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Going Private and Going Under: Leveraged Buyouts and the Fraudulent Conveyance Problem

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INTRODUCTION

The dramatic increase in the number and size of corporate acquisition transactions financed primarily through the use of debt, commonly referred to as "leveraged buyouts," has prompted concern for the health of the businesses involved and for the stability of the depositary institutions and capital markets which provide financing for these types of acquisitions.[1]

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1. For purposes of this discussion, the term "leveraged buyout" will be used to describe corporate acquisition transactions financed primarily by debt which is secured either directly or indirectly by the assets of the entity being acquired. As used here, the term "leveraged buyout" includes (1) "going private" transactions in which the interests of shareholders of a public company are purchased by a private investor group, (2) divestiture transactions in which a subsidiary or division of a public corporation is sold to a private investor group, and (3) leveraged sales of smaller private companies. In both types of transactions involving public companies, the purchasing investor group often includes members of the acquired entity's existing management and in such case the transactions are often referred to as "management buyouts." The third type of transaction involving the acquisition of a privately held corporation may exhibit a different dynamic—the current owner will often be selling to a buyer without access to the financial resources necessary to pay the owner in cash. In such circumstances, the seller may finance the transaction by agreeing to receive a portion of the purchase price in the form of debt issued by the company.

The number and size of leveraged buyouts involving public companies have increased dramatically during the past decade. The "going private" transactions of the mid-1970's tended to involve smaller companies which had made the transition from private to public ownership only a few years earlier during a hot market for new issues. Many of these companies found their stock price particularly depressed during the bear market of the mid-1970's. As a result, management of these firms, which characteristically held a significant block of stock, found it attractive to "return to the quiet shores of private life." Lowenstein, *No More Cozy Management Buyouts,* 64 HARV. BUS. REV. 147, 148 (Jan.-Feb. 1986) [hereinafter Lowenstein]. *See also* Lowenstein, *Management Buy-outs,* 85 COLUM. L. REV. 730 (1985) [hereinafter *Management Buy-outs*].

Although the decade subsequent to this initial flurry of going private transactions has seen a period of recession and exceptionally high interest rates, followed by a stock market boom and lower rates, the volume and value of leveraged buyouts has dramatically increased. The total annual dollar value of leveraged buyouts completed in 1980 was less than $1 billion. In 1984, there were 245 leveraged buyouts valued in the aggregate at more than $18 billion.

Until recently, discussions of the legal aspects of these transactions focused primarily on the problem of ensuring fair treatment to shareholders being

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Carlson, *Leveraged Buyouts in Bankruptcy,* 20 GA. L. REV. 73, n.1 (1985); Lowenstein, *supra,* at 148. As of 1979, the single largest leveraged buyout was the Houdaille Industries, Inc. transaction valued at $350 million. Lederman, *Leveraged Buy-outs,* 11 INST. ON SEC. REG. 405, 410 (1979). The size of the Houdaille transaction caught Wall Street's attention. One buyout expert recalled: "The public documents on that deal were grabbed up by every firm on Wall Street. . . . That showed everybody what could really be done. We all said, 'Holy mackerel, look at this!' " Sterngold, *Buyout Pioneer Quits the Fray,* N.Y. Times, June 19, 1987, § 2, at 25, col. 3, at 29, col. 2 (quoting Frank Richardson, President of Wesray Capital, a major leveraged buyout firm). Multi-billion dollar transactions have appeared in the 1980's—the leveraged buyout of Beatrice Companies, Inc., organized by Kohlbert, Kravis, Roberts & Co., was valued at $4.875 billion. Walter & Strasen, *Acquisition of Beatrice Companies, Inc.,* 64 TAXES 628 (1986). The 1987 leveraged buyout of Southland Corporation involved $5.1 billion in debt.

