connection with a buyout are discussed *infra* notes 42-49 and accompanying text.

The text mentions two categories of cases in which courts have subordinated claims—those involving undercapitalization and those involving breach of fiduciary duty. It is also possible that claims incurred in a leveraged buyout might be subordinated on grounds of fraud or illegality if courts determine that the transaction is a fraudulent conveyance. In that case, however, the claims would be avoidable and equitable subordination would be redundant.

39. See Chaitman, *supra* note 19, at 1565-71.

40. See, e.g., *Cosoff v. Rodman (In re W.T. Grant Co.)*, 699 F.2d 599, 609 (2d Cir. 1983); cf. 11 U.S.C. § 101(28) (Supp. III 1985) (definition of insider in Bankruptcy Code). See generally H. HENN & J. ALEXANDER, *LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES* § 235 (3d ed. 1983) (discussing officers, directors, and controlling shareholders as corporate fiduciaries).

41. In *In re Process-Manz Press*, 236 F. Supp. 333 (N.D. Ill. 1964), *rev'd on jurisdictional grounds*, 369 F.2d 513 (7th Cir. 1966), *cert. denied*, 386 U.S. 957 (1967), a financing company with no prior relationship to the debtor corporation loaned money to the corporation in connection with a buyout. The lender obtained a pledge of corporate shares, as well as a mortgage of corporate assets. Subsequently, it assumed control of corporate affairs. Among other maneuvers the lender caused the corporation to redeem stock and manipulated corporate assets in ways that strengthened its own position at the expense of other creditors. *Id.* at 336-44. The court determined both that the security interests given by the corporation to the lender were fraudulent conveyances, see *id.* at 346-48, and that all claims asserted by the lender should be subordinated to claims of general creditors, see *id.* at 348-49. With respect to subordination, the court determined that the lender "was not a secured creditor but in substance the owner" of the corporation, *id.* at 348, and that the lender's "control, domination, spoliation, ownership and breach of fiduciary duty" justified subordination of its claims, *id.* at 349.

A buyout often involves a pledge of stock of the acquired corporation, but an institutional lender generally would not exercise active control of the corporation as in *Process-Manz*.

3. Breach of Fiduciary Duty

Use of corporate assets to finance an acquisition of corporate shares may violate fiduciary duties owed to the corporation by the buyers and sellers as majority shareholders. The fiduciary responsibility of controlling shareholders in disposing of their shares is widely recognized.⁴² One fiduciary standard often cited is that

the owners of control are under a duty not to transfer it to outsiders if the circumstances surrounding the proposed transfer are such as to awaken suspicion and put a prudent man on his guard—unless a reasonably adequate investigation discloses such facts as would convince a reasonable person that no fraud is intended or likely to result.⁴³

Under this standard, selling shareholders have been held liable for negligence in selling their controlling shares to buyers who were likely to loot or mismanage the corporation.⁴⁴ The same principle can apply to a buyout in which the sellers know the transaction will encumber the corporate assets to such an extent as to leave the corporation in unsound financial condition.⁴⁵ The buyers also can be charged with breach of fiduciary

42. See *Doleman v. Meiji Mut. Life Ins. Co.*, 727 F.2d 1480, 1483 (9th Cir. 1984); *Swinney v. Keebler Co.*, 480 F.2d 573, 577-78 (4th Cir. 1973); *Estate of Hooper v. Virgin Islands*, 427 F.2d 45, 47 (3d Cir. 1970); *United States v. Gleneagles Inv. Co.*, 565 F. Supp. 556 (M.D. Pa. 1983), *aff'd sub nom. United States v. Tabor Court Realty Corp.*, 803 F.2d 1288 (3d Cir. 1986), *cert. denied*, 107 S. Ct. 3229 (1987); *Insuranshares Corp. v. Northern Fiscal Corp.*, 35 F. Supp. 22, 25 (E.D. Pa. 1940); *DeBaun v. First W. Bank & Trust Co.*, 46 Cal. App. 3d 686, 696-97, 120 Cal. Rptr. 354, 359-60 (1975). *But see Levy v. American Beverage Corp.*, 265 A.D. 208, 218-19, 38 N.Y.S.2d 517, 526-27 (App. Div. 1942). See generally 12B W. FLETCHER, *supra* note 13, § 5805 (covering sale of controlling shares); H. HENN & J. ALEXANDER, *supra* note 40, § 241; Brudney, *Fiduciary Ideology in Transactions Affecting Corporate Control*, 65 MICH. L. REV. 259, 294-99 (1966) (discussing insiders' obligations when selling controlling shares); O'Neal, *Sale of a Controlling Corporate Interest: Bases of Possible Seller Liability*, 38 U. PITT. L. REV. 9, 16-23 (1976) (describing doctrines courts have applied in cases involving sale of control).

43. *Insuranshares Corp.*, 35 F. Supp. at 25.

44. See *id.* at 28; *DeBaun*, 46 Cal. App. 3d at 696-97, 120 Cal. Rptr. at 360-61; Brudney, *supra* note 42, at 295; O'Neal, *supra* note 42, at 16-23; see also *Levy*, 265 A.D. at 218-19, 38 N.Y.S.2d at 526-27 (refusing to impose a duty on controlling shareholders to investigate purchasers, but suggesting sellers who knew that buyers would loot the corporation would be liable).

45. In *Gleneagles* the court held that selling shareholders who participated in a leveraged buyout were liable to corporate creditors for breach of fiduciary duty. See 565 F. Supp. at 584. In several other cases, the sellers' awareness that buyers intended to use corporate assets to finance the purchase was at least an important influence in holding the sellers liable for breach of duty. See *Swinney v. Keebler Co.*, 329 F. Supp. 216, 224 (D.S.C. 1971), *rev'd*, 480 F.2d 573 (4th Cir. 1973) (reversing on the ground that the sellers did not know or have reason to know of the buyers' intentions); *Insuranshares Corp.*,

responsibility based on their appropriation of corporate assets for use in the buyout.⁴⁶

The main question in applying fiduciary principles to a buyout is whether the fiduciary duties of controlling shareholders run not only to the corporation and minority shareholders but also to creditors of the corporation. Some courts have held that creditors, having no proprietary interest in the corporation, cannot recover on this ground.⁴⁷ Others have extended the right to recover for breach of fiduciary duty to creditors, allowing them (or a trustee in bankruptcy) to recover damages from the buying and selling shareholders if harm to creditors was foreseeable.⁴⁸ On the other hand, courts are not likely to

35 F. Supp. at 25; *see also* Dale v. Thomas H. Temple Co., 186 Tenn. 69, 85-93, 208 S.W.2d 344, 351-54 (1948) (holding selling shareholders liable on grounds of fraud and conspiracy when they had reason to know buyers would use corporate assets to pay purchase price).

46. *Cf.* Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 10-14 (1971) (buyer's arrangement to sell bonds owned by corporation to fund purchase of shares was both a breach of fiduciary duty and a fraud in the sale of securities (the bonds) under Rule 10b-5); Dale, 186 Tenn. at 85-86, 88, 208 S.W.2d at 351, 353 (on appeal of judgment against sellers for conspiracy and fraud, court assumed buyers had misappropriated corporate assets in using them to pay purchase price of shares). In Dale the diversion of corporate funds to pay for shares was less direct than in most buyouts. Apparently, the buyers caused the acquired corporation to form a subsidiary, to which it supplied oil on credit. The subsidiary then loaned proceeds of its sale of the oil to a holding company controlled by the buyers, which used the money to pay the sellers. *Id.* at 88, 208 S.W.2d at 353.

47. At least in cases involving mismanagement by officers and directors, this view has some following. *See* Sutton v. Regan & Lee, 405 S.W.2d 828, 835 (Tex. Civ. App. 1966); Equitable Life & Casualty Ins. Co. v. Inland Printing Co., 26 Utah 2d 19, 21, 484 P.2d 162, 163-64 (1971); H. BALLANTINE, BALLANTINE ON CORPORATIONS § 72a (rev. ed. 1946). If the majority shareholders participated in a leveraged buyout without the consent of the minority, the minority presumably could recover for the dilution of the value of their shares.

48. *See* Gleneagles, 565 F. Supp. at 584; Swinney, 329 F. Supp. at 224; 3A W. FLETCHER, *supra* note 13, § 1182.

The problem of creditors' standing to assert claims against corporate principals for breach of fiduciary duty is discussed in Campbell, *supra* note 35, at 55-70. Professor Campbell advocates the extension of rights and remedies for breach of duty to creditors as well as to minority shareholders, because both have interests in the corporation that have been harmed by activities beyond their control. *See id.* at 64-65. Further, creditors ultimately can reach an errant corporate fiduciary through a trustee in bankruptcy, who succeeds to the rights of the corporation. *Id.* at 68-70; *see* 11 U.S.C. §§ 323(a), 541, 704(1) (1982 & Supp. III 1985); 4 COLLIER, *supra* note 19, ¶ 541.10. On the other hand, a bankruptcy trustee's right of action for breach of fiduciary duty by shareholders who use corporate assets to finance a buyout should be limited to cases in which either there are minority shareholders or the corporation is left without adequate finances to sustain its business and pay creditors. If neither creditors nor minority shareholders are harmed, the transaction should not be viewed

hold an outside lender accountable to creditors for breach of duty unless the lender assumes a position of control that justifies treating it as a fiduciary.⁴⁹

4. Comment and Comparison to Fraudulent Conveyance Law

Each of the legal theories discussed in the preceding sections is potentially applicable to a buyout, but none provide a complete solution. The ultra vires doctrine is outdated and goes beyond what is necessary to protect the fair expectations of creditors. Although the courts' primary objective in applying the doctrine has been to protect creditors,⁵⁰ the concept of ultra vires acts is not well suited to this purpose. The ultra vires doctrine is not limited to situations of insolvency or precarious financial condition⁵¹ and therefore can affect transactions that were not, at the time they occurred, destructive of creditors' rights to an adequate source of payment. The doctrine thus places an unnecessary limit on the freedom of action that modern corporate legislation generally gives to corporations and their principals.

Principles of equitable subordination and fiduciary duty are useful in dealing with special circumstances of unfairness in a particular transaction. They do not, however, provide predictable standards of conduct for the parties to a buyout and they may be too limited in their application to protect creditors adequately. Further, neither relates in normal circumstances to an outside lender.⁵²

as a breach of duty to the entity. As one author has stated, "[t]he actual restrictions on, or prescriptions for, the fiduciary's conduct in any particular context are to be found more in the reasons for characterizing him as a fiduciary in that context than in any rules or articulated proscriptions derived from the mere fact of such a characterization." Brudney, *supra* note 42, at 259. "[F]unctional considerations do, and should, qualify the operation of fiduciary ideology in the corporate field . . ." *Id.* at 299.

49. See *supra* notes 40-41 and accompanying text.

50. This is suggested by the estoppel cases, which hold that if no creditors have been harmed, the corporation or consenting shareholders cannot object that a contract or conveyance was beyond corporate power. See *supra* note 15.

51. The ultra vires doctrine does not acknowledge a point at which creditors' interests in preserving corporate assets give way to the interest of the corporation and its shareholders in disposing of assets. Most decisions that apply the doctrine to corporate transfers for the benefit of third parties state simply that if the corporation receives no consideration for a transaction, the transaction is outside corporate purposes and powers. See, e.g., *Pantaze v. Murphy (In Re Nugrape Bottling Co.)*, 54 F.2d 895, 896 (5th Cir.), *cert. denied*, 287 U.S. 661 (1932).

52. Creditors might use several other theories to challenge corporate transfers in buyouts. For example, the transaction may be challenged as an

Fraudulent conveyance law is better suited than any of these theories to govern creditors' rights in most buyout cases. Fraudulent conveyance statutes address the specific problems of a buyout, inadequate consideration and adverse financial circumstances. Further, at least under the more detailed forms of legislation, they provide a statutory definition of the point at which the financial circumstances of the corporation cause a transfer without consideration to infringe on creditors' rights. Thus, the basic question of where the economic consequences of a buyout should fall should be addressed in terms of fraudulent conveyance law.

B. FRAUDULENT CONVEYANCE LAWS

Both state law and the federal Bankruptcy Code⁵³ protect creditors from transfers of property that are fraudulent in the sense that the transfers are intended to impair creditors' ability to enforce their rights to payment⁵⁴ or have the effect of depleting a debtor's assets at a time when its financial condition is precarious.⁵⁵ Laws governing fraudulent conveyances generally are statutory. The remedy provided to creditors, or to a bankruptcy trustee on creditors' behalf, is to avoid the transfer and recover the property or its value from transferees.⁵⁶

unlawful distribution to shareholders, or an unlawful redemption of shares, under statutes that limit the circumstances in which a corporation may take such action. See *Libco Corp. v. Leigh (In re Reliable Mfg. Corp.)*, 703 F.2d 996, 1000-01 (7th Cir. 1983); *Gleneagles*, 565 F. Supp. at 585; P. BLUMBERG, *supra* note 1, § 6.07.2; Coquillotte, *supra* note 4, at 446-48. Another theory sometimes raised is that the transfer lacks consideration in the sense required for a valid contract or security agreement. This argument fails quickly, because the benefit given to third parties (here, the purchasing and selling shareholders) is sufficient to support a contract or security interest. See *Reliable Mfg. Corp.*, 703 F.2d at 999-1000; *Cechettini v. Consumer Assocs.*, 260 Cal. App. 2d 295, 298, 67 Cal. Rptr. 15, 17 (1968); RESTATEMENT (SECOND) OF CONTRACTS § 71(4) & comment e (1979).

53. 11 U.S.C. §§ 101-1501 (1982 & Supp. III 1985). The section of the Bankruptcy Code relating to fraudulent conveyances is 11 U.S.C. § 548 (1982 & Supp. III 1985).

54. See 11 U.S.C. § 548(a)(1) (1982 & Supp. III 1985); UNIF. FRAUDULENT CONVEYANCE ACT (UFCA) § 7, 7A U.L.A. 427, 509 (1985).

55. See 11 U.S.C. § 548(a)(2) (1982 & Supp. III 1985); UFCA §§ 4-6, 7A U.L.A. 427, 474, 504, 507 (1985).

56. See 11 U.S.C. §§ 548(a), 550(a) (1982 & Supp. III 1985); UFCA § 9(1), 7A U.L.A. 427, 577-78 (1985).

There is some question whether the remedy extends to creditors whose claims arose after the transaction or is limited to creditors who had claims at the time of the transaction. See *Credit Managers Ass'n v. Federal Co.*, 629 F. Supp. 175, 180-81 (C.D. Cal. 1986); 11 U.S.C. § 548(a) (1982 & Supp. III 1985) (bankruptcy trustee can avoid certain transfers whether or not any current

The origins of modern fraudulent conveyance law can be traced to the English Statute of Elizabeth enacted in 1570⁵⁷ and possibly to earlier principles of common law.⁵⁸ The Statute of Elizabeth provided for avoidance of any conveyance made "to the End, Purpose and Intent to delay, hinder or defraud creditors."⁵⁹ In a saving provision, the statute provided that it did not apply to a good faith transferee for value.⁶⁰ The substance of this statute was either enacted by American states or incorporated into their common law.⁶¹

Although the language of early fraudulent conveyance statutes emphasized intent to defraud, courts typically relied on particular circumstances or transactional patterns ("badges of fraud") as presumptive evidence of fraudulent intent.⁶² For example, lack of consideration for a transfer, at least when combined with insolvency, raised a presumption of fraud that courts sometimes treated as conclusive.⁶³ Presumptions of this

creditors had claims when the transfer occurred); UFCA § 4, 7A U.L.A. 427, 474 (1985) (no mention of subsequent creditors); *id.* §§ 5-6, 7A U.L.A. at 504, 507 (avoidable by subsequent creditors); UNIF. FRAUDULENT TRANSFER ACT (UFTA) § 4, 7A U.L.A. 639, 652-53 (1985) (avoidable by subsequent creditors); *id.* § 5, 7A U.L.A. at 657 (limited to existing creditors); 1 G. GLENN, FRAUDULENT CONVEYANCES & PREFERENCES §§ 317-325, 334-335 (1940); Carlson, *supra* note 2, at 117-20. In a buyout the corporation's obligations to the lender should be on public record, but not all subsequent creditors are in a position to review the record and discover the liability before dealing with the corporation. Some may be involuntary creditors; some may extend credit voluntarily, but in circumstances in which a review of corporate obligations is not customary or cost-efficient.

57. Ch. 5 (1570).

58. See generally 1 G. GLENN, *supra* note 56, §§ 58-61d; 1 J. STORY, COMMENTARIES ON EQUITY JURISPRUDENCE §§ 474-477 (14th ed. 1918).

59. Ch. 5, § 1 (1570). Under the original English statute, property received from a transferee was divided between the injured creditor and the Crown. 1 G. GLENN, *supra* note 56, § 1b.

60. The Statute of Elizabeth stated:

[T]his Act . . . shall not extend to any Estate or Interest . . . conveyed . . . which Estate or Interest, is or shall be upon good Consideration and *bona fide*, lawfully conveyed . . . to any Person . . . not having at the Time of such Conveyance . . . any manner of Notice or Knowledge of such Covin, Fraud or Collusion . . .

Ch. 5, § 6 (1570).

61. 1 G. GLENN, *supra* note 56, § 58.

62. See *Twyne's Case*, 76 Eng. Rep. 809, 812-14 (Star Chamber 1601); UFCA prefatory note, 7A U.L.A. 427, 428 (1985); UFTA prefatory note, 7A U.L.A. 639, 639 (1985); 4 COLLIER, *supra* note 19, ¶ 548.02[5] (collecting "[c]ircumstances from which courts have been willing to infer fraud"); 1 G. GLENN, *supra* note 56, § 305.

63. See 1 G. GLENN, *supra* note 56, §§ 268-269; 1 J. STORY, *supra* note 58, § 476; McLaughlin, *Application of the Uniform Fraudulent Conveyance Act*, 46 HARV. L. REV. 404, 407-08 (1933).

kind permitted objective proof of fraud but also produced confusion in the law as courts adopted differing sets of specific rules.⁶⁴

This confusion led to the drafting of the Uniform Fraudulent Conveyance Act (UFCA)⁶⁵ and similar provisions in federal bankruptcy laws, which clarify the circumstances in which fraud should be presumed. Currently, twenty-two states have adopted the UFCA, and eight have adopted a revised version of the uniform law.⁶⁶ Others retain the older form of statute patterned on the Statute of Elizabeth.⁶⁷ The federal Bankruptcy Code contains both substantive fraudulent conveyance rules and a provision enabling the bankruptcy trustee to proceed according to applicable state law.⁶⁸ This Article assumes that the UFCA is in force, so that transfers that are prejudicial to creditors are subject to challenge under either the UFCA or the Bankruptcy Code.

1. Uniform Fraudulent Conveyance Act

The UFCA defines four categories of transactions that are fraudulent and avoidable by creditors. The first three are rules

64. UFCA prefatory note, 7A U.L.A. 427, 428 (1985); see 1 G. GLENN, *supra* note 56, § 266.

65. See UFCA prefatory note, 7A U.L.A. 427, 428 (1985).

66. UFCA table of jurisdictions wherein Act has been adopted, 7A U.L.A. 31, 31 (Supp. 1987); UFTA table of jurisdictions wherein Act has been adopted, 7A U.L.A. 40, 40 (Supp. 1987). The revised Uniform Law, titled the Uniform Fraudulent Transfer Act (UFTA), is discussed *infra* in the text accompanying notes 83-88.

67. See, e.g., COLO. REV. STAT. § 38-10-117 (1982); CONN. GEN. STAT. ANN. § 52-551 (West 1960); ILL. ANN. STAT. ch. 59, ¶ 4 (Smith-Hurd Supp. 1987).

68. Section 544(b) of the Bankruptcy Code, 11 U.S.C. § 544(b) (1982 & Supp. III 1985), gives the trustee a general power to avoid "any transfer of an interest of the debtor in property . . . that is voidable under applicable law by a creditor," with minor limitations. Thus, if any creditor would have had rights under state fraudulent conveyance law if the debtor were not in bankruptcy, the trustee can proceed under state as well as federal fraudulent conveyance provisions. This parallel state law remedy increases the time in which the trustee can challenge a transfer. The fraudulent conveyance provisions of the Bankruptcy Code are limited to transfers made within one year before bankruptcy proceedings commenced. 11 U.S.C. § 548(a) (1982 & Supp. III 1985). State periods of limitations, by contrast, may be as great as six years. See, e.g., *Moseley v. Briggs Realty Co.*, 320 Mass. 278, 285, 69 N.E.2d 7, 12 (1946). When the trustee asserts a state law claim under § 544(b), the state statute of limitation applies. See, e.g., *Anderson v. A.F. Walker & Son* (*In re A.F. Walker & Son*), 46 Bankr. 186, 187-88 (Bankr. D.N.H. 1985); 4 COLLIER, *supra* note 19, ¶¶ 544.03[2], 548.02[2]. There are also some substantive differences between the Bankruptcy Code provisions and the UFCA. See *infra* notes 79-82 and accompanying text.

of constructive fraud, which define circumstances in which transfers are deemed fraudulent whether or not the transferor actually intends to defraud creditors. Each form of constructive fraud is based on a combination of insufficient consideration for the transfer and unsound financial condition of the transferor. Specifically, the transfer is deemed fraudulent if it is made without fair consideration and, at the time of the transaction, the transferor either is insolvent or is rendered insolvent, is in business and is left with unreasonably small capital, or anticipates incurring debts beyond its ability to pay.⁶⁹ These constructive fraud provisions replace the system of judicial presumptions of fraudulent intent that developed under the Statute of Elizabeth.⁷⁰ The UFCA retains the general concept of intentional fraud, however, in a fourth provision that permits creditors to recover property conveyed with actual intent to hinder, delay, or defraud.⁷¹ Although this provision distinguishes intentional fraud from "intent presumed in law," courts still may infer intentional fraud from the circumstances of a transfer.⁷²

69. UFCA §§ 4-6, 7A U.L.A. 427, 474, 504, 507 (1985). The three constructive fraud sections provide as follows:

§ 4. Conveyances By Insolvent

Every conveyance made and every obligation incurred by a person who is or will be thereby rendered insolvent is fraudulent as to creditors without regard to his actual intent if the conveyance is made or the obligation is incurred without a fair consideration.