Public officials have found the trend alarming. In an address to the New York Financial Writers Association in June 1984, then Securities Exchange Commission Chairman, John S. R. Shad cautioned that "the more leveraged takeovers and buyouts today, the more bankruptcies tomorrow." Address by SEC Chairman John S. R. Shad, New York Financial Writers Ass'n (June 1984), *reprinted in* 1984 Fed. Sec. L. Rep. (CCH) ¶ 83,634. Similarly, officials of the Federal Reserve System have warned of the damage to financial institutions which could result from the bankruptcy of highly leveraged companies. *See The Financing of Mergers and Acquisitions: Hearings Before the Subcomm. on Domestic Monetary Policy of the House Comm. on Banking, Finance and Urban Affairs,* 99th Cong., 1st Sess. 8 (1985) (letter from Federal Reserve Board Chairman Paul Volcker) (suggesting that highly leveraged corporate acquisitions pose risks to depositary and thrift institutions); *Takeovers: Hearings Before the Subcomm. on Telecommunications of the House Comm. on Energy and Commerce,* 99th Cong., 1st Sess. (1985) (statement of Norman Raiden) ("The collapse of a single issue of junk bonds would have repercussions throughout the entire Federal Savings and Loan Corporations system."); *Tax Aspects of Acquisitions and Mergers: Hearings Before the Subcomm. on Oversight and the Subcomm. on Selected Revenue Measures of the House Comm. on Ways and Means,* 99th Cong., 1st Sess. 599 (1985) (statement by Preston Martin) (expressing concern about stability of financial institutions which provide financing for highly leveraged buyouts).

Similar concerns have been expressed by banking and securities firm officials in financial media reports. *See* Sloan, *Luring Banks Overboard?,* FORBES, Apr. 9, 1984, at 39; Williams, *Leveraged Buyouts Are Encountering More Resistance from Lenders, Investors,* Wall St. J., July 25, 1984, at 10, col. 1; Williams, *Fearing New Loan Troubles, Banks Start to Sour on Leveraged Buyouts,* Wall St. J., May 8, 1984, at 31, col. 3. *See also* Sterngold, *supra,* § 2, at 25, col. 3 (reporting that Jerome Kohlberg, one of the founding partners of Kohlberg, Kravis, Roberts & Co., a leading leveraged buyout firm, was withdrawing from an active role in the firm at least in part because of concern that the size of leveraged buyouts handled by the firm was too large, and that Mr. Kohlberg stated he would remain active in smaller transactions and would "stick with deals where reason still prevails").

Some analysts have suggested, however, that the rise in debt to equity ratios appearing on corporate balance sheets may not be cause for alarm. *See* Labick, *Is Business Taking on Too Much Debt?,* FORTUNE, July 22, 1985, at 82 (noting that since the asset values appearing on corporate balance sheets are in many instances well below market value, the debt to equity ratio tends to understate the value of shareholder's equity in relation to debt and that as a result of the decline in interest rates from historic high levels in the early 1980's, interest payments as a percentage of corporate cash flow have actually fallen in recent years). *See also* McDaniel, *Bondholders and Corporate Governance,* 41 BUS. LAW. 413, 414 (1986) (noting research indicating that if inflation is taken into account, the average debt to equity ratio of nonfinancial corporations is roughly comparable to that prior to World War II).

squeezed out in "going private" transactions[2] and on federal tax policies which encouraged the use of debt financing in corporate acquisitions.[3] Recent legal challenges to leveraged buyouts reflect a different concern. In cases where leveraged buyouts have been followed by the insolvency or bankruptcy of the acquired company, the financing transactions involved in the acquisition have been challenged as violative of statutory prohibitions of fraudulent conveyances.[4] These challenges have focused attention on another group affected by leveraged buyouts whose interests had heretofore been largely overlooked—the creditors of the corporate entity involved in the buyout.

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2. The first generation of going private transactions in the mid-1970's prompted a debate which has continued for more than a decade concerning the problems resulting from the conflict of interest inherent in management buyouts. *See* Booth, *Management Buyouts, Shareholder Welfare and the Limits of Fiduciary Duty,* 60 N.Y.U. L. REV. 630 (1985); Borden, *Going Private—Old Tort, New Tort or No Tort?,* 49 N.Y.U. L. REV. 987 (1974); Brudney, *Equal Treatment of Shareholders in Corporate Distributions and Reorganizations,* 71 CALIF. L. REV. 1072 (1983); Brudney & Chirelstein, *A Restatement of Corporate Freezeouts,* 87 YALE L.J. 1354 (1978); Schwartz, *Regulation of Leveraged Buyouts to Protect the Public Shareholder and Enhance the Corporate Image,* 35 CATH. U.L. REV. 489 (1986); Solomon, *Going Private: Business Practices, Legal Mechanics, Judicial Standards and Proposals for Reform,* 25 BUFFALO L. REV. 141 (1975); Sommer, *"Going Private": A Lesson in Corporate Responsibility,* [1974-75 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,010 (1974); Torres, *Minority Shareholder Protection in Leveraged Buyouts,* 13 SEC. REG. L.J. 356 (1986); Comment, *The Leveraged Buyout and Appraisal Rights: Balancing the Interests of Majority and Minority Shareholders,* 21 WILLAMETTE L.J. 123 (1985).

3. Historically, tax incentives, principally significant interest deductions and the step-up in the tax basis of the acquired company's assets, have provided major incentives for leveraged buyouts. Extraordinary interest deductions provided by such acquisitions have been criticized for undermining the integrity of the corporate income tax by effectively sanctioning "unrestricted ad hoc integration of corporate and shareholder taxation." Canellos, *The Overleveraged Acquisition,* 39 TAX LAW. 91 (1985). The repeal of the "General Utilities" doctrine in the Tax Reform Act of 1986 effectively removes the incentive for leveraged buyouts derived from the step-up in basis permitted to the acquirer under General Utilities.

4. *See* United States v. Gleneagles Inv. Co., 565 F. Supp. 556 (M.D. Pa. 1983) (Gleneagles I); United States v. Gleneagles Inv. Co., 571 F. Supp. 935, (1983) (Gleneagles II); United States v. Gleneagles Inv. Co., 584 F. Supp. 671 (1984) (Gleneagles III), *aff'd sub nom.* United States v. Tabor Court Realty Corp., 803 F.2d 1288 (3d Cir. 1986) (obligation and security interest of lender invalidated as fraudulent conveyance under Pennsylvania law). *See also* Credit Managers Ass'n v. Federal Co., 629 F. Supp. 175 (C.D. Cal. 1985) (leveraged buyout not fraudulent conveyance); *In re* Knox Kreations, Inc., 474 F. Supp. 567 (E.D. Tenn. 1979), *aff'd,* 656 F.2d 230 (6th Cir. 1981) (leveraged buyout did not render company insolvent, therefore guaranty given to selling shareholders was not fraudulent conveyance); *In re* Anderson Indus., 55 Bankr. 922 (W.D. Mich. 1985) (money received by selling shareholders in leveraged buyout recovered for benefit of estate under Michigan fraudulent conveyance law).

Newspaper and periodical reports indicate that these types of claims are being asserted with increasing frequency and are causing concern not only among the lawyers involved in counseling the parties to leveraged buyouts but to investors as well. Cook & Schwartz, *At a Troubled Company, Officers and Directors Owe Creditors First,* NAT'L L.J., Mar. 16, 1987, at 22, col. 1; Smith, *Shareholder Risks in Leveraged Buyouts Ride on Fear of Bankruptcy-Law Filings,* Wall St. J., July 25, 1984, at 10, col. 1; Victor, *Leveraged Buyout Alleged as Fraud in Bankruptcy Case,* Legal Times of Washington, Oct. 21, 1985, at 1, col. 2.