§ 5. Conveyances By Persons In Business

Every conveyance made without fair consideration when the person making it is engaged or is 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 as to creditors and as to other persons who become creditors during the continuance of such business or transaction without regard to his actual intent.

§ 6. Conveyances By A Person About To Incur Debts

Every conveyance made and every obligation incurred without fair consideration when the person making the conveyance or entering into the obligation intends or believes that he will incur debts beyond his ability to pay as they mature, is fraudulent as to both present and future creditors.

Id.

70. See *id.* prefatory note, 7A U.L.A. at 428; Note, *Good Faith & Fraudulent Conveyances*, 97 HARV. L. REV. 495, 496-99 (1983).

71. See UFCA § 7, 7A U.L.A. 427, 509 (1985). The intentional fraud section of the UFCA provides: "Every conveyance made and every obligation incurred with actual intent, as distinguished from intent presumed in law, to hinder, delay, or defraud either present or future creditors, is fraudulent as to both present and future creditors." *Id.*

72. One author has argued that the constructive fraud provisions of the UFCA were intended to exclude all other presumptions of fraud, either con-

The constructive fraud provisions of the UFCA are supplemented by definitions of fair consideration and insolvency. Fair consideration for a conveyance of property or the assumption of an obligation requires both a fair equivalent given in exchange and good faith in making the exchange.⁷³ The definition of insolvency focuses on the ability of the transferor to pay debts as they mature.⁷⁴

Two saving provisions of the UFCA protect innocent transferees and subtransferees who give value for property conveyed in fraud of creditors. On the face of the statute, these provisions apply to both intentional and constructive fraud. Creditors cannot recover from a "purchaser for fair consideration

clusive or evidentiary. See McLaughlin, *supra* note 63, at 423-26. Nevertheless, because of the difficulty of proving subjective intent, courts tend to rely on objective indicia of intent. See *Consove v. Cohen (In re Roco Corp.)*, 701 F.2d 978, 984 (1st Cir. 1983) (considering circumstantial evidence); *Gleneagles*, 565 F. Supp. at 581 (proof of motive not required to establish intentional fraud when lack of consideration and financial position of transferor made effect on creditors foreseeable); 4 COLLIER, *supra* note 19, ¶ 548.02[5]; 2 D. COWANS, BANKRUPTCY LAW AND PRACTICE § 10.9 (3d ed. 1986).

73. UFCA § 3(a), 7A U.L.A. 427, 448 (1985). The full definition is as follows:

§ 3. Fair Consideration

Fair consideration is given for property, or obligation,

(a) When in exchange for such property, or obligation, as a fair equivalent therefor, and in good faith, property is conveyed or an antecedent debt is satisfied, or

(b) When such property, or obligation is received in good faith to secure a present advance or antecedent debt in amount not disproportionately small as compared with the value of the property, or obligation obtained.

Id. § 3, 7A U.L.A. at 448-49.

The alternative statement of fair consideration in subsection (b), which applies to transfers made for security, has been criticized. See UFTA prefatory note, 7A U.L.A. 639, 641 (1985); Rosenberg, *supra* note 6, at 246-47. The value of a lien cannot exceed the debt it secures, regardless of the value of the property it encumbers. Therefore, the advance of funds given by the lender should be a fair consideration for the lien unless the face value of the obligation secured is greater than the amount actually advanced. In any event the impact of the special definition applicable to security transfers is lessened by a saving provision that allows a transferee who gives less than fair consideration for a transfer, but without fraudulent intent, to retain what the transferee received as security for repayment of the consideration paid. See UFCA § 9(2), 7A U.L.A. 427, 578 (1985); *infra* notes 75-76 and accompanying text.

74. See *Larrimer v. Feeney*, 411 Pa. 604, 608, 192 A.2d 351, 353 (1963); UFCA § 2, 7A U.L.A. 427, 442-43 (1985). The relevant portion of the definition of insolvency provides: "A person is insolvent when the present fair salable value of his assets is less than the amount that will be required to pay his probable liability on his existing debts as they become absolute and matured." *Id.*

without knowledge of the fraud."⁷⁵ A transferee who pays less than fair consideration, but who does so "without actual fraudulent intent," retains a lien to secure repayment of the consideration paid.⁷⁶ These provisions are analogous to protective limitations developed in interpretation of the Statute of Elizabeth and similar statutes.⁷⁷

2. Bankruptcy Code

The fraudulent conveyance provisions of the Bankruptcy Code, following the basic pattern of the UFCA, authorize a trustee in bankruptcy to avoid transfers that are intended to defraud creditors or that fall within three categories of constructive fraud.⁷⁸ As in the UFCA, constructive fraud depends

75. UFCA § 9(1), 7A U.L.A. 427, 577 (1985).

76. *Id.* § 9(2), 7A U.L.A. at 578. The full section provides:

(1) Where a conveyance or obligation is fraudulent as to a creditor, such creditor, when his claim has matured, may, as against any person except a purchaser for fair consideration without knowledge of the fraud at the time of the purchase, or one who has derived title immediately or mediately from such a purchaser,

(a) Have the conveyance set aside or obligation annulled to the extent necessary to satisfy his claim, or

(b) Disregard the conveyance and attach or levy execution upon the property conveyed.

(2) A purchaser who without actual fraudulent intent has given less than a fair consideration for the conveyance or obligation, may retain the property or obligation as security for repayment.

Id. § 9, 7A U.L.A. at 577-78.

77. See 1 G. GLENN, *supra* note 56, §§ 233-236a.

78. See 11 U.S.C. § 548(a) (1982 & Supp. III 1985). Section 548(a) defines the four types of fraudulent conveyance as follows:

(a) The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor voluntarily or involuntarily—

(1) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or

(2)(A) received less than a reasonably equivalent value in exchange for such transfer or obligation; and

(B)(i) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;

(ii) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or

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

on lack of adequate consideration for a transfer combined with insolvency, unreasonably small capital, or intent by the debtor to incur debts beyond its ability to pay. The principal difference between the Bankruptcy Code and the UFCA is in the phrasing of the consideration element of constructive fraud. Rather than fair consideration, the Bankruptcy Code requires a "reasonably equivalent value in exchange" for the transfer.⁷⁹ "Reasonably equivalent value" is not defined, and, in contrast to the UFCA, there is no express requirement of good faith in the exchange of value.⁸⁰

The Bankruptcy Code defines insolvency in the balance sheet sense, as arising when the debtor's total liabilities exceed the debtor's "property, at a fair valuation."⁸¹ Under a saving provision slightly different from the saving provisions of the UFCA, a transferee who "takes for value and in good faith" is given a lien, or may retain a lien transferred to it, to the extent of value given to the debtor.⁸²

3. Uniform Fraudulent Transfer Act

The National Conference of Commissioners on Uniform State Laws recently revised the UFCA under a new title, the

Id.

Congress enacted the present Bankruptcy Code provisions as part of the major revision of federal bankruptcy laws in 1978. The former Bankruptcy Act originally took the form of the Statute of Elizabeth, permitting a trustee in bankruptcy to avoid transfers made with intent to hinder, delay, or defraud creditors. *See* ch. 541, § 67e, 30 Stat. 544, 564-65 (1898) (amended 1938 and repealed 1978). A 1938 amendment to the Bankruptcy Act replaced the original language with provisions substantially similar to the UFCA. *See* Chandler Act, ch. 575, § 67(d), 52 Stat. 840, 877-78 (1938) (repealed 1978); 4 COLLIER, *supra* note 19, ¶¶ 548.01[1], 67.29[1]-[2].

79. 11 U.S.C. § 548(a)(2) (Supp. III 1985).

80. *See* 11 U.S.C. § 548 (1982 & Supp. III 1985). The Bankruptcy Code defines *value* as "property, or satisfaction or securing of a present or antecedent debt," with certain limitations not relevant here. *Id.* § 548(d)(2)(A) (Supp. III 1985).

81. 11 U.S.C. § 101(29)(A) (Supp. III 1985). The property to be considered in determining insolvency excludes concealed assets and property exempt under the Bankruptcy Code. *See id.*; 11 U.S.C. § 522 (1982 & Supp. III 1985).

82. *Id.* § 548(c) (Supp. III 1985). Section 548(c) provides:

Except to the extent that a transfer or obligation voidable under this section is voidable under section 544, 545, or 547 of this title, a transferee or obligee of such a transfer or obligation that takes for value and in good faith has a lien on or may retain any interest 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 in exchange for such transfer or obligation.

Id.; *see* 11 U.S.C. § 550(b)(1) (1982).

Uniform Fraudulent Transfer Act (UFTA).⁸³ The revised uniform law does not make radical changes in the structure adopted in the UFCA. The substance of the UFCA's categories of constructive and intentional fraud is carried over to the UFTA.⁸⁴

The UFTA adopts the terminology of the Bankruptcy Code with respect to consideration: the constructive fraud provisions ask whether the transferor has received "reasonably equivalent value" for property transferred and omit the subjective element of good faith.⁸⁵ As under the Bankruptcy Code, insolvency is determined by a balance sheet standard, comparing assets to debts. The UFTA adds, however, that failure to pay debts as due raises a presumption of insolvency.⁸⁶ The saving provisions of the UFTA afford complete protection to a transferee who takes "in good faith and for a reasonably equivalent value" and allow a good faith transferee to retain property or a lien to the extent of value given to the transferor.⁸⁷ The UFTA also sets out a list of factors, similar to the badges of fraud courts developed under the Statute of Elizabeth, to be considered in determining whether a transfer that does not fall within the

83. 7A U.L.A. 639 (1985).

84. The format is changed and one new category of constructive fraud is added. *See id.* §§ 4-5, 7A U.L.A. at 652-53, 657. Section 4 defines transfers that are fraudulent as to both present and future creditors. These include transfers made with intent to defraud and transfers for less than reasonably equivalent value if the transferor is in business and left with unreasonably small capital or intends to incur debts beyond its ability to pay. *Id.* § 4, 7A U.L.A. at 652-53. A separate section defines transfers fraudulent as to present creditors only. These include transfers made without reasonably equivalent value if the transferor is insolvent or is left insolvent and transfers made on account of an antecedent debt to an insider with reason to believe the transferor was insolvent. *Id.* § 5, 7A U.L.A. at 657. The last provision is interesting because it invalidates preferential payments or transfers to insiders, with no apparent time limitation except the statute of limitations applicable to fraudulent conveyance actions. In contrast, the preference provisions of the Bankruptcy Code are limited to transfers made either within 90 days before the petition or within one year in the case of insiders. *See* 11 U.S.C. § 547(b) (Supp. III 1985). The UFTA provision on insider preferences could increase the exposure of selling shareholders who accept corporate obligations for the purchase price of shares in a buyout. Specifically, creditors might be able to recover payments made by the corporation to the sellers within the applicable statute of limitations, even if the court did not view the original buyout transaction as a fraudulent conveyance.

85. *See* UFTA §§ 4(a)(2), 5, 7A U.L.A. 639, 653, 657 (1984); *id.* prefatory note, 7A U.L.A. at 641.

86. *See id.* § 2(a)-(b), 7A U.L.A. at 648.

87. *See id.* § 8(a), (d), 7A U.L.A. at 662. The UFTA creates several other exemptions not provided in the UFCA or Bankruptcy Code, but none are important here. *See id.* § 8(e)-(f), 7A U.L.A. at 662-63.

constructive fraud provisions is made with intent to defraud creditors.⁸⁸

C. APPLICATION OF FRAUDULENT CONVEYANCE LAWS TO BUYOUTS

The following sections describe how courts have applied fraudulent conveyance laws to buyouts and similar transactions. The first section discusses various approaches to transfers made in exchange for benefits to third parties.⁸⁹ Many of the difficulties of applying fraudulent conveyance laws to buyouts can be traced to this problem of third-party benefit. The next section describes cases involving creditors' claims against shareholders in connection with leveraged buyouts. Finally, several cases are discussed in which creditors attacked the interests of independent lenders who financed buyout transactions.

1. Three-Party Transfers

Courts generally have taken the view that benefits that flow to third parties as a result of a buyout or similar transaction are not fair consideration or reasonably equivalent value for a transfer.⁹⁰ Problems of third-party benefit arise in many

88. See *id.* § 4(b), 7A U.L.A. at 653.

89. As used in this Article, the term *third-party benefit* refers to any benefit that flows to a party other than the corporate debtor. For an analysis of three-party fraudulent conveyance problems focused on guaranty transactions, see Littman, *Multiple Intent, Veil-Piercing, and Burdens and Benefits: Fraudulent Conveyance Law and Multiparty Transactions*, 39 U. MIAMI L. REV. 307 (1985).

90. See *Rubin v. Manufacturers Hanover Trust Co.*, 661 F.2d 979, 991 (2d Cir. 1981); *Klein v. Tabatchnick*, 610 F.2d 1043, 1047 (2d Cir. 1979); *Diller v. Irving Trust Co. (In re College Chemists, Inc.)*, 62 F.2d 1058, 1058 (2d Cir. 1933) (per curiam); *Telefest v. VU-TV*, 591 F. Supp. 1368, 1377-78 (D.N.J. 1984); *Gleneagles*, 565 F. Supp. at 574; *Ear, Nose & Throat Surgeons, Inc. v. Guaranty Bank & Trust Co. (In re Ear, Nose & Throat Surgeons, Inc.)*, 49 Bankr. 316, 320 (Bankr. D. Mass. 1985); *Garrett v. Falkner (In re Royal Crown Bottlers)*, 23 Bankr. 28, 30 (Bankr. N.D. Ala. 1982); *Zellerbach Paper Co. v. Valley Nat'l Bank*, 13 Ariz. App. 431, 435, 477 P.2d 550, 554 (1970); P. BLUMBERG, *supra* note 1, § 7.05.1; 4 COLLIER, *supra* note 19, ¶ 548.09; see also *Consve v. Cohen (In re Roco Corp.)*, 701 F.2d 978, 982 (1st Cir. 1983) (in context of stock redemption, "the value to be considered is that received by the debtor and not that forfeited by the transferee"); *Bullard v. Aluminum Co. of America*, 468 F.2d 11, 13-14 (7th Cir. 1972) (transfer by corporation made in satisfaction of its own debt was not for fair consideration when the primary benefit went to a guarantor); *Wells Fargo Bank v. Desert View Bldg. Supplies*, 475 F. Supp. 693, 696-97 (D. Nev. 1978) (corporate obligations and security were not for fair consideration when loan proceeds were transferred to borrower's parent to pay the parent's debt), *aff'd mem.*, 633 F.2d 221, 225 (9th Cir. 1980); *In re Security Prods. Co.*, 310 F. Supp. 110, 115-19 (E.D. Mo. 1969) (assignment of subsidiary's ac-

different ways. One typical example is the case of a controlling shareholder who causes the corporation to pay a personal debt.⁹¹ Another setting is a loan transaction in which a corporation guarantees repayment of a sum advanced to its parent or affiliate.⁹²

In either case the corporation's transferee gives up value in an agreed exchange. Under general contract principles, this would be a sufficient consideration for the corporate transfer.⁹³ In fraudulent conveyance cases, however, the usual view is that a third-party benefit is inadequate consideration. Thus, if any of the financial circumstances specified in the constructive fraud provisions is present, creditors can recover corporate property from the transferee and set aside corporate obligations. The reason given for this result is that in the context of laws designed for the protection of creditors, adequacy of consideration should be assessed from the creditors' point of view.⁹⁴ Courts consider whether any benefit actually passed to the corporate transferor and to what extent the three-party transaction depleted the estate available to creditors.⁹⁵

A number of courts have qualified the third-party benefit

count receivable to secure loan to parent was not for fair consideration); *Steph v. Branch*, 255 F. Supp. 526, 531 (E.D. Okla. 1966) (corporate endorsement of buyers' note to seller in buyout and corporate transfers in payment of buyers' note were not for fair consideration), *aff'd*, 389 F.2d 233 (10th Cir. 1968); *In re Venie*, 80 F. Supp. 250, 254 (W.D. Mo. 1948) (mortgage of partnership property given to secure loan to partner for acquisition of partnership interest was not for fair consideration); *Hartwell v. Hartwell Co.*, 167 N.J. Super. 91, 98, 400 A.2d 529, 533 (Super. Ct. Ch. Div. 1979) (security interest in corporate assets given to sellers in buyout was valid only to extent of debt owed by the corporation to the sellers before the buyout); *Sharrer v. Sandlas*, 103 A.D.2d 873, 873, 477 N.Y.S.2d 897, 899 (App. Div.) (corporate mortgage given to sellers in buyout was not for fair consideration), *appeal denied*, 63 N.Y.2d 610, 473 N.E.2d 1190, 484 N.Y.S.2d 1024 (1984).

91. See, e.g., *Zellerbach Paper Co. v. Valley Nat'l Bank*, 13 Ariz. App. 431, 432, 477 P.2d 550, 551 (1970).

92. See *Rubin v. Manufacturers Hanover Trust Co.*, 661 F.2d 979, 991 (2d Cir. 1981); *Telefest v. VU-TV*, 591 F. Supp. 1368, 1377-78 (D.N.J. 1984). The possibility that a court will view a corporate guaranty and security interest as fraudulent conveyances is discussed in *Coquillet*, *supra* note 4, at 448-60; *Littman*, *supra* note 89; *Rosenberg*, *supra* note 6; and *Comment, Guarantees and Section 548(a)(2) of the Bankruptcy Code*, 52 U. CHI. L. REV. 194 (1985).

93. See *Libco Corp. v. Leigh (In re Reliable Mfg. Corp.)*, 703 F.2d 996, 1000 (7th Cir. 1983); *Diller v. Irving Trust Co. (In re College Chemists, Inc.)*, 62 F.2d 1058, 1058 (2d Cir. 1933) (*per curiam*); RESTATEMENT (SECOND) OF CONTRACTS § 71(4) & comment e (1979).

94. See *Gleneagles*, 565 F. Supp. at 574; *In re Security Prods. Co.*, 310 F. Supp. 110, 118 (E.D. Mo. 1969) (emphasizing protection of creditors).

95. See, e.g., *Rubin*, 661 F.2d at 991.

rule by recognizing that value given to a third party can produce indirect benefits for the transferor. For example, a loan made to an affiliate of the transferor may provide adequate consideration for the transfer if the businesses of the two companies are closely related.⁹⁶ The concept of indirect benefits as fair consideration in a three-party transfer, however, is best suited to intracorporate loans made for working capital and does not apply to most buyout situations.⁹⁷ The purpose and effect of a buyout is to change control from sellers to buyers and to permit sellers to realize the value of their equity. The corporation receives new management, but this is not of measurable value to the corporation and its creditors, particularly when viewed in hindsight from the vantage of bankruptcy proceedings.⁹⁸

Most commentary on three-party situations focuses on indirect benefits to the transferor and does not challenge the underlying proposition that value given to third parties is not fair

96. *See id.* at 991-93; *Klein v. Tabatchnick*, 610 F.2d 1043, 1047-48 (2d Cir. 1979); *Telefest*, 591 F. Supp. at 1378-81; *In re Jones*, 37 Bankr. 969, 975 (Bankr. N.D. Tex. 1984); *Garrett v. Falkner (In re Royal Crown Bottlers)*, 23 Bankr. 28, 30-31 (Bankr. N.D. Ala. 1982); *Rosenberg*, *supra* note 6, at 243-46.

In one leading case, *Rubin v. Manufacturers Hanover Trust Co.*, 661 F.2d 979 (2d Cir. 1981), two corporations in the business of issuing money orders guaranteed the debts of affiliated corporations in the business of cashing checks for the public and granted security interests in their assets to secure their obligations as guarantors. *Id.* at 981-84. The court acknowledged that benefits to affiliates generally do not provide fair consideration for a transfer, but found that the money order and check cashing businesses were so interdependent that loans to the check cashing affiliates might provide indirect benefits to the guarantors. These benefits, however, had to be measurable by a trier of fact, and would not provide fair consideration if they were "disproportionately small" in relation to the transfer. *Id.* at 991-94.

97. Professor Rosenberg, whose analysis of guaranties is frequently cited in cases of indirect benefit, reaches the same conclusion with respect to leveraged buyouts. *See Rosenberg*, *supra* note 6, at 263.

98. This is stated expressly in *Gleneagles*, 565 F. Supp. at 575-76, and *Credit Managers Ass'n v. Federal Co.*, 629 F. Supp. 175, 182 (C.D. Cal. 1986), and it is implicit in other decisions. *See, e.g., In re Venie*, 80 F. Supp. 250, 256 (W.D. Mo. 1948) ("no consideration of any sort" passed to acquired company).

In *Garrett v. Falkner (In re Royal Crown Bottlers)*, 23 Bankr. 28 (Bankr. N.D. Ala. 1982), the court suggested that removal of a shareholder from his position of ownership and management through a redemption of his shares produced a recognizable benefit to the corporation. *See id.* at 30. The circumstances, however, were unusual: a lender had required the shareholder's removal as a condition for financial assistance to the corporation's hard-pressed parent. *Id.* at 29. Further, the court based its final decision on other grounds, so it did not have to decide whether the benefit of the shareholder's absence was a reasonably equivalent value for corporate funds used to redeem his shares. *See id.* at 30-31.

consideration for a transfer.⁹⁹ One comment on the subject of intercorporate guaranties, however, suggests a different approach to third-party benefits. The comment proposes that a guaranty should be viewed as a fraudulent conveyance to the obligor whose debt was guaranteed, but not to the lender to whom it was given.¹⁰⁰ The obligor receives benefits from the guaranty because the guaranty enables the obligor to borrow on more favorable terms than it otherwise could obtain. The lender, in contrast, does not benefit from the transaction, because it advances funds equal to the value of the interests it receives. Therefore, the conveyance is not to the lender but to the obligor.¹⁰¹

99. Several writers have expressed concern that the application of fraudulent conveyance laws to invalidate guaranties may disrupt accepted lending practices and discourage financing transactions that serve useful purposes in the operation and transfer of businesses. See Coquillette, *supra* note 4, at 435-37, 452-59; Rosenberg, *supra* note 6, at 243-46, 252, 257, 262-65; Comment, *supra* note 92, at 202-07. These articles are concerned primarily with working capital loans made to one member of a corporate group and guaranteed by another.

Professor Rosenberg states that in many cases, a finding that an intercorporate guaranty lacks fair consideration does not reflect economic realities. See Rosenberg, *supra* note 6, at 243. He also suggests that a lender's awareness that the guarantor was insolvent should not be determinative because this would discourage loans made to "rehabilitate a failing business." *Id.* at 252. This argument is more persuasive in the context of a working capital loan than that of a buyout, because the working capital loan provides economic value to some members of the corporate group. *But see* Carlson, *supra* note 2, at 92-100 (discussing potential benefits from a leveraged buyout of a troubled corporation).

Mr. Coquillette proposes that in determining the solvency of a guarantor, the guaranty should not be treated as a liability in its full amount, but only in the amount of probable liability as of the date the guaranty is executed. See Coquillette, *supra* note 4, at 455, 458-59. *But see* Rosenberg, *supra* note 6, at 256-57 (valuation of contingent liabilities according to the likelihood of their coming due violates statutory language and adds another element of uncertainty). Further, Coquillette would treat rights of subrogation against the principal obligor as measurable assets. See Coquillette, *supra* note 4, at 456-59. Coquillette indicates, however, that his analysis of the economic effect of a guaranty would not extend to a guaranty of a buyout loan, because the primary obligor generally is a shell corporation formed by the buyers. See *id.* at 458. Subrogation in that case would have little value, and the parties expect and intend that the corporation will be the source of repayment of the debt. *But see* Cate v. Nicely (*In re* Knox Kreations), 474 F. Supp. 567, 571-72 (E.D. Tenn. 1979) (giving weight to rights of subrogation in assessing the effect of a guaranty of a buyout loan as a liability on bankrupt corporation's balance sheet), *aff'd in part, rev'd in part*, 656 F.2d 230 (6th Cir. 1981); *cf.* Carlson, *supra* note 2, at 90-91 (discussing possible grounds for discounting corporate liability on a buyout guaranty).

100. Comment, *supra* note 92, at 207.

101. *Id.* at 202-07.

Two bankruptcy decisions suggest another variation from the general approach to three-party situations.¹⁰² Both cases involved transactions among a corporate transferor, an individual in control of the corporation, and a creditor of the individual.¹⁰³ In each case the controlling individual caused the corporation to purchase a cashier's check, which the individual remitted to the creditor in payment of his own debt.¹⁰⁴ Both courts held that the primary transferee was not the creditor who received the funds, but rather the controlling individual for whose benefit the transfer was made.¹⁰⁵ The transaction in each case was viewed as two distinct transfers: a fraudulent transfer to the controlling individual and a valid transfer from the individual to the creditor.¹⁰⁶ These cases imply that a transfer in exchange for third-party benefits can be deemed a conveyance to the party who receives the principal benefit of the overall

102. See *Davis v. Cook Constr. Co. (In re SLF News Distrib.)*, 649 F.2d 613 (8th Cir. 1981); *Still v. American Nat'l Bank & Trust Co. (In re Jorge's Carpet Mills)*, 50 Bankr. 84 (Bankr. E.D. Tenn. 1985).

103. See *Jorge's Carpet Mills*, 50 Bankr. at 84. In *SLF News*, the relationship between the individual and the corporation was not clear. See *SLF News*, 649 F.2d at 614 n.2.

104. See *SLF News*, 649 F.2d at 614; *Jorge's Carpet Mills*, 50 Bankr. at 84.

105. See *SLF News*, 629 F.2d at 616; *Jorge's Carpet Mills*, 50 Bankr. at 85.

106. Under the courts' analyses, the creditors became subtransferees, having received corporate assets from the controlling individual. See *SLF News*, 649 F.2d at 616; *Jorge's Carpet Mills*, 50 Bankr. at 85. Although the creditors' remedy under fraudulent conveyance statutes extends to subtransferees as well as primary transferees, the distinction between the primary and subsequent transfers is important in applying the saving provisions. Under both the UFCA and the Bankruptcy Code, the saving provisions protect a transferee only to the extent it has given consideration for the transfer. See 11 U.S.C. §§ 548(c), 550(b) (1982 & Supp. III 1985); UFCA § 9, 7A U.L.A. 427, 577-78 (1985). If the creditors who received the cashiers' checks purchased with corporate funds were considered primary transferees, the general rule that third-party benefits are not consideration for purposes of fraudulent conveyance law would prevent application of the saving provisions. See *supra* notes 90-95 and accompanying text. But if the creditors are treated as subtransferees, the consideration they provided to the primary transferee (the shareholder who received the benefit of the transaction) satisfies the consideration element of the saving provisions. Therefore, if they acted in good faith, or without knowledge of a fraud, other creditors cannot set aside the conveyance in their hands.

The analysis provided in the comment discussed *supra* in the text accompanying note 101 differs from *SLF News* and *Jorge's Carpet Mills* with respect to the liability of the direct transferee. The comment views a guaranty as a transfer to the primary obligor only and not to the lender. Conceptually, there is first a valid transaction between the lender and the borrower and then a fraudulent conveyance from the borrower to the primary obligor. Comment, *supra* note 92, at 205-07. *SLF News* and *Jorge's Carpet Mills* suggest that when a corporation pays the debt of a shareholder, the shareholder is the primary transferee and the shareholder's creditor is a subtransferee who must estab-

transaction. Rather than following the direct path of the transferor's property, a court using this approach would trace the substantive benefit of the transfer to identify the fraudulent conveyance and to decide which party should be responsible to creditors of the transferor.¹⁰⁷

An approach that focuses on the substantive distribution of benefits in a three-party transaction has the advantage of making the party who receives the primary benefit of the transaction accountable to creditors of the party whose assets are depleted. On the other hand, it may go too far in relieving the direct transferee of responsibility to creditors. Although the direct transferee in a three-party case receives no net benefit from the transaction, this does not necessarily determine who, as between the transferee and the general creditors, should bear the loss if the primary beneficiary is unavailable to satisfy creditors' claims.¹⁰⁸

2. Buyout Transactions: Liability of Shareholders

In a number of cases, corporate creditors have asserted claims against shareholders in the aftermath of a buyout.¹⁰⁹ Most involve transactions in which selling shareholders fi-

lish good faith or lack of knowledge to claim the protection of the saving provisions. See *SLF News*, 649 F.2d at 616; *Jorges Carpet Mills*, 50 Bankr. at 85.

For an explanation and defense of the approach taken in *SLF News* and *Jorges Carpet Mills*, see Comment, *In re SLF News Distributors, Inc.: Fraudulent Conveyances and the Protection of Good Faith Subtransferees*, 15 CREIGHTON L. REV. 811 (1982).

107. *SLF News* and *Jorges Carpet Mills* may not signal a major change in the treatment of third-party benefits in fraudulent conveyance cases. In each case the individual for whose benefit the transfer was made had also physically received the cashier's check. This may explain the courts' characterization of the transaction as a transfer to the individual rather than the creditor. Further, the creditors who received the checks were unaware of the source of the funds, and the decisions could be confined to that situation. See *SLF News*, 649 F.2d at 616; *Jorges Carpet Mills*, 50 Bankr. at 85.

108. Liability to creditors under fraudulent conveyance law is not limited to a defendant's net gain from the challenged transaction. This is apparent in the saving provisions, which require a transferee for value to make an additional showing that it acted in good faith or without knowledge of fraud. See 11 U.S.C. § 548(c) (Supp. III 1985) (good faith); UFCA § 9, 7A U.L.A. 427, 577-78 (1985) (no knowledge of fraud, or with respect to lien protection, no actual fraudulent intent). A transferee who does not meet the test of good faith or lack of knowledge must restore the transfer, even in the absence of any enrichment. See 1 G. GLENN, *supra* note 56, §§ 299b-c, 300, 302 (describing situations in which creditors can recover against a transferee who gave equivalent value to the transferor, if the transferee was aware that the transferor intended to conceal the facts of the transfer from other creditors).

109. See *Credit Managers Ass'n v. Federal Co.*, 629 F. Supp. 175 (C.D. Cal.

nanced the buyout by accepting a note secured by corporate obligations in exchange for their shares. Consistent with the general rule applied to third-party benefits,¹¹⁰ the consensus of the courts in these cases is that the sellers' transfer of control to the buyers is not fair consideration for corporate transfers to the sellers. Further, courts have not viewed a change in management as a measurable benefit to the corporation.¹¹¹ As a result the creditors usually have prevailed.¹¹²

Several courts, however, have denied creditors' claims against selling shareholders.¹¹³ The decision in each case was based on a finding of solvency, but the courts' opinions indicate a general discomfort with the application of fraudulent conveyance law to buyouts.¹¹⁴ In one case, for example, the court expressed sympathy for the view that fraudulent conveyance law should not apply to leveraged buyouts because a buyout can promote creditors' interests by regenerating the acquired busi-

1986); *Gleneagles*, 565 F. Supp. 556 (M.D. Pa. 1983); *Hartwell v. Hartwell Co.*, 167 N.J. Super. 91, 400 A.2d 529 (Super. Ct. Ch. Div. 1979).

110. See, e.g., *Diller v. Irving Trust Co. (In re College Chemists, Inc.)*, 62 F.2d 1058, 1058 (2d Cir. 1933) (per curiam).

111. See *supra* note 98 and accompanying text.

112. See *College Chemists*, 62 F.2d at 1058; *Steph v. Branch*, 255 F. Supp. 526, 531-32 (E.D. Okla. 1966), *aff'd*, 389 F.2d 233 (10th Cir. 1968); *In re Venie*, 80 F. Supp. 250, 254-56 (W.D. Mo. 1948); *Sharrer v. Sandlas*, 103 A.D.2d 873, 873, 477 N.Y.S.2d 897, 898 (App. Div.), *appeal denied*, 63 N.Y.2d 610, 473 N.E.2d 1190, 484 N.Y.S.2d 1024 (1984); see also *In re Atlas Foundry Co.*, 155 F. Supp. 615 (D.N.J. 1957).

Atlas Foundry involved a complex buyout transaction, apparently designed to avoid fraudulent conveyance claims. The lender in *Atlas Foundry* was a corporation formed by the buyers to purchase the shares of the acquired corporation. The parent obtained \$250,000 from outside sources, advanced this to the acquired corporation, and took a mortgage of corporate assets. It then assigned the mortgage to selling shareholders to secure its \$250,000 note for the purchase of shares. In this way the sellers obtained a security interest in corporate assets indirectly, rather than directly, in consideration for the sale of shares. After acquiring the shares, the parent withdrew cash from corporate reserves to repay the \$250,000 it had borrowed and advanced to the corporation. *Atlas Foundry*, 155 F. Supp. at 616-17. The court found the parent's advance was an artifice with no real benefit to the corporation. The corporation was left with unreasonably small capital, and therefore the mortgage it gave to the buyers was fraudulent. *Id.* at 618. Further, creditors could avoid the mortgage in the hands of the sellers to whom it had been assigned because the sellers knew and intended the results of the transaction. *Id.*

113. See *Credit Managers Ass'n v. Federal Co.*, 629 F. Supp. 175 (C.D. Cal. 1986); *Cate v. Nicely (In re Knox Kreations)*, 474 F. Supp. 567 (E.D. Tenn. 1979), *aff'd in part, rev'd in part*, 656 F.2d 230 (6th Cir. 1981); *Emerald Hills Country Club v. Hollywood, Inc. (In re Emerald Hills Country Club)*, 32 Bankr. 408 (Bankr. S.D. Fla. 1983).

114. See *Credit Managers*, 629 F. Supp. at 179; *Knox Kreations*, 474 F. Supp. at 571 n.4; *Emerald Hills*, 32 Bankr. at 420.

ness.¹¹⁵ In another case the court stated that it “[did] not seem fair to distinguish so strictly between a corporation and its sole stockholders.”¹¹⁶ This suggests that at least in the case of a closely held corporation, the court viewed the transfer of shares from sellers to buyers as a fair consideration for corporate transfers.¹¹⁷

Decisions holding shareholders liable to creditors typically involve transactions financed by selling shareholders. In cases of buyouts financed by an outside lender, the question of shareholder liability to creditors has not often been raised. Creditors are more likely to pursue the lender, who directly receives corporate property and obligations. Further, depending on the

115. See *Credit Managers*, 629 F. Supp. at 179 n.6. In this respect the court commended the analysis of Professors Baird and Jackson, which is described briefly *supra* note 10. The court did not decide the case on that ground but found instead that the buyout did not leave the corporation insolvent or without reasonable capital and so was not within the constructive fraud provisions of the applicable statute. 629 F. Supp. at 183-88.

116. *Knox Kreations*, 474 F. Supp. at 571 n.4. But see *In re Security Prods. Co.*, 310 F. Supp. 110, 117-19 (E.D. Mo. 1969) (disregard of corporate entity is an equitable principle that should be used only to prevent fraud and not to defeat the rights of defrauded creditors). In *Knox Kreations* the court upheld interests obtained by selling shareholders in a buyout against creditors' claims. As in *Credit Managers*, the court based its decision on a finding that the financial conditions for constructive fraud were not present. See *id.* at 571-72. The selling shareholders had transferred their shares to the buyers in exchange for \$25,000 in cash and a \$200,000 note. The buyers caused the corporation to endorse their note, to secure the note with a security interest in corporate assets, and to place a percentage of gross sales in escrow for payment of the note. *Id.* at 569. On the question of insolvency, the court reasoned that the corporation must not have been insolvent if the buyers were willing to pay such a substantial price for the shares. See *id.* at 571. (This might be questioned because the buyers paid only a small portion of the price in cash.) The court also felt the guaranty should not be treated as a liability in its face amount because it was not certain the buyers would default on their note. See *id.* at 571-72.

In *Emerald Hills* the court upheld a corporate mortgage given to selling shareholders. The decision was based in part on a finding that the corporation was solvent, but the court also indicated that there was adequate consideration for the mortgage. 32 Bankr. at 416. The mortgage transaction involved not only the sale of shares, but also a sale of condominium properties by the sellers to an affiliate of the acquired corporation, an agreement by the sellers to provide favorable financing for condominium resales, and other terms the court found beneficial to the acquired corporation. *Id.* at 412-14, 417. The court viewed these benefits as a “bargained for” consideration for the mortgage and concluded that the evidence did not show a lack of reasonably equivalent value for the transfer. See *id.* at 420.

117. The court, however, found that the transfers were not fraudulent on other grounds and thus declined to decide whether the transfer of shares from sellers to buyers is fair consideration for a corporate transfer. See *Knox Kreations*, 474 F. Supp. at 571 n.4.

form of the buyout, it may be difficult in an externally financed buyout to identify a transfer from the corporation to the buying or selling shareholders. In a merger form buyout, for example, an entity formed by the buyers simultaneously borrows the acquisition price from a lender, purchases the acquired corporation from the sellers, merges with the acquired corporation, and mortgages the assets of the combined entity to the lender. On the face of the transaction, no property or obligation passes from the corporation to the buyers. In another form of buyout, the principals cause the corporation to borrow the amount of the acquisition price from a lender and to relend it to the buyers, who use it to purchase shares from the sellers in a simultaneous transaction. Here, there is no direct transfer from the corporation to the sellers.¹¹⁸

Although the transfer may be difficult to identify, the benefits of the transaction to the buyers and sellers are apparent. Buyers obtain control of the corporation, and sellers realize the value of their equity, or more, in cash. This may be a sufficient basis to hold them liable to creditors for the amount of the transfer if the elements of constructive fraud are met. The Bankruptcy Code provides specifically that a trustee in bankruptcy can recover from any party "for whose benefit such transfer was made."¹¹⁹ There is no comparable provision in the UFCA,¹²⁰ but a remedy against shareholders can be sup-

118. This was the form of the buyout in *Gleneagles*, in which the court determined that the use of proceeds of corporate borrowing to pay the purchase price of shares was a fraudulent conveyance to the sellers, for which they were liable to creditors. 556 F. Supp. at 585. The central issue in the case, however, was the liability of the lender, and the court did not elaborate on the point of shareholder liability.

119. 11 U.S.C. § 550(a)(1) (1982 & Supp. III 1985). This provision should apply whether the trustee in bankruptcy is proceeding under the fraudulent conveyance provisions of the Bankruptcy Code or on the basis of state law. *See id.* § 544(b) (1982).

120. The remedial provisions of the UFCA state only that creditors can "have the conveyance set aside or obligation annulled" or can "disregard the conveyance" and execute on the transferred property. UFCA § 9, 7A U.L.A. 427, 577-78 (1985). This language has not caused courts to limit creditors' affirmative remedy to recovery of the specific property transferred by their debtor. Many decisions have allowed creditors to recover money damages, at least against transferees who were no longer in possession of the transferred property. *See Pereira v. Checkmate Communications Co. (In re Checkmate Stereo & Elecs.)*, 9 Bankr. 585, 620-23 (Bankr. E.D.N.Y. 1981), *aff'd*, 21 Bankr. 402 (E.D.N.Y. 1982); *Damazo v. Wahby*, 269 Md. 252, 256-57, 305 A.2d 138, 141-42 (1973); *Flowers & Sons Dev. Corp. v. Municipal Court*, 86 Cal. App. 3d 818, 825, 150 Cal. Rptr. 555, 559 (1978); *Hickson v. Thielman*, 147 Cal. App. 2d 11, 14-16, 304 P.2d 122, 124-25 (1956); 1 G. GLENN, *supra* note 56, § 56; McLaughlin,

ported by analogy to decisions in which courts have treated the parties who receive the substantive benefit of a transfer as transferees.¹²¹

3. Buyout Transactions: Liability of an Independent Lender

In several cases creditors have used fraudulent conveyance law to go beyond the principal parties in a buyout and set aside transfers to an outside lender who financed the transaction.¹²² These cases begin with the premise that benefits given to third parties in exchange for a transfer are not sufficient considera-

supra note 63, at 442-43. The courts' broad interpretation of the remedial provisions is justified on the ground that "equity will not allow itself to be frustrated but will adapt its relief to the exigencies of the case." *Damazo*, 296 Md. at 257, 305 A.2d at 142. The same general principle could be extended to support recovery of damages against parties who obtained the substantive benefit of a transfer but designed the transaction in such a way that they did not receive property or obligations of the transferor.

121. See *supra* notes 102-07 and accompanying text. Other decisions indicate that creditors can recover from indirect beneficiaries of a fraudulent transfer, at least when the direct transferee is a corporation managed as the alter ego of a controlling individual. See *Bartle v. Markson*, 357 F.2d 517, 522 (2d Cir. 1966); *Checkmate Stereo & Elecs.*, 9 Bankr. at 620-22. *Bartle* was a buyout case. The selling shareholder caused the corporation to loan money to a new parent corporation formed by the buyers, which the parent used to pay the acquisition price. *Bartle*, 357 F.2d at 520. Discussing federal jurisdiction over an action by creditors against the selling shareholder, the court stated that the seller was a proper defendant, although the direct transferee was the new parent company. See *id.* at 522. The *Bartle* decision might be explained on the ground that the seller was a secondary transferee of the corporation's funds, but the court's emphasis was on his receipt of the benefit of the transaction rather than his receipt of particular property. See *Bartle v. Markson*, 299 F. Supp. 958, 966-67 (N.D.N.Y. 1969) (holding shareholder liable after trial, having found that the corporate transfers were "to his benefit"), *aff'd*, 423 F.2d 637 (2d Cir. 1970).