Professors Douglas Baird and Thomas Jackson have criticized the application of fraudulent conveyance statutes to leveraged buyouts[5] on the grounds that fraudulent conveyance statutes, as the descendants of sixteenth century laws enacted to prevent collusive transfers between individual debtors and their families and friends, should be construed narrowly and should apply only to invalidate sham transactions and gratuitous transfers.[6] Professors Baird and Jackson argue that fraudulent conveyance statutes should not affect any "arms-length"[7] transactions, even if such transactions injure creditors.[8] Applying these general principles concerning the proper scope of fraudulent conveyance law, Professors Baird and Jackson conclude that leveraged buyouts should be categorically excluded from the application of fraudulent conveyance statutes, because "[a] firm that incurs obligations in the course of a buyout does not seem at all like the Elizabethan deadbeat who sells his sheep to his brother for a pittance."[9]

This Article sets forth several propositions. First, it contends that the conclusion of Professors Baird and Jackson, that the application of fraudulent conveyance statutes to leveraged buyouts is not in the best interests of creditors, fails to comprehend fully the distinctive potential for harm to creditors in those leveraged buyout transactions occurring under circumstances which trigger the application of fraudulent conveyance statutes. Second, this Article argues that the application of fraudulent conveyance statutes to leveraged buyouts which occur under such circumstances is consistent with the policies underlying traditional applications of fraudulent conveyance statutes and is both necessary and appropriate to afford creditors protection against transactions which are the functional equivalent of transactions generally prohibited under state corporation laws. Finally, it concludes that the application of fraudulent conveyance statutes to invalidate the loan transaction underlying a leveraged buyout is not unfair to the third-party lender.

I. Conflicts of Interest and Creditors' Interests

The basic structure of a leveraged buyout involves a transfer of corporate ownership financed primarily by borrowings made directly or indirectly by the target corporation and secured by that entity's assets. The proceeds of the borrowings are advanced to the purchasers who use the funds to pay

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5. Baird & Jackson, *Fraudulent Conveyance Law and Its Proper Domain,* 38 Vand. L. Rev. 829 (1985).

6. *Id.* at 840.

7. *Id.* at 854.

8. *Id.* at 833-35.

9. *Id.* at 852.

the purchase price owed to the selling shareholders.[10] In practice, leveraged buyouts occur in many different contexts. The largest leveraged buyouts tend to involve "going-private" transactions in which shareholders in a public corporation sell their stock to a private investor group, often comprised principally of management, who finance their purchase with debt. However, leveraged buyout techniques have also been used to finance divestitures in which a private investment group acquires a division or subsidiary of a public corporation,[11] and in situations in which a smaller private company's shareholders sell their interest to new ownership having no previous connection with the venture.

Regardless of the context in which a leveraged buyout occurs, the transactions present basically the same questions with respect to the application of fraudulent conveyance statutes. In all of the above cases, there are two essential characteristics which identify the transaction as a leveraged buyout. First, the purchaser acquires the funds necessary for the acquisition through borrowings secured directly or indirectly by the assets of the company being acquired. Second, the lender who provides such funds is looking primarily to the future operating earnings of the acquired company and/or to the proceeds from future sales of assets of the company, rather than to any other assets of the purchasers, to repay the borrowings used to effect the acquisition.[12] A leveraged buyout generally results in the substitution of a

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10. Although leveraged buyouts may be structured in a number of different ways, the most common form is the cash merger. The acquisition group forms two new corporations, a parent company and a wholly owned subsidiary. The subsidiary borrows the money necessary for the acquisition, either through bank financing, loans from other institutional lenders, and/or public issuance of debt (so-called "junk bonds") and is merged into the company to be acquired. The proceeds of these borrowings are paid to the selling shareholders of the company being acquired and the assets of the acquired venture are pledged to secure the acquisition debt. In some instances the borrowings are made at the parent company level with the assets of the acquired venture secured for the benefit of the acquisition lenders through upstream guaranties. Lederman, *supra* note 1, at 409.

Professor Carlson has described a number of structural variations in leveraged buyout transactions, but for purposes of the discussion of the possible fraudulent conveyance liability stemming from such transactions, the critical common factor is the use of the acquired entity's assets to secure the acquisition debt, either directly through mortgages and security interests or indirectly through secured guaranties. Carlson, *supra* note 1, at 81-83.