Professor Glenn suggests that the creditor's remedy under fraudulent conveyance statutes is limited to recovery of property conveyed or recovery of its value from a "guilty person through whose hands the asset may have passed." 1 G. GLENN, *supra* note 56, § 56. This focus on physical receipt of property, however, seems unnecessarily formal. The editors of *Collier* take a broader view, stating that when there is proof of "an actual principal-agency relationship or other participation in the transaction by the defendant, it seems that the court should find no difficulty in piercing the forms of the dealings in order to enable the trustee [in bankruptcy] to recover from the party properly responsible." 4 COLLIER, *supra* note 19, ¶ 548.07[5]. *But cf.* *Klein v. Tabatchnick*, 610 F.2d 1043, 1048 n.4 (2d Cir. 1979) (interpreting fraudulent conveyance provision of former Bankruptcy Act as limited to claims against recipients of transferred property).

122. See, e.g., *Gleneagles*, 565 F. Supp. at 573-83; *Roxbury State Bank v. The Clarendon*, 129 N.J. Super. 358, 378-79, 324 A.2d 34, 35 (Super. Ct. App. Div.), *certif. denied*, 66 N.J. 316, 331 A.2d 16 (1974).

tion to sustain the transfer.¹²³ In addition, the courts have looked beyond the form of the exchange between the lender and the transferor to the larger transaction of which it was a part and have determined that the transferor did not receive the substantive benefits of the loan. The most notable of these decisions is *United States v. Gleneagles Investment Co.*¹²⁴ The approach taken in *Gleneagles* permits creditors to recover from a lender who advances funds directly to the acquired corporation in return for the transfers it receives if the loan is earmarked for uses that do not benefit the corporation.¹²⁵

In *Gleneagles* buyers and sellers arranged for a loan from an unrelated lender to the group of corporations to be acquired.¹²⁶ The loan was secured by liens on the assets of each corporation and cross-guaranties among all the corporations.¹²⁷ In a transaction simultaneous with the loan, the corporate group loaned the proceeds of the borrowing to a holding company the buyers had formed to acquire the shares of the group's parent.¹²⁸ The holding company used the funds to pay selling shareholders for the shares.¹²⁹ The lender clearly knew of the use of the loan proceeds.¹³⁰

A federal district court held that the mortgages given to the lender to secure corporate borrowing were fraudulent and avoidable under the Pennsylvania version of the UFCA.¹³¹ On its face the case involved a direct exchange of funds for secured

123. See *Gleneagles*, 565 F. Supp. at 574. The general rule with respect to third-party benefits is discussed *supra* notes 90-95 and accompanying text.

124. 565 F. Supp. 556 (M.D. Pa. 1983), *aff'd sub nom.* *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288 (2d Cir. 1986), *cert. denied*, 107 S. Ct. 3229 (1987).

125. Generally, the creditors' remedy against a lender would not be an affirmative recovery: the court would simply invalidate the corporation's obligations to the lender and the lender's security interest in corporate assets. In some cases, however, creditors might demand a return of payments made by the corporation to the lender. See *Cate v. Nicely (In re Knox Kreations)*, 656 F.2d 230, 230-31 (6th Cir. 1981). This raises a further question whether creditors should be entitled to recover the interest component of debt service payments. Cf. *Gleneagles III*, 584 F. Supp. at 681 (interest considered in determining whether settlement with sellers satisfied creditor's claims against lender).

126. 565 F. Supp. at 568.

127. *Id.* at 569.

128. *Id.* at 570.

129. *Id.* at 569-70. The court was careful to state that in finding the transaction fraudulent, it did not rely on the participation of James Hoffa, Sr., as a principal of the holding company formed to purchase the shares. *Id.* at 582.

130. *Id.* at 582.

131. See *id.* at 573-83.

obligations between an outside lender and the corporate borrowers.¹³² Viewing the buyout transaction as a whole, however, the court determined that the borrowing corporations did not receive fair consideration for their transfers to the lender.¹³³ Although they received advances from the lender, the sums advanced were passed on to the buyers' holding company.¹³⁴ Because that entity had no assets other than the shares acquired, its notes to the group of borrowing corporations were valueless.¹³⁵ The court rejected an argument that the change in control provided consideration to the acquired group.¹³⁶ New management, at least in the absence of special skill and experience, was not of sufficient value to support the transaction.¹³⁷

Further, because the lender knew of the use of loan proceeds and the precarious financial condition of the corporations, the element of good faith, as required by the statutory definition of fair consideration, was absent.¹³⁸ Although the court did not define good faith expressly, the opinion suggests that it judged the lender's good or bad faith according to the lender's knowledge of facts that would establish a constructive fraud.¹³⁹ Lack of fair consideration, together with findings that the corporate group was left insolvent and without reasonable capital, entitled creditors to avoid both the corporate obligations to the lender and the mortgages securing them.¹⁴⁰

In addition to its finding of constructive fraud, the court determined that the transfer was made with actual intent to defraud creditors.¹⁴¹ The parties could foresee that a diversion of corporate assets to finance a purchase of shares, combined with the adverse financial condition of the corporations, would hinder creditors.¹⁴² In the court's view, if they could foresee these consequences, they must be assumed to have intended them.¹⁴³

132. Under the loan agreement with the lender, certain of the corporations were direct borrowers, while other members of the group guaranteed the loans but did not receive advances. *Id.* at 569. Ultimately, this distinction was not important because the court found that the transfers by both the borrowers and the guarantors were fraudulent. *See id.* at 573-83.

133. *See id.* at 573-77.

134. *Id.* at 575.

135. *Id.*

136. *See id.* at 576.

137. *Id.*

138. *Id.* at 574-76.

139. *See id.* at 574.

140. *Id.* at 577-80.

141. *See id.* at 580-82.

142. *Id.*

143. *See id.* at 581.

Although the lender was independent from the buyers and sellers and did not receive any of the loan proceeds, it was responsible because it knew of the use of loan proceeds and the financial state of the borrowers.¹⁴⁴ Therefore, it could not claim protection under the saving provision of the UFCA as a purchaser for fair consideration without knowledge of the fraud.¹⁴⁵

144. *Id.* at 581-82.

145. *Id.* at 580-82; see UFCA § 9, 7A U.L.A. 427, 577-78 (1985). The court emphasized the lender's knowledge of the purpose of the loan, pointing out that its lawyers had designed the loan agreement, which specified that loan proceeds would be used to pay for shares. See *Gleneagles II*, 571 F. Supp. at 955; *Gleneagles*, 565 F. Supp. at 582.

The court did not discuss the saving provisions of the UFCA in detail in the original *Gleneagles* opinion. It addressed the issue more specifically in *Gleneagles II* and *Gleneagles III*, in connection with creditors' claims against a subtransferee of the corporate mortgages. See *Gleneagles III*, 584 F. Supp. at 681-83; *Gleneagles II*, 571 F. Supp. at 951-53. About three years after the buyout, following a default in payment of the buyout loan, the original lender had discounted and sold the corporate group's notes and mortgages to another party. *Gleneagles II*, 571 F. Supp. at 941. This purchaser was the holder of the mortgages when the case arose, and creditors sought to avoid the mortgages in its hands. The court first considered whether the first saving provision protected the purchaser of the mortgages as a "purchaser for fair consideration without knowledge of the fraud." UFCA § 9(1), 7A U.L.A. 427, 577 (1985); see *Gleneagles II*, 571 F. Supp. at 951. The court found that the mortgage purchaser had constructive knowledge of a fraud, because closing binders from the original loan transaction disclosed both the use of loan proceeds to pay for shares and the financial difficulties of the borrowing corporations. See *Gleneagles II*, 571 F. Supp. at 953-55. Further, the purchaser had connections to the parties to the original buyout and may have aided in financing it, which suggested that it had actual knowledge of the fraud. *Id.* at 955-57.

In *Gleneagles III*, the purchaser proposed that it should have a lien in the amount it had paid for the mortgages, under the saving provision for purchasers who have given less than fair consideration but "without fraudulent intent." See *Gleneagles III*, 584 F. Supp. at 683; UFCA § 9(2), 7A U.L.A. 427, 578 (1985). The court rejected this argument, holding that a subtransferee is liable to creditors unless it qualifies for protection under the first saving provision, which incorporates a standard of good faith through the term *fair consideration*. See *Gleneagles III*, 584 F. Supp. at 682. The court also pointed out that the purchaser did not have clean hands because it had arranged tax sales of the mortgaged property in a way that eradicated liens of other creditors under local law. See *id.* at 684.

These holdings could have serious consequences for financial institutions that purchase mortgages or participating interests in mortgages. They suggest that creditors can set aside mortgages in the hands of a subtransferee if the subtransferee had notice, based on closing binders, that loan proceeds were used for purposes that did not benefit the borrowing corporation and the borrower was in financial difficulty at the time of the loan. On the other hand, the facts of *Gleneagles* can be distinguished from most secondary mortgage transactions in that the mortgage purchaser was a competitor, had some involvement in the acquisition transaction, and had manipulated tax lien foreclosure laws to the disadvantage of other creditors. Further, the court noted that

The Court of Appeals for the Third Circuit affirmed,¹⁴⁶ basing its decision primarily on the good faith requirement in the UFCA's definition of fair consideration.¹⁴⁷ The Third Circuit stated explicitly that good faith should be understood as a standard of knowledge rather than intent.¹⁴⁸

In a similar decision, *Roxbury State Bank v. The Clarendon*,¹⁴⁹ a New Jersey court applied the New Jersey version of the UFCA to a mortgage given to a lender for a loan used to finance a buyout.¹⁵⁰ Purchasing shareholders caused the acquired corporation to borrow from an outside lender and to give the lender a mortgage of corporate assets.¹⁵¹ Although the decision is unclear on this point, the lender apparently ad-

the purchaser "was not in the business of buying mortgages." *Gleneagles II*, 571 F. Supp. at 945; see Carlson, *supra* note 2, at 105 n.102 (discussing the unique facts of the *Gleneagles* transaction).

146. *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288, 1296 (3d Cir. 1986), *cert. denied*, 107 S. Ct. 3229 (1987). The Third Circuit affirmed the district court's conclusion that the acquired corporations did not receive fair consideration for their transfers to the lender and endorsed the general approach of the district court, which, in its words, "looked beyond the exchange of funds" between the lender and the corporate borrowers. *Id.* at 1302.

147. *See id.* at 1296-97.

148. Because the lender was aware that loan proceeds would be used for a buyout and that the corporate borrowers would be left insolvent, its advances to the corporations were not made in good faith. *Id.* at 1295-96. The Third Circuit also affirmed the district court's finding of intentional fraud. *See id.* at 1305. The Third Circuit seemed reluctant, however, to accept the district court's reasoning on this point. The defendants questioned the district court's statement that "[i]f the parties could have foreseen the effect on creditors . . . the parties must be deemed to have intended the same." *Id.* (quoting *Gleneagles*, 565 F. Supp. at 581). The Third Circuit resolved the issue by equating the district court's reference to foreseeability with the principle that people must intend the natural consequences of their acts. *See id.*

The Third Circuit affirmed the district court's holding that the secondary purchaser of the mortgages was not protected by the saving provisions of the UFCA. *See id.* at 1299. On appeal, the mortgage purchaser claimed protection under the second saving provision, which allows a lien for repayment to a purchaser who paid less than fair consideration, but without actual fraudulent intent. *Id.* at 1298. The circuit court held that the purchaser was not entitled to lien protection because it had not purchased the mortgages in good faith. *See id.* The court rejected an argument by the transferee that the lien provision did not require good faith. *See id.* In the court's view, the statute was inartfully worded; but by reference to the policies of the UFCA, the saving provision must be read to require good faith as well as lack of actual fraudulent intent. *See id.*

149. 129 N.J. Super. 358, 324 A.2d. 24 (Super. Ct. App. Div.), *certif. denied*, 66 N.J. 316, 331 A.2d 16 (1974).

150. *See id.* at 368-76, 324 A.2d at 29-33.

151. *Id.* at 374, 324 A.2d at 32.

vanced the borrowed funds directly to the corporation.¹⁵² With the lender's knowledge, a portion of the funds was used to make a down payment to selling shareholders for the purchase of shares in a buyout.¹⁵³ The court held that to the extent of funds applied to the buyout, the mortgage was not supported by fair consideration because the corporation did not beneficially receive this part of the loan.¹⁵⁴ The court stated that

a bank lending money on a mortgage to a corporation, which *knows* that a substantial portion of the mortgage proceeds will be used to finance a sale of the corporate stock by a shareholder to third persons, is on notice that the mortgage is to that extent voidable, and such a mortgage is made at the peril of invalidation.¹⁵⁵

The two cases just discussed have broad implications. In each case the defendant lender had no interest in the buyout beyond its participation as a supplier of funds, and it had in fact advanced money to the corporation.¹⁵⁶ Nevertheless, each court held the lender responsible to creditors based on the diversion of consideration from the corporate debtor.¹⁵⁷

152. *See id.* at 365, 376, 324 A.2d at 27, 33.

153. *Id.* at 365, 378-79, 324 A.2d at 27, 34-35. The lender (a bank) had advanced \$160,000 to the corporation. The court found the mortgage fraudulent to the extent of \$50,000 used to pay selling shareholders for shares and \$34,000 used to pay debts owed by affiliated corporations to the bank. *See id.* at 373-74, 324 A.2d at 32. The court also invalidated a mortgage given to the sellers for a portion of the acquisition price (with adjustments for property the sellers conveyed to the corporation). *See id.* at 374-76, 324 A.2d at 32-33.

154. *See id.* at 374, 324 A.2d at 32.

155. *Id.* at 379, 324 A.2d at 35 (emphasis in original). The court did not discuss the saving provisions of the UFCFA, probably because it found the bank had not given fair consideration for the corporate mortgage. *See* UFCFA § 9, 7A U.L.A. 427, 577-78 (1985).

156. In *Roxbury* the lender had an interest in one of the three planned uses of loan proceeds. The funds were used in part to pay selling shareholders for shares, in part for corporate purposes, and in part to repay debts owed by affiliates to the lender. *Roxbury*, 129 N.J. Super. at 365, 324 A.2d at 27. The court, however, did not emphasize the lender's interest in the third use of funds. It focused on the lack of substantial benefit to the corporate borrower and set aside the mortgage not only as to funds applied to affiliates' debts to the lender, but also as to funds applied to the buyout, in which the lender had no interest. *See id.* at 373-74, 324 A.2d at 31-32.

157. A similar case is *In re Process-Manz Press*, 236 F. Supp. 333 (N.D. Ill. 1964), *rev'd on jurisdictional grounds*, 369 F.2d 513 (7th Cir. 1966), *cert. denied*, 386 U.S. 957 (1967), a buyout case in which the lender initially was an outsider but became an interested participant in the acquisition. In the original buyout transaction, the buyer gave notes to selling shareholders in return for the sellers' agreement to deliver shares over a period of time upon receipt of installment payments on the notes. *Id.* at 336-37. In a series of subsequent transactions, the acquired corporation borrowed money on a secured basis from the lender (a financing company), then loaned a portion of the proceeds to the buyer to repay the buyer's notes to the selling shareholders. The corpo-

The standard the courts adopted in *Gleneagles* and

ration later redeemed most of its stock from the buyer and applied the redemption price to satisfy the buyer's indebtedness to it for the funds used to repay the buyer's notes. *Id.* at 338-39. In this way the acquisition was financed through the corporation's secured borrowing. The lender not only knew of the use of loan proceeds but directed corporate decision making throughout the series of transactions and in later confrontations with creditors. *Id.* at 340-44. Further, the lender had obtained an assignment of the buyer's right to obtain shares under the buyout agreement as additional security for the loan and thus had a beneficial interest in payment of installments on the buyer's notes. *Id.* at 337-38.

The court held that because loan proceeds were used to pay selling shareholders for shares of the borrowing corporation, the corporation had not received fair consideration for its secured obligation to the lender. *Id.* at 346. The transaction also left the corporation with unreasonably small capital; therefore the transfer was fraudulent and creditors could avoid the lender's security interests under the constructive fraud provisions of the Bankruptcy Act. *Id.* The court also determined that all parties had acted with actual intent to defraud creditors. To find intentional fraud, the court relied on the substantial diversion of working capital and the lender's exercise of control over the corporation in the course of the transactions. *See id.* at 346-47.

Process-Manz was a special case because the lender assumed the position of a principal in the buyout transaction as it progressed. *Process-Manz* may be limited to cases in which the lender takes an interested role in the acquisition, leaving most buyout financing transactions unaffected.

Several other decisions (not involving buyouts) also suggest that when a lender derives a personal benefit from a diversion of loan proceeds to third parties, the borrower's obligations to the lender should be treated as fraudulent transfers. One such case is *Wells Fargo Bank v. Desert View Bldg. Supplies*, 475 F. Supp. 693 (D. Nev. 1978), *aff'd mem.*, 633 F.2d 221, 225 (9th Cir. 1980). In *Wells Fargo* a corporation had borrowed funds from a bank, giving the lender a security interest in its assets. The corporation then transferred the money in the form of a dividend to its parent, which used the money to repay a debt it owed to the same bank. *Id.* at 695. The court held that the corporation had not received fair consideration for the security interest it gave to the bank because it did not benefit from the bank's loan. *See id.* at 696.

Wells Fargo implies that a court may look past the form of a transaction styled as a secured loan to determine whether the borrower actually received the benefits of the loan. It is not clear, however, that lack of benefit alone would have led the court to conclude there was no fair consideration. The court also quoted comments of the bankruptcy judge concerning the bank's interest in the transaction and the influence it exerted. *See id.* The loan had enabled the bank to improve its position from that of a creditor of the parent, secured only by a pledge of the subsidiary's stock, to that of a secured creditor of the subsidiary. *Id.*

Two similar cases are *Consumers Credit Union v. Widett (In re Health Gourmet, Inc.)*, 29 Bankr. 673 (Bankr. D. Mass. 1983), and *Coleman Am. Moving Servs. v. First Nat'l Bank & Trust Co. (In re American Properties)*, 14 Bankr. 637 (Bankr. D. Kan. 1981). In each case proceeds of a secured loan to a corporate borrower were used to pay an unsecured debt owed by a shareholder or affiliate to the same lender. *See Health Gourmet*, 29 Bankr. at 675; *American Properties*, 14 Bankr. at 639-40. The courts set aside corporate transfers to the lenders on the basis of intentional fraud. *See Health Gourmet*, 29 Bankr. at 676-77; *American Properties*, 14 Bankr. at 642-44. These cases might be

Roxbury for holding an independent lender responsible to creditors was knowledge of facts that made the buyout a fraud on creditors. Although these cases do not require lenders to investigate the use of borrowed money,¹⁵⁸ they effectively place a duty on independent lenders to evaluate the legality of a buyout, on the basis of known facts, before extending financing. To assure itself that the obligations and security it receives from the acquired corporation will be valid and enforceable, a lender must apply the legal standards set out in fraudulent conveyance statutes to the facts it knows about the use of loan proceeds and the finances of the acquired corporation.

In particular, *Gleneagles* and *Roxbury* require the lender to evaluate the financial condition of the borrowing corporation before extending funds in a buyout. Under the reasoning of

questioned for their reliance on *Dean v. Davis*, 242 U.S. 438 (1917), in which the United States Supreme Court held that secured borrowing to finance a preferential payment to an unsecured creditor was an intentional fraud against creditors. Current citation of *Dean v. Davis* in cases arising under the Bankruptcy Code overlooks the evolution of federal bankruptcy laws; the rule of *Dean v. Davis* was at one time codified in the Bankruptcy Act, but that provision was repealed in 1978 and omitted from the new Bankruptcy Code. See Chandler Act, ch. 575, § 67(d)(3), 52 Stat. 840, 878 (1938) (repealed 1978). On the other hand, the *Health Gourmet* and *American Properties* cases differ from *Dean v. Davis* in that the lenders not only aided in creating a preference, they were the preferred creditors.

158. Both decisions are clearly limited to cases in which the lender is fully aware that loan proceeds will be used for an acquisition of shares. The New Jersey court stated this expressly. See *Roxbury*, 129 N.J. Super. at 377-79, 324 A.2d at 34-35. In *Gleneagles* the district court emphasized the lender's knowledge of the intended use of loan proceeds at several points. See *Gleneagles*, 565 F. Supp. at 574, 582. The Third Circuit's analysis focused on the good faith element of fair consideration, which it defined in terms of the lender's knowledge of circumstances that made the transaction a fraud. See *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288, 1296 (3d Cir. 1986), *cert. denied*, 107 S. Ct. 3229 (1987).

The risk that the lender's interests may be avoided by creditors does not, and should not, extend to situations in which loan proceeds are diverted to the benefit of third parties without the knowledge of the lender. If the lender has no knowledge or control of the use of funds, there is no justification for treating the lender's advance and the subsequent diversion of funds as a single transaction. The loan in that case should be viewed as a valid exchange between the lender and the corporation.

A lending institution that finances a buyout usually has knowledge of the relevant facts. The loan and the purchase of shares often take place in a single closing, and loan documents set out the terms of the related transactions. Further, a prudent lender probably would not advance funds without full information about the use of loan proceeds and the financial condition of its borrower. It is not likely that the requirement of knowledge in *Roxbury* and *Gleneagles* will encourage lenders to alter this practice. The lender has too much at stake to remain intentionally ignorant.

Gleneagles and *Roxbury*, a loan destined for use in a buyout cannot be fair consideration for corporate transfers. Lack of fair consideration, however, is not enough to establish constructive fraud; the statutes require both insufficient consideration and unsound financial condition of the transferor. Therefore, to protect its interests against a challenge by creditors, the lender must determine whether the corporation will be left insolvent or with unreasonably small capital or intends to incur debts beyond its ability to pay.¹⁵⁹ In addition, the lender may have to consider whether there are any circumstances present from which a court could infer intent to defraud creditors.

Other courts might not accept the conclusion reached in *Gleneagles* and *Roxbury*. *Jones v. National City Bank of Rome (In re Greenbrook Carpet Co.)*,¹⁶⁰ while not involving a buyout, suggests a different general view of a lender's responsibility for the use of loan proceeds, which might carry over to the context of an externally financed buyout. In *Greenbrook* a bank loaned funds to a corporation, taking a security interest in corporate assets.¹⁶¹ The corporation then transferred the loan proceeds to its controlling shareholders, who used the funds to purchase stock of another corporation.¹⁶² The shareholders gave the first corporation a nonrecourse note secured by the "relatively worthless" stock they acquired.¹⁶³ As in *Gleneagles* and *Roxbury*, the bank was aware of the intended use of loan proceeds by controlling shareholders.¹⁶⁴

Nevertheless, the Court of Appeals for the Eleventh Circuit affirmed the district court's holding that the bank had given a reasonably equivalent value for its security interest in corporate assets, as required by the fraudulent conveyance provisions of the Bankruptcy Code.¹⁶⁵ Therefore, a trustee in bankruptcy could not avoid the bank's security interest.¹⁶⁶ The court rejected an argument by the trustee that the bank's loan should be viewed as an advance to the shareholders rather than the corporation. In the court's view, the "issue [was] whether

159. 11 U.S.C. § 548(a)(2) (1982 & Supp. III 1985); UFCA §§ 4-6, 7A U.L.A. 427, 474, 504, 507 (1985).

160. 722 F.2d 659 (11th Cir. 1984) (per curiam).

161. *See id.* at 660.

162. *Id.*

163. *Id.*

164. *See id.* The bank did not know the note from the shareholders to the corporation was nonrecourse. *Id.* It appeared, however, that their note would have little value in any event.

165. *See id.* at 661.

166. *See id.*

the *bank* received more consideration than it was due; if the transaction between Greenbrook [the corporation] and the Greens [its shareholders] constituted a fraudulent transfer, the trustee may sue the Greens."¹⁶⁷ In other words the court treated the loan from the lender to the corporation as a separate transaction from the diversion of funds for the benefit of shareholders, despite the bank's knowledge of the intended use of loan proceeds. The decision implies that when a lender has advanced funds directly to the entity whose obligations it holds in a standard loan transaction, it should not be held responsible for the use of borrowed funds.

The transaction in *Greenbrook* can be distinguished from a buyout. Proceeds of the loan were used by shareholders to purchase another corporation, so the borrower may have derived some indirect benefit through affiliation of a related business or expansion of the enterprise.¹⁶⁸ Further, the corporation obtained a pledge of shares that had at least some present or potential value. The court's brief opinion, however, suggests that its holding was based on the court's view of the role and duties of a lender acting in the ordinary course of its business, rather than its assessment of the possible benefits to the borrowing corporation.

II. GENERAL CONSIDERATIONS IN IMPOSING LIABILITY IN BUYOUTS

A. THE BALANCE OF INTERESTS

This section identifies the interests affected by application of fraudulent conveyance statutes to buyouts and suggests how courts might weigh those interests. Leveraged buyouts and other transactions involving transfers for the benefit of third parties can harm creditors in exactly the way that fraudulent conveyance laws are designed to prevent.¹⁶⁹ The effect of the

167. *Id.* (emphasis in original). The court's focus on overcompensation of the bank, rather than depletion of the transferor's estate, departs from the usual view of three-party transfers. See *Consove v. Cohen (In re Roco Corp.)*, 701 F.2d 978, 982 (1st Cir. 1983) (consideration should be viewed in terms of what the transferor received); *supra* notes 90-95 and accompanying text.

The *Greenbrook* decision is discussed in Littman, *supra* note 89, at 331-32. Mr. Littman introduces *Greenbrook* as an illustration of how "strongly . . . [the] characterization of the transaction may influence the outcome of the case." *Id.* at 331.

168. See *Telefest v. VU-TV*, 591 F. Supp. 1368, 1380-81 (D.N.J. 1984); *supra* note 96 and accompanying text.

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

transfer is to deplete the estate available to pay creditors' claims. If the transferor is left insolvent, creditors lose the ability to collect their claims in full, although they might have done so immediately before the transfer. If the transferor is solvent in the sense of net worth, but is left without sufficient cash or unencumbered assets for its business, the transaction impairs its capacity to generate income to meet debts, leading eventually to the same result.¹⁷⁰ In the case of a buyout, although the corporation may survive under new management, the transaction increases the risks to creditors beyond the point that is acceptable under fraudulent conveyance statutes.

Nevertheless, courts should be sensitive to the character of a buyout as a three-party transaction and the special impact of the fraudulent conveyance remedy in this context. In most cases of constructive fraud, the creditors' remedy against the transferee is restitutionary. A defendant who receives value without consideration from an insolvent transferee, to the detriment of the transferee's creditors, is unjustly enriched. In a buyout or other three-party situation, however, creditors may assert claims against parties who have not been enriched. This does not prevent the application of fraudulent conveyance law, but in cases of this nature courts should consider the role the defendant played in the transaction and the effects of holding the defendant accountable to creditors.

1. Shareholders

Creditors of a corporation acquired in a leveraged buyout may assert fraudulent conveyance claims against buying and selling shareholders in several contexts.¹⁷¹ The sellers may be direct recipients of corporate transfers if they finance the buyout by accepting notes secured by corporate assets in exchange for their shares. Alternatively, if the direct recipient of corporate transfers is an outside lender, creditors may assert claims against the buyers and sellers as indirect beneficiaries of the transfer.

In either case the principal parties (buyers and sellers) should be responsible to creditors for the assets diverted from the corporation if the buyout violates the financial standards of fraudulent conveyance laws. This is true even though a buyout can be in the best interests of creditors. The corporation may

170. See 1 G. GLENN, *supra* note 56, § 334.

171. Creditors' claims against shareholders are discussed *supra* notes 109-21 and accompanying text.

be more efficient under new management and may generate more income, so that creditors may be able to collect their claims without liquidation.¹⁷² Nevertheless, the buyers and sellers control the terms of the transaction and are its primary beneficiaries. Even though the liability imposed on buyers and sellers may exceed their gains from the transaction, they should bear the risk of corporate failure to creditors if the financial circumstances of the buyout bring it within the range defined by statute as constructive fraud against creditors. A highly leveraged buyout is a gamble. When the transaction exceeds the statutory limits, it is a gamble the principals should take rather than creditors.¹⁷³

2. Independent Lender

Application of fraudulent conveyance laws to an independent lender who finances a buyout is a more difficult question. *United States v. Gleneagles Investment Co.*¹⁷⁴ and *Roxbury State Bank v. The Clarendon*¹⁷⁵ hold that a lender who participates only by its extension of funds is accountable to creditors if it knows the facts of a buyout transaction. In contrast, the *Greenbrook* decision suggests that a lending institution should not be responsible for the use of loan proceeds as long as it advances money to an entity whose obligations it holds.

A compromise position seems more appropriate. An independent lender who finances a buyout should be held responsible to creditors for the economic consequences of the transaction, but only to the extent it can protect itself against liability by a reasonable preliminary review. Beyond this the lender should not be required to relinquish interests and property it negotiates to receive in exchange for an advance of funds.

172. See *Credit Managers Ass'n v. Federal Co.*, 629 F. Supp. 175, 179 n.6 (C.D. Cal. 1986); Baird & Jackson, *supra* note 10, at 853-54; Carlson, *supra* note 2, at 79-80, 93-95. *But cf. Credit Managers*, 629 F. Supp. at 182 (new management is not fair consideration as a factual matter).

173. "Many an embarrassed debtor holds the genuine belief that if suits can be staved off for a season, he will weather a financial storm The belief, even though well founded, does not clothe him with a privilege to build up obstructions that will hold his creditors at bay." *Shapiro v. Wilgus*, 287 U.S. 348, 354 (1932) (Cardozo, J.) (citation omitted).

174. 565 F. Supp. 556 (M.D. Pa. 1983), *aff'd sub nom. United States v. Tabor Court Realty Corp.*, 803 F.2d 1288 (3d Cir. 1986), *cert. denied*, 107 S. Ct. 3229 (1987).

175. 129 N.J. Super. 358, 324 A.2d 34 (Super. Ct. App. Div.), *certif. denied*, 66 N.J. 316, 331 A.2d 16 (1974).

3. Objectives in Imposing Liability on Lenders

From the creditors' perspective, application of fraudulent conveyance law to set aside the interests of a buyout lender has two advantages. One is that lenders who foresee that transfers to them could be set aside as fraudulent conveyances will evaluate the economic impact of buyouts and will refuse to participate if the buyout appears fraudulent against creditors. Often the buyout will be impossible without outside financing, and the lender's withdrawal will force the parties to adjust their terms or abandon the transaction.

This is a sound objective in applying fraudulent conveyance law. The lender who finances a buyout is in a better position than general creditors to assess and control the financial impact of the transaction on the corporation and its creditors. The lender generally is informed of the use of loan proceeds and the financial circumstances of the borrowing corporation, can influence the terms of the transaction, and has the ultimate option to refuse to advance funds.¹⁷⁶ Other creditors have no voice in the transaction and may be unable to protect themselves effectively against its consequences.¹⁷⁷ Therefore, even an independent lender should not be completely free of responsibility; it is reasonable to impose a duty on the lender to review the buyout for compliance with fraudulent conveyance law.

The other advantage to creditors in holding the lender liable is a source of compensation for loss caused by the buyout. If creditors are unable to collect from other parties, whether legally or practically, they can recover the amount by which their debtor's estate was depleted from the lender, who is likely to be

176. The lender might require the buyers to shore up corporate finances to a degree it found satisfactory. For example, if the transaction were arranged so that the corporation borrowed from the lender and reloaned the proceeds to the buyers to pay for shares, the buyers might be required to furnish a portion of the purchase price, representing the amount of cash or net assets a business similar in nature to the acquired corporation reasonably should maintain, from another source. In a merger form buyout, the buyers could be required to contribute a similar amount of capital to the corporation they formed for the acquisition.

177. Involuntary creditors have no means of protection. Voluntary creditors whose claims arose before the buyout may not have been in a position to demand security and in any event should not be expected to anticipate such a sudden and substantial change in the net worth of the corporation. Subsequent creditors dealing voluntarily with the corporation have constructive notice of corporate obligations from public records. Whether it is reasonable to expect them to review corporate finances before extending credit depends on the nature of their business with the debtor.

solvent and accessible. This is not a sound objective when considered in relation to the lender's role in the transaction. The lender advances funds in return for the obligations and interests it holds and so is not enriched by the transfer of corporate property and obligations. Unjust enrichment is not an essential condition of liability under fraudulent conveyance law,¹⁷⁸ but the absence of enrichment becomes important when considered in light of the lender's commercial position.¹⁷⁹ The lender participates in the buyout as an outside party providing a service in the usual course of its business. Apart from the normal incidents of its financing services, the lender derives no advantage from the buyout. Further, the lender has no relationship to the corporation that under traditional principles would give rise to fiduciary responsibilities to the corporation or its creditors.¹⁸⁰

The possibility that the lender's interest will be set aside in these circumstances injects a substantial risk of loss into transactions that, to the lender, are ordinary business activities. Application of fraudulent conveyance laws to the lender also may discourage legitimate buyout transactions. This would be unfortunate, because leveraged buyouts can serve useful purposes apart from enrichment of shareholders. They provide a means for present owners to withdraw from their investments without liquidation and transfer control to investors who may be in a better position to undertake management responsibility and realize the potential of the business. When a buyout leaves the corporation in an unsound financial condition, the risk imposed on creditors outweighs any positive aspects of the transaction. On the other hand, when the borrowing exceeds what a lender would extend on the basis of the buyers' assets, but does not so deplete corporate assets as to impair creditors' prospects of payment, leveraged buyouts can be efficient both for the particular corporation involved and for the liquidity of investments

178. See *supra* note 108.

179. This may have been the underlying concern in *Davis v. Cook Constr. Co.* (*In re SLF News Distrib.*), 649 F.2d 613 (8th Cir. 1981), and *Still v. American Nat'l Bank & Trust Co.* (*In re Jorge's Carpet Mills*), 50 Bankr. 84 (Bankr. E.D. Tenn. 1985), in which the courts treated transfers of corporate funds by a shareholder to a lender in satisfaction of the shareholder's debt as conveyances to the shareholder rather than the lender. See *SLF News*, 649 F.2d at 616; *Jorge's Carpet Mills*, 50 Bankr. at 86; *supra* notes 102-07 and accompanying text. Though neither court referred expressly to enrichment, their characterization of the transfer may have been based on the combination of a lack of net benefit to the lender and the lender's unawareness of the source of funds.

180. See *supra* note 40 and accompanying text.

generally.¹⁸¹

Limiting the lender's liability to cases in which it fails to make a reasonable evaluation of the transaction is consistent with the policies reflected in the constructive fraud provisions of the UFCA and the Bankruptcy Code. These provisions do not give creditors the right to avoid all transfers made without consideration. Instead, by defining the financial conditions that make a transfer fraudulent, they strike a balance that permits free disposition of property when there is no substantial threat to creditors' rights of payment. The point at which the risk to creditors becomes unacceptable is fixed by the terms of the statutes, and a buyout that does not impair corporate finances to the specified degree is outside the intended scope of the statutes. In that case there is no reason to prevent buying and selling shareholders from extracting a portion of the value of their equity interests in a transfer of control.

In theory the creditors' remedy under fraudulent conveyance law affects only those transactions that fall within what the statutes define as the zone of unacceptable risk to creditors. But as applied to an independent lender, the impact of fraudulent conveyance law on buyout transactions could be much broader. An institution in the business of lending will not advance funds without reasonable assurance that the interests it has negotiated to hold as security will be enforceable, and it is likely to be conservative in the degree of assurance it demands. If the standard of liability is too uncertain to allow the lender to determine the validity of the transaction in advance, and it gives no weight to the lender's reasonable judgment when later applied by a court, the lender's fear of potential liability will prevent it from financing legitimate transactions.

The risk of liability may also deter buying and selling shareholders from undertaking desirable buyouts, but there are stronger reasons to hold these parties liable to creditors. Buying and selling shareholders initiate the transaction and derive its benefits. Further, the principal parties, with more to gain, are more willing to assume risks in a close case. The lender, with only its fees and interest at stake, is likely to be very cautious if it cannot predict the risk of liability to creditors.

Weighing these considerations, courts should interpret

181. Positive aspects of leveraged buyouts are described in Baird & Jackson, *supra* note 10, at 853; Carlson, *supra* note 2, at 79-80. For a description of an apparently successful leveraged buyout, see Serrin, *In New Bedford, Union Efforts Keep a Plant Alive*, N.Y. Times, June 15, 1986, at 14, col. 3 (nat'l ed.).

fraudulent conveyance laws in a way that requires a buyout lender to make a reasonable determination that the buyout is consistent with the rights of creditors before advancing funds. The courts should not, however, impose an absolute liability on the lender. If the lender is able to control its risk of loss by reasonable attention to the consequences of the transaction for other creditors, the exposure of its interests to creditor claims is justified to further the protective policies of the law. On the other hand, the lender should not become an insurer of the corporation's continued ability to pay its debts, because this would place too great a burden on neutral business activities and would discourage legitimate transactions.

B. PROBLEMS OF CURRENT STANDARDS

To avoid placing the lender in the position of insuring the success of a buyout, either the legal rules defining fraud must be definite and predictable so the lender can apply them with confidence at the time of the transaction, or some saving principle must protect the lender's reasonable judgment. The first of these alternatives is not practical. The legal definition of a fraudulent conveyance is not precise enough to ensure predictable results.

One source of difficulty is the concept of intentional fraud. In *Gleneagles*, for example, the court determined that the buyout was an intentional fraud on creditors because the parties could foresee that a diversion of corporate assets, combined with adverse financial condition, would hinder creditors.¹⁸² By its nature intentional fraud is an unpredictable standard. Perhaps if the lender is aware of unusual devices by which the principle parties plan to obstruct creditors, it can anticipate a finding of intentional fraud. But to the extent that courts infer fraudulent intent from adverse financial circumstances in a buyout, the lender cannot make a reliable determination of the risk of liability to creditors.¹⁸³

The constructive fraud standards also produce uncertainties for the lender. The constructive fraud provisions pose two legal questions: whether the lender has given adequate consid-

182. See *Gleneagles*, 565 F. Supp. at 580-82; see also *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288, 1304-05 (3d Cir. 1986), cert. denied, 107 S. Ct. 3229 (1987); *supra* notes 144-45 and accompanying text.

183. In *Gleneagles*, for example, the court stated that intent to defraud creditors is inferable when "consideration is lacking" and the parties "know that the creditors cannot be paid." *Gleneagles*, 565 F. Supp. at 580.

eration for its interests ("fair consideration" under the UFCA or "reasonably equivalent value" under the Bankruptcy Code) and whether any of the three alternative financial elements is present (insolvency, unreasonably small capital, or anticipation of debts beyond the debtor's ability to pay). Under *Gleneagles* and *Roxbury*, the answer to the first question is clear. If the lender knows loan proceeds will be used to carry out a buyout, there is no fair consideration. The answer to the second question, relating to the financial condition of the corporation, is more indefinite. Here, the lender's task is complicated by differences in the wording of statutory provisions, as well as varying interpretations by the courts.

The Bankruptcy Code and the UFCA differ in their definitions of the first element of financial condition, insolvency.¹⁸⁴ Under the Bankruptcy Code, a transferor is insolvent when its debts are "greater than all of [its] property, at a fair valuation."¹⁸⁵ This standard, sometimes called the "legal" or "balance sheet" test of insolvency, compares assets and liabilities in a fairly straightforward way.¹⁸⁶ The obligations incurred by the corporation to the lender are included in the calculation, and if these new debts bring the total liabilities of the corporation to a sum in excess of its assets, the transaction is fraudulent.¹⁸⁷ The

184. To protect its interests, the lender must consider both statutes. In bankruptcy proceedings the trustee can proceed under either the Bankruptcy Code's fraudulent conveyance provisions or state statutes. See 11 U.S.C. §§ 544(b), 548(a) (1982 & Supp. III 1985); *supra* note 68. Unless the one year time limit for avoidance under Bankruptcy Code provisions has expired, the trustee can choose the standard most favorable under the circumstances.

185. 11 U.S.C. § 101(29)(A) (Supp. III 1985).

186. See *Consove v. Cohen (In re Roco Corp.)*, 701 F.2d 978, 983 (1st Cir. 1983) (comparing assets and liabilities based on unaudited balance sheet); *Parlon v. Claiborne (In re Kaylor Equip. & Rental)*, 56 Bankr. 58, 61 (Bankr. E.D. Tenn. 1985) (balance sheet); *Willis v. Borg-Warner Acceptance Corp. (In re Willis)*, 48 Bankr. 295, 301-02 (S.D. Tex. 1985) (balance sheet); *Perdido Bay Country Club Estates v. Equitable Trust Co. (In re Perdido Bay Country Club Estates)*, 23 Bankr. 36, 42 (Bankr. S.D. Fla. 1982) (balance sheet).

187. Debts, as defined in the Bankruptcy Code, include all liabilities, whether or not they are fixed or matured. See 11 U.S.C. § 101(4)(A), 101(11) (1982). Some writers and courts have suggested that a contingent liability such as a guaranty should not be included at its full face value among balance sheet liabilities. See *Cate v. Nicely (In re Knox Kreations)*, 474 F. Supp. 567, 571-72 (E.D. Tenn. 1979), *aff'd in part, rev'd in part*, 656 F.2d 230 (6th Cir. 1981); *Ear, Nose & Throat Surgeons, Inc. v. Guaranty Bank & Trust Co. (In re Ear, Nose & Throat Surgeons, Inc.)*, 49 Bankr. 316, 321 (Bankr. D. Mass. 1985); *Carlson, supra* note 2, at 90-91; *Coquillet, supra* note 4, at 458-59; see also *Emerald Hills Country Club v. Hollywood, Inc. (In re Emerald Hills Country Club)*, 32 Bankr. 408, 420-21 (Bankr. S.D. Fla. 1983) (discounting liability based on rights of subrogation or indemnity); *supra* note 99. In any event, if the corporation is

balance sheet standard leaves some questions open, though. In particular, the concept of fair valuation is difficult to apply. The lender cannot rely on book values for this purpose; fair valuation implies the value that can be realized through a sale of assets under hypothetical conditions representing a fair balance of the interests of the parties.¹⁸⁸ This value might fall anywhere between the proceeds of immediate liquidation and the price the corporation expects to obtain through gradual disposition in the course of its business.¹⁸⁹ Another problem is whether the business should be valued as a going concern rather than on the basis of discrete assets.¹⁹⁰

Insolvency under the UFCA is even less precise. Here, the transferor is insolvent when "the present fair salable value of his assets is less than the amount that will be required to pay his probable liability on his existing debts as they become absolute and matured."¹⁹¹ This test resembles the traditional equity test of insolvency, which focuses on a debtor's ability to pay debts in the ordinary course of business.¹⁹² It introduces addi-

the primary borrower in a buyout, the debt is not contingent and must be included in full.

188. See 2 COLLIER, *supra* note 19, ¶ 101.29[4].

189. *Id.* Collier states that there are "manifold judicial glosses" on the term *fair valuation*. See *id.* The editors propose that fair valuation is what can be realized out of the assets within a reasonable time either through collection [of receivables] or sale [of property] at the regular market value, conceiving the latter as the amount which could be obtained for the property in question within such period by a "capable and diligent business man" from an interested buyer "who is willing to purchase under the ordinary selling conditions."

Id. (quoting *In re Kobre*, 224 F. 106, 117 (E.D.N.Y. 1915)) (footnotes omitted). The complexity of applying such a standard is evident. For a discussion of the difficulties a bankruptcy trustee may encounter in establishing a fair valuation of assets, see Levit, *The Archaic Concept of Balance Sheet Insolvency*, 47 AM. BANKR. L.J. 215, 218-20 (1973).

190. Mr. Levit suggests that courts have been inconsistent on this point, accepting proof of going concern value but rejecting the inclusion of good will in a tally of assets. See Levit, *supra* note 189, at 220; see also 2 COLLIER, *supra* note 19, ¶ 101.29[2] (good will usually disregarded in determining solvency); *id.* 101.29[4] (going concern valuation usually appropriate); *cf.* *Glosband v. Watts Detective Agency*, 21 Bankr. 963, 975-76 (D. Mass. 1981) (distinguishing concepts of good will and going concern value but acknowledging the relevance of both).

191. UFCA § 2, 7A U.L.A. 427, 442 (1985).

192. See *Gleneagles*, 565 F. Supp. at 578; *Larrimer v. Feeney*, 411 Pa. 604, 607-08, 192 A.2d 351, 353 (1963); *Meyer v. General Am. Corp.*, 569 P.2d 1094, 1096 (Utah 1977); 1 G. GLENN, *supra* note 56, § 272 (UFCA standard reflects the commercial definition often applied by equity courts). Interpretations are not uniform; some courts applying the UFCA have made a balance sheet comparison similar to the Bankruptcy Code standard of insolvency. See, e.g., *Furni-*

tional variables to the inquiry, including the nature of particular liabilities and the resources necessary to make timely payment.¹⁹³ Some courts have viewed the UFCA standard as broader than the balance sheet test of the Bankruptcy Code. On this view the transferor may have a positive net worth and still be considered insolvent if it does not have sufficient cash flow or liquid assets to remain current in payment of debts.¹⁹⁴ On the other hand some courts have interpreted the UFCA definition to allow consideration of sources of credit and other means of payment available to a transferor whose balance sheet shows a negative net worth.¹⁹⁵ In any event there are many areas of uncertainty for the lender attempting to determine at

ture *Mfrs. Sales v. Deamer*, 680 P.2d 398, 400 (Utah 1984) (UFCA requires "a fact and figure balancing of assets and liabilities"; cash shortage and failure to pay bills do not establish insolvency). Professor McLaughlin distinguishes the UFCA from both the balance sheet test required by federal bankruptcy laws and the traditional equity test of failure to pay one's debts as due. He explains the equity test as requiring a valuation of assets at "present quick saleable value," as opposed to "present fair saleable value" in the UFCA. The UFCA, therefore, is "intermediate between the other two." McLaughlin, *supra* note 63, at 420; *cf.* *Cellar Lumber Co. v. Holley*, 9 Ohio App. 2d 288, 290-91, 224 N.E.2d 360, 363 (1967) (suggesting the UFCA goes beyond equity insolvency, because it includes not only failure to meet present debts, but also probable failure to meet future debts).

193. The cases show a wide variety in both the courts' explanations of the standard and the facts the courts consider in reaching a decision. *See Telefest v. VU-TV*, 591 F. Supp. 1368, 1375-76 (D.N.J. 1984) ("significant capital assets to offset working capital deficits," and transferor's "reasonable expectation that business conditions will improve"); *Gleneagles*, 565 F. Supp. at 578-79 (inability to generate cash in operations, lack of liquid assets, and restrictions in loan documents on disposition of assets); *Zellerbach Paper Co. v. Valley Nat'l Bank*, 13 Ariz. App. 431, 434, 477 P.2d 550, 553 (1970) (cessation of operation, increase in liabilities, and decrease in asset value in proximity to transfer). In one buyout case, the court pointed to the buyers' willingness to pay a substantial price for the corporation's stock as evidence of solvency. *See Cate v. Nicely (In re Knox Kreations)*, 474 F. Supp. 567, 571 (E.D. Tenn. 1979), *aff'd in part, rev'd in part*, 656 F.2d 230 (6th Cir. 1981). This overlooks the nature of the buyout, since the parties contemplate that the corporation will pay most of the purchase price. Further, under the statutes, a transfer without consideration is fraudulent not only if the transferor was insolvent before the transfer, but also if the transfer rendered it insolvent.

194. *See Gleneagles*, 565 F. Supp. at 578-79; *Toledo Trust Co. v. Poole (In re Poole)*, 15 Bankr. 422, 428 (Bankr. N.D. Ohio 1981); *Cellar Lumber*, 9 Ohio App. 2d at 290-91, 224 N.E.2d at 363; *Larrimer v. Feeney*, 411 Pa. 604, 609, 192 A.2d 351, 354 (1963).

195. *See, e.g., Telefest*, 591 F. Supp. at 1375-76 (suggesting that credit sources should be considered and that an excess of liabilities over assets does not require a finding of insolvency if the debtor is able to continue operations). *But see Gleneagles*, 565 F. Supp. at 578 (ability to trade on credit does not establish solvency under UFCA).

the time of the transaction what conclusion a court might reach in a later challenge by creditors.

The second element of financial condition, whether the property remaining with the transferor after the transfer is an unreasonably small capital, raises more problems for the lender.¹⁹⁶ There is no difference in the wording of this element in the UFCA and the Bankruptcy Code; the two statutes are equally vague. Neither defines capital, but the references to "property remaining with the debtor" suggest that capital means not only the values traditionally entered as capital items on a balance sheet, but also all the assets on which a corporation depends to operate its business.¹⁹⁷ Further, the reasonableness of capital is an inexact concept subject to the influence of a wide range of circumstances, such as the nature of the transferor's business.¹⁹⁸ Typically, courts simply list facts they

196. The Bankruptcy Code and UFCA provisions differ in minor respects, but each uses the term *unreasonably small capital*. See 11 U.S.C. § 548(a)(2)(B)(ii) (Supp. III 1985); UFCA § 5, 7A U.L.A. 427, 504 (1985). This aspect of constructive fraud is limited to cases in which the transferor is engaged or about to engage in a business or a transaction requiring capital resources. Of course, that requirement will always be met in a buyout.

One decision suggests that both the second and third financial standards (unreasonably small capital and intent to incur debts beyond the debtor's ability to pay) apply only to "circumstances of obvious potential self-dealing, such as intra-family transfers." *Knox Creations*, 474 F. Supp. at 572. This is too narrow an interpretation, at least with respect to unreasonably small capital. The statutory provisions are not restricted to self-dealing or family transactions, and the apparent object of the requirement of reasonable capital is to recognize creditors' expectations that a business debtor will maintain the capital necessary to continue in business.

197. See *Gleneagles*, 565 F. Supp. at 580; UFTA § 5 comment 4, 7A U.L.A. 639, 654 (1985) (substituting the term *assets* for *capital* to avoid special meanings associated with capital in corporate law); Hackney & Benson, *supra* note 19, at 890-91 (in context of shareholder liability or equitable subordination based on inadequate capital, "[a]nything owned by the corporation which would contribute to its operating capabilities would qualify" as capital). Compare *Steph v. Branch*, 255 F. Supp. 526, 528-29 (E.D. Okla. 1966) (apparently equating capital with net worth), *aff'd*, 389 F.2d 233 (10th Cir. 1968) and *Sharrer v. Sandlas*, 103 A.D.2d 873, 873, 477 N.Y.S.2d 897, 898 (App. Div.) (same), *appeal denied*, 63 N.Y.2d 610, 473 N.E.2d 1190, 484 N.Y.S.2d 1024 (1984) with *Credit Managers Ass'n v. Federal Co.*, 629 F. Supp. 175, 183, 187 (C.D. Cal. 1986) (emphasizing cash flow rather than ratio of debt to equity) and *Widett v. George*, 336 Mass. 746, 750, 148 N.E.2d 172, 175 (1958) (sound prospects and the possession of particular assets required for the business may be more important than equity in assets).

198. For example, in *Widett*, a case involving a restaurant corporation, the court pointed out that a restaurant normally has a prompt turnover of inventory. Therefore, the restaurant might reasonably expect to finance its operations primarily from current receipts. *Widett*, 336 Mass. at 750-51, 148 N.E.2d at 175.

consider relevant to the issue of reasonable capital in the particular case without defining a general approach to the problem.¹⁹⁹

The third financial element is whether the transferor intended or believed at the time of the transfer that it would incur debts beyond its ability to pay.²⁰⁰ Courts have not often elaborated on this standard. Several decisions suggest it encompasses not only actual, purposive intent, but also situations in which persons in control of a corporate transferor knew or should have anticipated that the corporation would be unable to pay future debts.²⁰¹ In *Gleneagles*, for example, the court reasoned that corporate principals must have intended or believed the corporation would be unable to pay debts, because the corporation, although certain to become liable for substantial property taxes, had ceased production and agreed in buyout loan documents to limit sales of assets from which it might have raised money for taxes.²⁰²

This third standard causes special difficulty because it focuses on the transferor's state of mind.²⁰³ In some cases, such

199. See *Steph*, 255 F. Supp. at 532 (citing testimony as to reasonable capital); *In re Process-Manz Press*, 236 F. Supp. 333, 346 (N.D. Ill. 1964) (citing inability to meet debts), *rev'd on jurisdictional grounds*, 369 F.2d 513 (7th Cir. 1966), *cert. denied*, 386 U.S. 957 (1967); *Widett*, 336 Mass. at 750, 148 N.E.2d at 175 (citing prospects of income).

Wells Fargo Bank v. Desert View Bldg. Supplies, 475 F. Supp. 693 (D. Nev. 1978), *aff'd mem.*, 633 F.2d 221, 225 (9th Cir. 1980), is typical of opinions on this subject. In that case a corporation obtained a loan and transferred the proceeds to its parent for payment of a debt of the parent. See *id.* at 695. The debtor had retained earnings after the transaction and was able to continue its business and obtain trade credit, but it had an earnings deficit in the year of the transfer, suffered subsequent losses, and had an "extremely low" cash reserve for a business its size. *Id.* at 695-97. Viewing all these circumstances together, the court upheld a finding that the borrowing had left the corporation with unreasonably small capital. See *id.* at 697.

200. 11 U.S.C. § 548(a)(2)(B)(iii) (1982); UFCA § 6, 7A U.L.A. 427, 507 (1985). These provisions are substantially similar in wording.

201. See *Gleneagles*, 565 F. Supp. at 580, 582-83; *Roxbury*, 129 N.J. Super. at 375-76, 324 A.2d at 33; *Waukesha County Dep't of Social Servs. v. Loper*, 53 Wis. 2d 713, 717, 193 N.W.2d 679, 681 (1972) (whether individual debtor "knew or should have known" it would be unable to pay debts). But see *McLaughlin*, *supra* note 63, at 421 (interpreting statute to require specific intent).

202. *Gleneagles*, 565 F. Supp. at 582. In addition to finding insolvency and unreasonably small capital, the court also noted that the third constructive fraud provision was satisfied. *Id.* at 580.

203. By the terms of the statutes, the relevant intent or belief is that of the transferor. In one buyout case, the court appeared to focus on the transferee's knowledge that the acquired corporation would incur debts it could not pay after the buyout. See *Process-Manz*, 236 F. Supp. at 346. The court's attention to the transferee's state of mind, however, is explainable by the particular cir-

as *Gleneagles*, loan documents and other facts known to the lender establish the transferor's awareness that it will incur debts it cannot pay. It is also possible, however, that the transferor's principals intend at the time of the buyout to incur specific obligations that are not known or disclosed to the lender. Even though the lender in such a case could not perceive the defect and refuse to advance funds, creditors might be able to avoid the lender's interests.

The lender's problems in applying any of the three financial standards are complicated by the courts' tendency to rely on hindsight in evaluating a transferor's financial condition. By the terms of the statutes, the transferor's financial condition at the time of the transfer determines whether the transfer is a fraud.²⁰⁴ Nevertheless, courts may follow the logic of Professor Glenn, who observed that because "insolvency is not reached overnight,—at least in normal times—it is a fair conclusion that if the evidence shows a man to be insolvent to-day, he was probably in the same plight yesterday."²⁰⁵ In one buyout case, for example, a court based its finding of inadequate capital primarily on a doubling of trade debt in the year following the transaction.²⁰⁶

In sum, the financial condition standards of constructive fraud, as courts apply them, are not standards that a lender can apply with certainty to determine the validity of corporate transfers in a buyout. The tests of insolvency, unreasonably small capital, and intent to incur debts are too indefinite. Further, with respect to the transferor's anticipation of incurring debts it cannot pay, the information needed to make an informed decision may not be available to a lender. These considerations, combined with the influence of hindsight and a deferential standard of review,²⁰⁷ create a substantial risk that

cumstances of the case. The court found the transferee (a lender) had assumed effective control of the corporate transferor, and on that basis, it may have imputed the transferor's knowledge and intent to the transferee. *See id.* at 337.

204. *See* 11 U.S.C. § 548(a)(2)(B) (1982 & Supp. III 1985); UFCA §§ 4-6, 7A U.L.A. 427, 474, 504, 507 (1985); *Credit Managers Ass'n v. Federal Co.*, 629 F. Supp. 175, 184, 186-87 (C.D. Cal. 1986); *Rosenberg*, *supra* note 6, at 252.

205. 1 G. GLENN, *supra* note 56, § 229b. *See Zellerbach Paper Co. v. Valley Nat'l Bank*, 13 Ariz. App. 431, 434-35, 477 P.2d 550, 553-54 (1970).

206. *See Process-Manz*, 236 F. Supp. at 346.

207. Insolvency and the other financial condition components of constructive fraud are mixed issues of fact and law. *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288, 1303 (3d Cir. 1986), *cert. denied*, 107 S. Ct. 3229 (1987). Often, though, courts emphasize the factual side of the inquiry and give substantial weight to the overall conclusions of a trial court or master.

the lender's reasonable judgment at the time of the buyout will differ from the later judgment of a court.²⁰⁸

Burdens of proof may assist the lender in some cases but do not provide dependable protection. Generally, a creditor or trustee who challenges a transfer must prove the elements of the case.²⁰⁹ Courts have not all agreed on this point, however. Some opinions suggest that once the creditor or trustee establishes that the transferor did not receive a fair consideration, the burden of production, or even persuasion, shifts to the transferee on the issue of insolvency.²¹⁰ In any event the protection a lender may obtain through the allocation of difficult burdens of proof to other parties depends on the obscurity of relevant facts. Reallocating burdens of proof is therefore not a satisfactory means of limiting the lender's exposure.

The problems facing the buyout lender cannot be solved by rewriting fraudulent conveyance laws to provide simple and predictable tests of financial condition. The statutory standards of financial condition are designed to apply to all types of transfers made for less than fair consideration. The degree of financial strength required to protect creditors' reasonable expectations of payment is a subtle question, and courts need room to adapt the statutory tests to specific cases. The present standards are not wrong; they simply do not permit a lender to

See *Consove v. Cohen (In re Roco Corp.)*, 701 F.2d 978, 981-82 (1st Cir. 1983); *Telefest v. VU-TV*, 591 F. Supp. 1368, 1376 (D.N.J. 1984); 4 COLLIER, *supra* note 19, ¶ 548.04 (reasonable capital is an issue of fact); *cf. Zellerbach Paper*, 13 Ariz. App. at 435, 477 P.2d at 554 (standard of clear error, but error found).

208. See *Baird & Jackson*, *supra* note 10, at 838, 840-43 (referring to costs of uncertainty and discussing the difficulty of applying the financial condition standards).

209. 4 COLLIER, *supra* note 19, ¶¶ 548.04, 548.10; see *Rubin v. Manufacturers Hanover Trust Co.*, 661 F.2d 979, 994 (2d Cir. 1981); *Constructora Maza, Inc. v. Banco de Ponce*, 616 F.2d 573, 576 (1st Cir. 1980); *Telefest*, 591 F. Supp. at 1375-76 (D.N.J. 1984); *Emerald Hills Country Club v. Hollywood, Inc. (In re Emerald Hills Country Club)*, 32 Bankr. 408, 420 (Bankr. S.D. Fla. 1983).

210. See *Gleneagles*, 565 F. Supp. at 577; *Hasset v. Far W. Fed. Savings & Loan Ass'n (In re O.P.M. Leasing Servs.)*, 40 Bankr. 380, 393 (Bankr. S.D.N.Y.), *aff'd*, 44 Bankr. 1023 (S.D.N.Y. 1984), *aff'd*, 769 F.2d 911 (2d Cir. 1985); *Colandrea v. Colandrea (In re Colandrea)*, 17 Bankr. 568, 579-80 (Bankr. D. Md. 1982); *Toledo Trust Co. v. Poole (In re Poole)*, 15 Bankr. 422, 428-29 (Bankr. N.D. Ohio 1981); *Zellerbach Paper*, 13 Ariz. App. at 435, 477 P.2d at 554; *cf. Kirkland v. Risso*, 98 Cal. App. 3d 971, 978-79, 159 Cal. Rptr. 798, 801-02 (1979) (on showing of insolvency, burden shifts to transferee to show fair consideration); *Stinner v. Stinner*, 446 A.2d 651, 652 (Pa. Super. Ct. 1982) (on showing that transferee was in debt at time of the transaction, burden of persuasion on issues of fair consideration and insolvency shifts to transferee).

make a definite assessment of the legality of a buyout transaction.

Because the legal standards for constructive fraud are imprecise, the solution for the lender must take the form of a limiting principle that will protect the lender's reasonable judgment and avoid making it an insurer of the transaction. The natural place to look for this solution is in the saving provisions of the statutes, which prevent creditors from asserting claims against a transferee who took for value and in good faith. Saving provisions have long been a part of the structure of fraudulent conveyance laws.²¹¹ They reflect a judgment that when a transferee pays value for interests received and is not culpably involved in the fraud, creditors have no superior equities that entitle them to claim the property.²¹² As a general principle, this might extend to a buyout lender who reviews the buyout transaction before going forward and reaches a reasonable (but wrong) conclusion that it is not a fraud against creditors.²¹³

Under the reasoning of *Gleneagles* and *Roxbury*, however, the saving provisions are of no practical help to the lender. Under both the UFCA and the Code, the saving provisions apply only when the transferor has given consideration for the transfer.²¹⁴ The logic of *Gleneagles* and *Roxbury* prevents the

211. See *supra* note 60. For general discussions of the protection afforded to good faith transferees for value, see M. BIGELOW, *THE LAW OF FRAUDULENT CONVEYANCES* 529-615 (1911); 1 G. GLENN, *supra* note 56, §§ 233-235, 304; Erlich, *Avoidance of Foreclosure Sales as Fraudulent Conveyances: Accommodating State and Federal Objectives*, 71 VA. L. REV. 933, 970-71 (1985).

212. See M. BIGELOW, *supra* note 211, at 529-30; Erlich, *supra* note 211, at 952; cf. 1 G. GLENN, *supra* note 56, § 235 (suggesting the saving provision is based on both the equities favoring the purchaser and the fact that an exchange of value does not deplete the transferor's estate).

213. For an analysis of leveraged buyouts based on the saving provision of the Bankruptcy Code, see Carlson, *supra* note 2. Professor Carlson suggests that the consideration requirement in the saving provision should be interpreted differently from the consideration requirement in the provisions defining constructive fraud. See *id.* at 86-87. He points out that in contrast to the main constructive fraud provisions, which focus on the transferor and its estate, the saving provision focuses on the transferee. See *id.* Therefore, consideration for purposes of the saving provision should mean value given up by the transferee. *Id.*

214. The UFCA exempts a "purchaser for fair consideration" who has no knowledge of fraud and allows a lien "for repayment" to "a purchaser who without actual fraudulent intent has given less than a fair consideration." UFCA § 9, 7A U.L.A. 427, 577-78 (1985). The Bankruptcy Code protects a good faith transferee to the extent of value given to the debtor. See 11 U.S.C. §§ 548(c), 550(b)(1) (1982 & Supp. III 1985).

lender from satisfying the consideration requirement. The premise of both cases is that a lender's advance of funds to a corporation to finance a buyout is not fair consideration or reasonably equivalent value for the obligations assumed by the corporation and the encumbrance of the corporation's assets. If the same reasoning is applied in connection with the saving provisions, the lender's advance cannot be regarded as value and the saving provisions do not apply.²¹⁵ Therefore, the lender has no defense, regardless of its good faith or lack of knowledge of fraud.

III. PROPOSALS

Leveraged buyouts do not fit easily into the framework of fraudulent conveyance laws as currently interpreted, especially when the buyout is externally financed. The decisions in *United States v. Gleneagles Investment Co.*²¹⁶ and *Roxbury State Bank v. The Clarendon*²¹⁷ are unsatisfactory because they place too broad a potential liability on independent lenders who finance leveraged buyouts. The legal standards that determine liability do not permit the lender to predict with certainty the outcome in a particular case, and the saving provisions do not protect a lender who makes a reasonable but erroneous judgment. Although fraudulent conveyance statutes should apply to buyouts, limitations are needed to accommodate the different interests and policies involved. The first proposal below concerns the role of intentional fraud. The second, borrowing from standards of liability for aiding and abetting violations of securities laws, suggests an interpretation of the element of *fair consideration* or *reasonably equivalent value in exchange* in constructive fraud provisions.

A. INTENTIONAL FRAUD

Intentional fraud should not enter into the analysis of a leveraged buyout unless the facts show a motive or plan to hin-

215. The court in *Gleneagles* did not discuss whether its concept of fair consideration would carry over to disqualify the lender for protection under the saving provisions. Instead, it held that the saving provisions were inapplicable because the lender had knowledge of the fraud. See *Gleneagles III*, 584 F. Supp. at 681-82; *Gleneagles*, 565 F. Supp. at 580-82.

216. 565 F. Supp. 556 (M.D. Pa. 1983), *aff'd sub nom.* *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288 (3d Cir. 1986), *cert. denied*, 107 S. Ct. 3229 (1987).

217. 129 N.J. Super. 358, 324 A.2d 34 (Super. Ct. App. Div.), *certif. denied*, 66 N.J. 316, 331 A.2d 16 (1974).

der creditors beyond simply using corporate assets to finance a purchase of shares. In some circumstances the concept of intentional fraud may be applicable to a buyout. In *Gleneagles*, for example, evidence suggested that the purchasing shareholders, in collusion with other parties, intended from the outset to liquidate corporate assets and to defeat claims of creditors through tax sales of corporate property.²¹⁸ In these circumstances creditors should have recourse against the principal parties on the basis of intentional fraud, without regard to adequacy of consideration or financial condition. If an outside lender participates with knowledge of the principals' plan to defraud creditors, creditors should also be able to avoid corporate transfers to the lender.

Gleneagles, however, went further than this. The court determined that both the principals and the lender were chargeable with intentional fraud because they could foresee that creditors would be adversely affected by the substantial new secured obligation undertaken when the acquired corporations were in a precarious financial condition.²¹⁹ Thus, the finding of intentional fraud was based not on the buyers' specific designs to hinder creditors, but merely on the fact that they engaged in a leveraged buyout.

This application of the intentional fraud branch of fraudulent conveyance laws is not necessary and should be avoided. In the absence of unusual circumstances, the concerns involved in a leveraged buyout are exactly those addressed in the con-

218. See *Gleneagles III*, 584 F. Supp. at 684; *Gleneagles II*, 571 F. Supp. at 940, 946-49, 955-58. The district court's opinions indicate that the buyers began to liquidate corporate assets soon after completing the buyout. See *Gleneagles II*, 571 F. Supp. at 955; *Gleneagles*, 565 F. Supp. at 572. The buyers also permitted tax sales of corporate lands, with the understanding that nominees of one of the defendants, Pagnotti Enterprises, would purchase the lands at the tax sales. See *Gleneagles II*, 571 F. Supp. at 946-48. Principals of Pagnotti Enterprises apparently had been involved in the initial planning and financing of the buyout, and Pagnotti affiliates ultimately purchased the buyout mortgages and gained control of the corporations. See *id.* at 945-50. Although the district court did not find intentional fraud in the connection with the tax sales, it suggested that it might have viewed this manipulation of assets as intentional fraud if there had been "clear and convincing evidence" of a conspiracy. See *id.* at 958.

Some of the undercurrents of the buyout in *Gleneagles* are described in Carlson, *supra* note 2, at 105 n.102. Professor Carlson cites *Gleneagles* as an example of a "looting scheme," which is one of the circumstances in which he would allow creditors to recover. See *id.* at 104-06, 120-21.

219. See *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288, 1305 (3d Cir. 1986), *cert. denied*, 107 S. Ct. 3229 (1987); *Gleneagles*, 565 F. Supp. at 580-82; *supra* notes 141-45, 182 and accompanying text.

structive fraud provisions of fraudulent conveyance laws—lack of adequate consideration to the transferor and adverse financial condition. Constructive fraud was introduced to the statutes to avoid the uncertainty of a subjective standard in situations that could be objectively defined.²²⁰ Further, when the issues raised by a particular conveyance are consideration and financial condition, the constructive fraud provisions strike a balance between the interests of creditors and those of the parties to the transaction that should not be modified under the heading of intentional fraud. The statutes retained the concept of intentional fraud to cover other problems that could not be anticipated in specific terms. It should be limited to that role and excluded from consideration in a standard buyout transaction.

B. FAIR CONSIDERATION

1. The Role of Good Faith in Three-Party Transactions

The second proposal calls for closer attention to the role of different parties in applying the element of fair consideration in constructive fraud. The premise of the decisions in *Gleneagles* and *Roxbury* is that a lender who advances money to a corporation knowing the loan will be used to carry out a buyout does not give fair consideration for the corporate property and obligations it receives. To reach this conclusion, both courts relied on the good faith requirement that is part of the definition of fair consideration under the UFCA. In each case the lender gave money directly to the corporation but failed nonetheless to meet the courts' concept of good faith.²²¹

As *Gleneagles* and *Roxbury* demonstrate, the effect of such a good faith requirement is that a party who gives up value still may be held responsible to creditors on the ground of constructive fraud. In most situations good faith seems out of place in a constructive fraud provision. Constructive fraud focuses on objective circumstances—depletion of the transferor's net estate and financial conditions that make the transaction harmful to creditors.²²² In an equal exchange, creditors will not be

220. See *supra* notes 70, 72 and accompanying text.

221. See *Gleneagles*, 565 F. Supp. at 574; *Roxbury*, 129 N.J. Super. at 373-74, 324 A.2d at 32.

222. Some authors have suggested that the inclusion of good faith in the definition of fair consideration conflicts with the general intent of the UFCA drafters to provide an objective standard of decision. See Rosenberg, *supra* note 6, at 248; Note, *supra* note 70, at 502-03. Both the Bankruptcy Code and

harmed unless the exchange is part of a design to hinder them. In that case the question should be one of intentional rather than constructive fraud.

In three-party transactions, however, the good faith element of fair consideration can serve a useful purpose. The direct transferee may give up value in return for the transfer received, but the value passes directly or indirectly to a third party rather than to the transferor. In such a case, the requirement of good faith gives the court a point of reference to determine whether the direct transferee should be liable to creditors even though it does not realize a gain.

The facts of *Gleneagles* and *Roxbury* illustrate the function of the good faith standard. In each case the transferee (a lender) advanced money directly to the corporate transferor, but proceeds of the loan were used in a buyout. In that situation the lender should not be held liable to creditors simply because the benefits of its loan are diverted from the borrower. At the same time, however, it should not be insulated from liability because the form of the transaction is an advance to the borrower. A good faith standard permits the court to consider whether the lender made a reasonable evaluation of the transaction and its consequences to the creditors.

The good faith requirement also could be used to determine the liability of a transferee who gives value directly to a third party in consideration for a transfer. To do this it would first be necessary to modify the usual view of third-party benefits. Courts generally have held that a benefit flowing to a third party is not fair consideration for purposes of fraudulent conveyance law.²²³ This conclusion is not inevitable, though. The statutory definition of fair consideration does not exclude third-party benefits.²²⁴ The true beneficiary of the transaction

the UFTA omit the requirement of good faith from their constructive fraud provisions. See 11 U.S.C. § 548(a)(2)(A) (1982 & Supp. III 1985); UFTA §§ 4(a)(2), 5, 7A U.L.A. 639, 653, 657 (1985); *id.* prefatory note, 7A U.L.A. at 641.

223. See *supra* notes 90-95 and accompanying text.

224. The definition of fair consideration in the UFCA requires only that "property is conveyed or an antecedent debt is satisfied." UFCA § 3, 7A U.L.A. 427, 448 (1985). The consideration must be given "in exchange," but under contract principles this does not necessarily mean it must augment the transferor's assets. See RESTATEMENT (SECOND) OF CONTRACTS § 71(4) & comment e (1979). The Bankruptcy Code and the UFTA require "reasonably equivalent value in exchange," with no specific direction that the value must go to the transferor's estate. See 11 U.S.C. § 548(a)(2)(A) (1982 & Supp. III 1985); UFTA §§ 4(a)(2), 5(a), 7A U.L.A. 639, 653, 657 (1985).

is the third party who receives the consideration, and creditors should be able to recover against that party.²²⁵ Whether they also should have recourse against the direct transferee who provides the third-party benefit in return for a conveyance requires a more delicate balance. Here, the good faith standard is useful as a shorthand for circumstances that warrant holding the party who parted with value accountable to creditors for the amount of the conveyance.

This reasoning would apply to a buyout in which a lender advances funds to purchasing shareholders and obtains a secured guaranty of repayment from the acquired corporation. Although the corporation does not receive the advance or derive any measurable benefit from it, the loan and guaranty are an agreed exchange. If the lender acts in good faith, its loan would be treated as fair consideration for the guaranty it received; if not, creditors would be able to avoid the guaranty. In any event creditors could recover from the buyers who received the benefit of the guaranty.²²⁶

2. Defining a Standard of Good Faith

Although good faith may be useful in determining liability in three-party transactions, a new definition of good faith is needed. As an element of fair consideration, good faith depends on the transferee's scienter or awareness of a fraud against creditors. Cases interpreting the term *good faith* suggest at least three different standards of liability: notice, based on suspicious circumstances of the transaction; knowledge, generally meaning actual knowledge of facts that establish a fraud; and participation, in the sense that the transferee shares the motive or benefits of the transaction.²²⁷ The standard applied

225. Creditors' claims against parties who received the benefit of a transfer without receiving specific property of the transferor, and in particular against the principal parties in a leveraged buyout, are discussed *supra* notes 102-08, 119-21 and accompanying text.

226. Other writers' analyses of guaranty transactions are discussed *supra* notes 99-101 and accompanying text.

227. See *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288, 1296 (3d Cir. 1986) (knowledge), *cert. denied*, 107 S. Ct. 3229 (1987); *In re Southern Land Title Corp.*, 316 F. Supp. 1059, 1064-65 (E.D. La. 1970) (stating that subjective intent controls but focusing on transferee's knowledge of transferor's insolvency), *aff'd*, 474 F.2d 1033 (5th Cir. 1973); *In re Atlas Foundry Co.*, 155 F. Supp. 615, 618 (D.N.J. 1957) (awareness of and intent to assist a fraudulent purpose); *Pereira v. Checkmate Communications Co.* (*In re Checkmate Stereo & Elecs.*), 9 Bankr. 585, 617-18 (Bankr. E.D.N.Y. 1981) (stating several standards, including knowledge of adverse financial condition, intent to obtain advantage, and abuse of controlling position), *aff'd*, 21 Bankr. 402 (E.D.N.Y.

in *Gleneagles* and *Roxbury* was knowledge of facts that would

1982); *Shay v. Gagne*, 275 Mass. 386, 391, 176 N.E. 200, 202 (1931) (collusion to obtain benefit or intent to hinder other creditors); *Roxbury*, 129 N.J. Super. at 373-74, 324 A.2d at 32 (knowledge); *Smith v. Whitman*, 39 N.J. 397, 405, 189 A.2d 15, 20 (1963) (knowing assistance of a plan to secrete assets or hinder creditors); *Tacoma Ass'n of Credit Men v. Lester*, 72 Wash. 2d 453, 458, 433 P.2d 901, 904 (1967) (good faith requires "(1) An honest belief in the propriety of the activities . . . ; (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"); *Sparkman & McLean Co. v. Derber*, 4 Wash. App. 341, 348-50, 481 P.2d 585, 591 (1971) (same, applied as a standard of inquiry notice). In some cases courts have not viewed good faith in terms of scienter but instead have asked whether the exchange had the "earmarks of an arms-length bargain." *Bullard v. Aluminum Co. of Am.*, 468 F.2d 11, 13 (7th Cir. 1972) (quoting *Holahan v. Henderson*, 277 F. Supp. 890, 899 (W.D. La. 1967), *aff'd*, 394 F.2d 177 (5th Cir.), *cert. denied*, 393 U.S. 848 (1968)); see *Wells Fargo Bank v. Desert View Bldg. Supplies (In re Desert View Bldg. Supplies)*, 475 F. Supp. 693, 696 (D. Nev. 1978), *aff'd mem.*, 633 F.2d 221, 225 (9th Cir. 1980). A few decisions suggest both the transferor and the transferee must have acted in good faith to satisfy the requirement of fair consideration. See, e.g., *Checkmate Stereo & Elecs.*, 9 Bankr. at 617. Other courts, however, have referred only to the good faith of the transferee, which is appropriate for a provision relating to the adequacy of consideration. See, e.g., *Duberstein v. Werner*, 256 F. Supp. 515, 520 (E.D.N.Y. 1966); *Shay v. Gagne*, 275 Mass. 386, 391, 176 N.E. 200, 202 (1931).

The term *participation* is taken from Note, *supra* note 70, at 508-09. The note discusses the application of the good faith requirement when a transferee has accepted a payment or transfer on account of an antecedent debt of the transferor. It divides standards of good faith applied by courts into two categories: standards of "knowledge" and standards of "participation." See *id.* at 506-09. At least in the context of preferential payments, the note recommends a participation standard as more consistent with the structure and purpose of the constructive fraud provisions. See *id.* at 509-10. Standards of good faith are also discussed in *Rosenberg*, *supra* note 6, at 248-52.

Professor Glenn defines good faith, for the purpose of determining fair consideration, as lack of knowledge or notice of the transferor's intent to defraud creditors. See 1 G. GLENN, *supra* note 56, §§ 294-296. Apparently, he would infer bad faith if the transferee "knew or should have known . . . he was not trading normally." *Id.* § 295. In the context of constructive fraud, knowledge of the transferor's fraudulent intent is incongruous; presumably it means knowledge that the consideration given for the transfer was inadequate and the transferor was in adverse financial condition.

The state of mind of the transferee of a fraudulent conveyance is also an element of the saving provisions. The saving provision of the Bankruptcy Code requires good faith. See 11 U.S.C. § 548(c) (Supp. III 1985); *id.* § 550(b)(1) (1982) (trustee may not recover from good faith transferee). The UFCA protects a "purchaser for fair consideration without knowledge of the fraud," and gives a lien to a purchaser for less than fair consideration who acted "without actual fraudulent intent." UFCA § 9, 7A U.L.A. 427, 578 (1985). Here too, courts have adopted varying standards of scienter to define the transferee's defense. See *Edward Hines W. Pipe Co. v. First Nat'l Bank*, 61 F.2d 503, 510 (7th Cir. 1932) (knowing participation); *In re Venie*, 80 F. Supp. 250, 256 (W.D. Mo. 1948) (knowledge of purpose); *Potter v. Walker*, 2 F.2d 774, 778 (E.D.N.Y. 1924) (notice); *Enos v. Picacho Gold Mining Co.*, 56 Cal. App. 2d 765, 773-74, 133 P.2d

bring the buyout within the definition of constructive fraud.²²⁸

None of these accepted definitions of good faith provides a good solution to the problem of fair consideration in a buyout. A standard based on notice of facts that make the transfer a fraud against creditors might be appropriate to determine the good faith of selling shareholders who accept corporate obligations and security in exchange for their shares. Applied to an independent lender, however, a notice standard could alter normal lending practices if it required lenders to investigate the use of loan proceeds beyond the supervision they would exercise in their own interests.²²⁹

An actual knowledge standard also is unworkable. Such a standard may be too lenient in the case of selling shareholders, who should be assumed to know the financial circumstances of their corporation and the terms of the buyout. As applied to an

663, 668-69 (1943) (knowledge of or participation in fraudulent intent); *Berger v. Hi-Gear Tire & Auto Supply*, 257 Md. 470, 477, 263 A.2d 507, 510 (1970) (suspicious circumstances place burden on transferee to show no knowledge or participation); *O'Neill v. Little*, 107 N.J. Super. 426, 434, 258 A.2d 731, 735 (Super. Ct. Ch. Div. 1969) (notice); *Goodhope v. Overgaard*, 56 S.D. 28, 34, 227 N.W. 380, 382-83 (1929) (knowledge of insolvency); *Columbia Int'l Corp. v. Perry*, 54 Wash. 2d 876, 879, 344 P.2d 509, 511-12 (1959) (notice or knowledge); *Waukesha County Dep't of Social Servs. v. Loper*, 53 Wisc. 2d 713, 717-18, 193 N.W.2d 679, 682 (1972) (participation in fraudulent intent); M. BIGELOW, *supra* note 211, at 589-602; 4 COLLIER, *supra* note 19, ¶ 548.07[2]-[3]; 1 G. GLENN, *supra* note 56, § 304.

Under the UFCA, interpretation is complicated by the possibility of an interplay between the subjective good faith element of fair consideration and the language limiting the saving defense to purchasers without knowledge of fraud. Arguably, if the defense of a purchaser for fair consideration turns on lack of knowledge, knowledge cannot be the test of good faith because the requirements of fair consideration and lack of knowledge would be redundant. On the other hand, the saving provision for purchasers without knowledge seems designed for cases of intentional fraud, when the question is whether the transferee knew of a fraudulent scheme on the part of the transferor. Therefore, it is not necessarily related to the standard of good faith that determines the adequacy of consideration for purposes of constructive fraud. *Cf.* 4 COLLIER, *supra* note 19, ¶ 548.07[3] (comparing the good faith requirement to the requirement of no "actual fraudulent intent" in the second saving provision, and suggesting knowledge of insolvency or fraud establishes bad faith).

228. In *Gleneagles*, for example, the court stated that the lender did not meet the standard of good faith because it knew of the planned use of loan proceeds and "knew or strongly suspected that [the buyout] would probably render [the corporate borrowers] insolvent." *Gleneagles*, 565 F. Supp. at 574; *see Roxbury*, 129 N.J. Super. at 379, 324 A.2d at 34 (no fair consideration when bank knew of use of loan proceeds).

229. In *Roxbury* the court emphasized that its decision was not intended to impose a duty of investigation on lenders; the bank's liability depended on actual knowledge of the use of loan proceeds. *See Roxbury*, 129 N.J. Super. at 379, 324 A.2d at 34.

outside lender, actual knowledge of fraud is too broad a basis for liability. The legal conclusion of fraud is not susceptible to actual knowledge, particularly in light of the uncertainty of the financial condition elements of constructive fraud. Assuming, then, that *knowledge* means knowledge of facts that are later determined to establish fraud, the knowledge standard gives the lender no margin for reasonable error in its legal judgment. The lender must either reject all proposed transactions in which there is any doubt that the financial requirements of fraudulent conveyance law are met, or risk losses that are not appropriate to its role in the transaction.

A participation standard also is inadequate, because it fails to impose any meaningful duty on an independent lender financing a buyout. In an ordinary buyout financing, the lender does not participate in the sense of having a personal interest in the accomplishment of the buyout. The only benefit it derives is the compensation incidental to its lending services. In addition, the lender normally cannot be considered to share a conscious intent of the buyers and sellers to hinder or defraud creditors. Therefore, if good faith were interpreted to require only that the lender does not participate in the fraud, fair consideration would be present in all but extraordinary cases. The lender would have no incentive to assess the financial impact of the buyout on creditors before extending funds.

Most courts have approached the interpretation of good faith by identifying a standard intended to define good and bad faith in all cases.²³⁰ Whatever the standard—notice, knowledge, participation, or some combination of the three—it is assumed to apply generally to all transferees. This method of analysis may explain why none of the prevalent standards is satisfactory in a buyout case. A single standard of good faith excludes consideration of the particular interests and policies involved in holding different parties responsible to creditors. Rather than selecting one degree of scienter to determine the good faith of all transferees, courts should develop a set of principles defining how the scienter standard should vary in different contexts.

230. Some courts have indicated they would apply a special standard to an insider who received a transfer from the corporation. *See, e.g.,* *Duberstein v. Werner*, 256 F. Supp. 515, 520-21 (E.D.N.Y. 1966). *Gleneagles* is more typical: the Third Circuit chose knowledge of fraud as a general standard to define good faith, without reference to the nature of the transaction or the role in which the defendant participated. *See United States v. Tabor Court Realty Corp.*, 803 F.2d 1288, 1296 (3d Cir. 1986), *cert. denied*, 107 S. Ct. 3229 (1987).

The possibility of a variable requirement of scienter is illustrated by developments in securities law relating to secondary liability for violations of securities regulations. Under the heading of aiding and abetting, courts have imposed liability for the consequences of an illegal securities transaction on lenders, lawyers, accountants, and other parties performing business services for the primary wrongdoers.²³¹ Under the accepted standard, there are three essential elements to establish liability for aiding and abetting: a primary violation by another party; substantial assistance by the defendant; and scienter on the part of the defendant.²³²

The scienter element of liability for aiding and abetting securities fraud usually requires that the defendant be aware of both the primary violation and the defendant's role in assisting it.²³³ Courts have differed on the content of this standard. Some accept proof of reckless disregard of illegal activity, while others require proof of a "conscious intent" to assist the violation.²³⁴ The most interesting aspect of the cases in this area is

231. See *Metge v. Baehler*, 762 F.2d 621 (8th Cir. 1985), *cert. denied*, 474 U.S. 1057 (1986); *Monsen v. Consolidated Dressed Beef Co.*, 579 F.2d 793 (3d Cir.), *cert. denied*, 439 U.S. 930 (1978); *Ruder, Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution*, 120 U. PA. L. REV. 597, 599 & n.5 (1972).

232. See *IIT v. Cornfeld*, 619 F.2d 909, 922 (2d Cir. 1980). Courts of appeals' decisions adopting essentially the same standard are collected in *Woods v. Barnett Bank*, 765 F.2d 1004, 1009 n.8 (11th Cir. 1985). The standard is drawn from the standard of secondary liability set out in the RESTATEMENT (SECOND) OF TORTS § 876(b) (1979).

Courts in securities cases have varied somewhat in their statements of the test. One formula often used is that "some other party has committed a securities law violation, . . . the accused party had general awareness that his role was part of an overall activity that is improper, and . . . the accused aider-abettor knowingly and substantially assisted the violation." *SEC v. Coffey*, 493 F.2d 1304, 1316 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975). The United States Supreme Court has declined so far to consider aiding and abetting as a basis of liability in securities cases. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 192 n.7 (1976). For more substantial discussion and analysis of this area of law, see *Ruder, supra* note 231; Note, *Liability for Aiding and Abetting Violations of Rule 10b-5: The Recklessness Standard in Civil Damage Actions*, 62 TEX. L. REV. 1087 (1984); Comment, *Establishment of Liability for Aiding and Abetting Fraud Under Rule 10b-5 and the Common Law*, 25 UCLA L. REV. 862 (1978); Commentary, *Rule 10b-5: Liability for Aiding and Abetting After Ernst & Ernst v. Hochfelder*, 28 U. FLA. L. REV. 999 (1976).

233. See *Cleary v. Perfectune, Inc.*, 700 F.2d 774, 777 (1st Cir. 1983); *Monsen*, 579 F.2d at 799; Comment, *supra* note 232, at 868-71; Commentary, *supra* note 232, at 1002-15. Professor *Ruder* suggests that knowledge should mean not only awareness of the facts but awareness that they add up to an illegal situation. See *Ruder, supra* note 231, at 636-38.

234. See *Woods*, 765 F.2d at 1010 (recklessness); *Metge*, 762 F.2d at 625 (con-

that several courts have adopted a variable range of standards—recklessness, actual knowledge, or conscious intent—depending on the defendant's commercial position and role in the transaction.²³⁵

In one leading case, for example, the court found a connection between the element of scienter and the manner in which the defendant assisted in the violation.²³⁶ As a result different defendants would be subject to different scienter standards depending on the nature of their role in a questioned transaction.²³⁷ The court also identified relevant circumstances that could serve as guidelines in applying a variable scienter standard. One of these circumstances relates to the business character of the defendant's activities. The court stated that when the defendant has assisted a securities violation by affirmative action (such as financing),

the degree of knowledge required should depend on how ordinary the assisting activity is in the business involved. If the evidence shows no more than transactions constituting the daily grist of the mill, we would be loathe to find . . . liability without clear proof of intent to violate the securities laws. Conversely, if the method or transaction is atypical or lacks business justification, it may be possible to infer the knowledge necessary for aiding and abetting liability.²³⁸

scious intent in some circumstances); *Cleary*, 700 F.2d at 777 (recklessness); *IIT*, 619 F.2d at 923 (recklessness); *Woodward v. Metro Bank*, 522 F.2d 84, 97 (5th Cir. 1975) (conscious intent in some circumstances). The different standards are discussed in the three student articles cited *supra* note 232.

235. See *Woods*, 765 F.2d at 1010; *SEC v. Washington County Util. Dist.*, 676 F.2d 218, 226 (6th Cir. 1982); *Monsen*, 579 F.2d at 799 & n.9; *Woodward*, 522 F.2d at 97.

236. See *Woodward*, 522 F.2d at 97. *Woodward* involved an alleged nondisclosure in connection with the cosigning of a corporation's note to a bank. See *id.* at 87-89. The cosignor sought to hold the bank liable for aiding and abetting. *Id.* at 89.

237. See *id.* at 95, 97; see also *IIT*, 619 F.2d at 922 (emphasizing the connection between the scienter element and the defendant's role).

238. *Woodward*, 522 F.2d at 97. The court identified a number of possible situations in which different scienter standards would be appropriate: (1) assistance in the form of silence by a defendant who has no duty of disclosure; (2) assistance in the form of silence by a defendant who owes a duty of disclosure to investors; (3) affirmative assistance by a defendant acting in the ordinary course of its business; and (4) affirmative assistance when the defendant's activity is not a typical business transaction. See *id.* at 96-97. The court did not define specifically the standard it would apply in each of these cases. The conduct of the defendant bank apparently fell into the first category, for which the court's standard was "conscious intent" to assist illegal activity. See *id.* at 100. On this basis the court concluded the bank was not liable. See *id.* *Woodward* has been cited frequently, both for its varying standard of scienter and for its caution in imposing liability on defendants engaged in ordinary business activities. See *Woods v. Barnett Bank*, 765 F.2d 1004, 1009-10 (11th Cir. 1985);

Another relevant fact, at least in a case of passive assistance (such as nondisclosure), is whether the defendant owed a duty to securities investors in connection with the transaction.²³⁹ A broker or an accountant preparing financial statements for use in a prospectus, for example, might be held liable on a lesser standard of scienter.²⁴⁰ A third circumstance that might influence the scienter standard in an aiding and abetting case is whether the defendants benefit from the wrongdoing.²⁴¹

The concerns that have led courts to make these distinctions are comparable to those involved in the imposition of fraudulent conveyance liability on the various parties to a leveraged buyout. In securities cases courts have been reluctant to place new burdens on ordinary business activities, because those burdens could increase the risk and cost of services peripheral to the securities industry.²⁴² Courts appear to sense that broad potential liability is not justified when the defendant has no stake in the principal transaction except remuneration for a service that is not specifically related to securities investors. Another problem common to both aiding and abetting liability in securities law and fraudulent conveyance liability is the difficulty of applying a scienter standard based on knowledge to a wrong that depends on obscure or uncertain legal standards. The difficulty a lender has in judging the application of securities laws is comparable to the uncertainty a lender faces in predicting a court's legal conclusion on the financial condition of the acquired corporation in a leveraged buyout.

Although some of the problems in these two areas are similar, this does not mean the scienter standards developed in securities cases should be carried over in full to define fair consideration or good faith in fraudulent conveyance law. The

SEC v. Washington County Util. Dist., 676 F.2d 218, 226 (6th Cir. 1982); Saltzman v. Zern, 407 F. Supp. 49, 55 (E.D. Pa. 1976).

239. *Woodward*, 522 F.2d at 97.

240. *See id.* at 97 n.28.

241. *See Monsen v. Consolidated Dressed Beef Co.*, 579 F.2d 793 (3d Cir.), *cert. denied*, 439 U.S. 930 (1978). The defendant in *Monsen* was a bank charged with abetting disclosure and registration violations by a corporate client in connection with the client's program of borrowing from employees through payroll deductions. *Id.* at 795-96. The court held the bank liable, noting that the bank benefited from the continuation of the client's employee loan program. *See id.* at 803 n.17. Discussing scienter, the court stated that "the requirement of knowledge may be less strict where the alleged aider and abettor derives benefits from the wrongdoing." *Id.* at 799 (quoting *Gould v. American-Hawaiian S.S. Co.*, 535 F.2d 761, 780 (3d Cir. 1976)).

242. *See Monsen*, 579 F.2d at 799; *Woodward*, 522 F.2d at 96 (quoting *Ruder*, *supra* note 231, at 630-31); *Ruder*, *supra* note 231, at 632-33.

underlying policies and problems in these two areas are different and require separate analyses.²⁴³ But the method used in securities cases—adjusting the meaning of a scienter standard according to context and outlining principles to govern when and how it should vary—could be incorporated into fraudulent conveyance decisions.

A variable standard of good faith is consistent with the function of good faith as an element of fair consideration in constructive fraud provisions. In the context of a leveraged buyout or other three-party transfer, the good faith requirement defines when a transferee who gives up value in a transaction is nevertheless liable to creditors of the party with whom the transferee deals. It imposes a responsibility on the defendant for the interests of creditors. The variable scienter requirement simply recognizes that the degree of responsibility assigned to a particular defendant should depend on the business context, the defendant's role in the transaction, and what competing policies or interests may be at stake.

Accepting the possibility of a variable standard of good faith, the next step is to determine specifically how the standard should apply to the different parties involved in a buyout. This requires consideration of both the characteristics of each party as a participant in the transaction and the proper objectives in holding that party accountable to creditors. An independent lender who provides funds for an acquisition has no direct interest in the transaction. In an ordinary case, the only benefits the lender derives from the buyout are the normal incidents of its lending services. It participates in the ordinary course of a business that extends beyond and is separable from the world of leveraged buyouts. It owes no special duty, beyond that imposed by fraudulent conveyance law, to creditors of the corporate borrower.

The objective in holding a party in this position liable to

243. Apart from the different objectives of the statutes involved, securities cases may be influenced by judicial concern with the proper scope of implied private remedies. Cf. Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 CALIF. L. REV. 80 (1981). Further, the burden placed on a securities defendant differs in nature from liability for a fraudulent conveyance. Securities laws require or proscribe a wide range of conduct and are sometimes highly technical. The legal issues a transferee must consider to assess its risk of liability under fraudulent conveyance law (adequacy of consideration and financial condition) are difficult to apply, but narrower in scope. The defendant's potential liability also is likely to be greater in securities cases than in fraudulent conveyance actions, in which liability is confined to the value of the challenged transfer.

creditors of the corporation is to encourage an independent review of the impact of the transaction on creditors. The standard of liability should protect a lender who fulfills this purpose by making a reasonable judgment that the transaction is in compliance with the standards of fraudulent conveyance law. Specifically, the lender should be liable only if it had actual knowledge of facts establishing a constructive fraud—defined as use of loan proceeds to finance an acquisition and financial circumstances the court determines to be in violation of the statutory requirements—and it either failed to consider whether the buyout was a fraudulent conveyance or was not reasonable in its legal judgment. If the court decides the buyout was fraudulent on the basis of facts unknown to the lender, or if the lender made a reasonable determination at the time of the transaction that the financial consequences of the transaction were within the boundaries set by the statute (although differing from the ultimate conclusion of the court), the lender should prevail. In either case it gave fair consideration, in good faith, for the transfers it received. This standard imposes an obligation on the lender to make and substantiate an evaluation of the impact of a buyout on creditors but does not require an investigation of facts beyond the lender's normal practice. It also allows the lender to rely on a reasonable determination that the transaction complies with the legal standards of fraudulent conveyance laws.²⁴⁴

244. Professor Carlson reaches a similar, though not identical, conclusion with respect to the lender in his article on the application of the Bankruptcy Code's fraudulent conveyance provisions to leveraged buyouts. Specifically, Carlson proposes an interpretation of the saving provision of the Bankruptcy Code that would protect a buyout lender "whenever the lender believes in good faith that it is financing a corporate acquisition with a decent chance of survival." Carlson, *supra* note 2, at 120-21. By this standard, even if the acquired corporation was insolvent at the time of the buyout, the lender could defend against creditors' claims if it entered the transaction in the reasonable belief that the business could generate enough cash flow to pay all debts. *Id.* at 92-103.

The present analysis focuses on the element of fair consideration rather than the saving provisions. In addition, the proposed standard of liability differs from the standard suggested by Carlson. First, it relies on the statutory definition of the financial circumstances that establish constructive fraud. An independent lender is protected if it makes a reasonable assessment of the transaction, but the tests the lender must apply are the statutory standards of solvency and reasonable capitalization. These standards represent the present legislative statement of the point at which the risk to creditors is unacceptable and should be placed on parties to the transfer.

A second difference relates to the treatment of buying and selling shareholders. Carlson, while giving some weight to the independence of the lender,

This proposed standard is based on the lender's position as a disinterested party performing services in the ordinary course of business.²⁴⁵ Analogy to securities cases suggests that if the lender has a special interest in the buyout transaction or departs substantially from normal business practice, a stricter standard of good faith would be appropriate. For example, a stricter standard would apply to the lender who acquired an active equity interest in the corporation and therefore had an interest in the completion of the buyout.²⁴⁶ Similarly, the lender might be subject to a stricter standard if the interest rate for the buyout loan were unusually high.

For purchasing and selling shareholders, a notice standard is appropriate. Selling shareholders have a definite interest in the accomplishment of the buyout. Although they part with their shares for a bargained-for consideration, the buyout enables them to exchange an equity interest for cash. In addition to receiving the full value of their interests without the need for liquidation, they move from a position behind creditors to one removed from the risks of the business. Purchasing shareholders also benefit from the buyout, acquiring control of the corporation and potential profits without investing their own funds. Neither the buyers nor the sellers can claim to be acting in the ordinary course of a separate business. Further, as some

concludes that shareholders also should be allowed a good faith defense, which would be governed by the same standard applied to the lender. *See id.* at 100, 112. The proposal here is for a varying standard that would afford less protection to buying and selling shareholders than to an independent lender. *See infra* notes 246-47 and accompanying text.

245. In *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288 (3d Cir. 1986), *cert. denied*, 107 S. Ct. 3229 (1987), the Third Circuit suggested that the financing of the *Gleneagles* buyout was not a transaction in the ordinary course of business. *See id.* at 1297. Although the lender was independent from the principal parties, "the severe economic circumstances in which the [corporate group] found itself, the obligation, without benefit, incurred by the [corporate group,] and the small number of shareholders benefited by the transaction" distinguished it from normal lending activity. *Id.* This statement by the court reflects too narrow a concept of the ordinary business of a lender. If the fact of a corporate obligation benefiting a small number of shareholders were enough to remove a financing transaction from the ordinary course, buyout lending would seldom be a normal business activity. The economic circumstances in *Gleneagles* may have been severe enough to make the transaction extraordinary, but if so the court could also have concluded that the lender did not make a reasonable determination that the buyout complied with the financial standards of fraudulent conveyance law.

246. *See In re Process-Manz Press*, 236 F. Supp. 333, 348-49 (N.D. Ill. 1964), *rev'd on jurisdictional grounds*, 369 F.2d 513 (7th Cir. 1966), *cert. denied*, 386 U.S. 957 (1967).

courts have held, they may owe a fiduciary responsibility to creditors in their management of the corporation.²⁴⁷

In this situation the object of fraudulent conveyance law goes beyond assuring reasonable review of the transaction. These parties, who are directly involved as the principal engineers and beneficiaries of the buyout, should bear the risk of negative consequences if the transaction does not in fact comply with the standards for creditor protection set out in the fraudulent conveyance statutes. The standard of their good faith, therefore, should depend on notice of facts. They should be accountable to creditors for the benefits diverted from the corporation if they knew or should have known, in their respective positions as selling or purchasing shareholders, of facts the court determines to establish a constructive fraud against creditors. Courts should limit their analysis to facts existing at the time of the buyout; even the principal parties should not be held responsible for unforeseeable developments after the buyout.²⁴⁸ On the other hand, there is no reason to protect reasonable legal judgment in the case of parties who instigated the buyout and should expect to assume the risk of liability to creditors if they cut close to the limits of fraudulent conveyance law.

3. Applying the Standard in Cases Arising Under the Bankruptcy Code or the UFTA

So far this discussion has addressed only the UFCA, proposing an interpretation of the good faith element of fair consideration for purposes of that statute. The Bankruptcy Code and the UFTA have deleted the reference to good faith as an aspect of the consideration requirement.²⁴⁹ Both statutes use the phrase "reasonably equivalent value in exchange," without definition, in place of "fair consideration." The analysis and standards outlined above, however, could be applied to define the concept of an exchange in three-party situations.

To determine whether value given to a third party as the agreed consideration for a transfer should be treated as an ex-

247. See *supra* notes 42-46 and accompanying text.

248. This point was emphasized by the court in *Credit Managers Ass'n v. Federal Co.*, 629 F. Supp. 175, 184, 186-87 (C.D. Cal. 1986). If the acquired corporation became insolvent after the buyout as a result of mismanagement by the buyers, both buyers and sellers might be liable to creditors for breach of fiduciary duty, but they should not be liable under fraudulent conveyance law.

249. See 11 U.S.C. § 548(a)(2)(A) (1982 & Supp. III 1985); UFTA §§ 4(a)(2), 5, 7A U.L.A. 639, 653, 657 (1985); *id.* prefatory note, 7A U.L.A. at 641.

change, it is reasonable to consider whether the transferee is aware that the transaction is fraudulent against the transferor's creditors. Once this element of scienter is incorporated into the meaning of an exchange, analysis of each defendant's liability can follow the same pattern proposed for application of the good faith requirement of the UFCA. The standard applied to any transferee would depend on its role and interest in the overall transaction. Although this approach reintroduces a subjective element to the question of consideration under the Bankruptcy Code and the UFTA, its effect would be limited to cases involving third-party benefits. Normally, it is only in three-party cases that the exchange would be in doubt.

CONCLUSION

Leveraged buyouts raise special problems in the application of fraudulent conveyance statutes and other laws protective of creditors' rights. This is due in part to the conflicting policies at stake. A buyout financed with the assets of the acquired corporation depletes the estate available to corporate creditors. If the state of corporate finances after the transaction is impermissible under fraudulent conveyance law, it impairs creditors' protected expectations of payment. On the other hand, it would be a mistake to apply the fraudulent conveyance remedy so broadly that lenders would be discouraged from advancing funds for legitimate business acquisitions.

Further, it is difficult to adapt fraudulent conveyance statutes to a buyout because the transaction does not fit the typical pattern of constructive fraud, a two-party transfer for less than adequate consideration. A buyout typically involves transfers of value among multiple parties, and the party who receives corporate assets may not be the primary beneficiary of the transaction. The hardest problems arise when the buyout is financed by loans from an independent lender to the acquired corporation and creditors seek to set aside corporate transfers to the lender. This situation calls for an application of the statutes that will encourage the lender to assess the impact of the transaction on other creditors without placing too great a risk of liability on ordinary financing services.

There are several ways in which courts should refine their application of fraudulent conveyance law to buyouts and other transfers among three or more parties. First, creditors' rights against parties to a buyout should be judged by the standards of constructive fraud set out in fraudulent conveyance statutes.

The concept of intentional fraud should be reserved for cases that involve not only the basic problem of depletion of corporate assets under adverse financial conditions, but also specific manipulations designed to impede creditors.

Second, when multiple parties are involved, the court should consider the nature of each party's participation in the transaction in determining that party's responsibility to creditors. The concepts of *fair consideration* under the UFCA, and *value given in exchange* under the Bankruptcy Code and the UFTA permit such an analysis. Each of these terms can be read to incorporate a standard of scienter or awareness of fraud, and by analogy to cases in the area of securities fraud, this standard can be varied according to the defendant's role and interest in the transaction.

This approach allows a court not only to protect creditors against overreaching or undue risk in a buyout but also to consider the business setting as it determines the liability of different parties. An independent lender, who participates by providing funds in the ordinary course of its lending business, would be responsible to creditors only if the lender had actual knowledge of facts that establish a fraud and failed to make a reasonable judgment that the transaction met the financial standards set out in fraudulent conveyance statutes. Buying and selling shareholders, who have a direct interest in the buyout transaction, would be liable to creditors for the amount of corporate transfers if they had notice of the facts from which the court concludes the transaction was a fraud.