11. The acquiring entity in a leveraged buyout is almost always a private as opposed to a publicly held venture. Few public companies can afford the significantly increased debt associated with such transactions without affecting their credit ratings. In addition, the increased interest expense and depreciation resulting from these transactions, although attractive from a tax standpoint, reduce earnings and depress the acquiring company's stock price. Lederman, *supra* note 1, at 412; Sloan, *supra* note 1, at 39.

12. Leveraged buyout investors thus generally view cash flow, the money available for working capital and debt service, as the most important factor in assessing a potential buyout candidate. Wolske, *Playing by the Numbers, How to Size Up a Potential LBO,* BARRON'S, Feb. 17, 1986, at 18. Mature companies with a history of stable earnings and modest capital expenditure projections have traditionally been the most attractive leveraged buyout candidates. Ferenbach, *L.B.O.s: A New Capital Market (And How to Cope with It),* MERGERS &

significant amount of new debt in the place of equity in the corporation's capital structure. In transactions where banks or other institutional lenders provide the major portion of the debt financing, this new debt is likely to be senior secured debt. Thus, by definition, leveraged buyouts adversely affect existing creditors of the company by reducing the assets available for the satisfaction of the obligations owed to them.[13]

In arguing that this detrimental impact on creditors is not within the compass of injuries which fraudulent conveyance statutes are intended to remedy, Professors Baird and Jackson begin from the premise that the principal function of "per se" or "off the rack" rules such as fraudulent conveyance statutes[14] is to "provide all the parties [to a transaction] with the type of contract that they would have agreed to if they had the time

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ACQUISITIONS, Fall 1983, at 21 ("The characteristics generally sought in an l.b.o. are by now well known: slow growth, steady earnings, mature business, . . . solvent financial condition . . . ."). *See also* Adkins, *Why Leveraged Buyouts Are Getting Riskier,* 123 DUN'S BUS. MONTH, Apr. 1984, at 33, 34. Adkins states:

> Leveraged buyouts that have a good chance of succeeding generally share a number of characteristics . . . . [L]enders and investors are advised to look for a company that is a low-cost producer in its industry, has a stable and predictable growth pattern, makes a product that is either a leader or has a special niche in its market and has a diversified customer base . . . . It is also advisable to avoid companies with a high level of future capital requirements . . . .

Id. A consistent pattern of high earnings is desirable because firms with substantial debt charges have little tolerance for revenue fluctuations. Firms having stable revenues can tolerate a higher ratio of interest to total expenses. *See* Mendelson, *The Threat of Corporate Debt,* 6 J. COMP. BUS. & CAPITAL MARKET LAW 149, 155 (1984).

As the popularity and the prices of leveraged buyouts have increased, however, there have been an increasing number of more aggressive transactions, in which the projected cash flow was insufficient to cover the acquisition debt. For example, the prospectus relating to the $647 million leveraged buyout of Dr. Pepper projected that following the buyout, the company would have a ratio of earnings to fixed charges of .7 to 1. Sloan, *supra* note 1, at 43. Such transactions are viable only because the lenders and investors involved expect to use revenue from the sale of some of the acquired company's assets to reduce the heavy burden of the acquisition debt, in effect a partial liquidation, or to seek an additional infusion of equity capital to pay down the debt through quickly taking the company public again, thus betting that improved stock market conditions will bail them out of this precarious financial posture. Accurate predictions as to the market value of corporate assets or divisions is often critical to structuring a successful buyout. *See Southland Corp. Buyout to Force Some Unit Sales,* Wall St. J., July 7, 1987, at 3, col. 1.

13. Any transaction which involves an increase in a corporation's debt to equity ratio has an adverse impact on existing creditors by increasing the risk of default. McDaniel, *supra* note 1, at 418; Posner, *The Rights of Creditors of Affiliated Corporations,* 43 U. CHI. L. REV. 499, 504 n.14 (1976).

14. In describing the constructive fraud provisions of section 4 of the Uniform Fraudulent Conveyance Act, 7A U.L.A. 427 (1985) (referred to throughout this Article as UFCA), and the analogous provisions of the Bankruptcy Code, 11 U.S.C. § 548(a) (1982), Baird and Jackson use the terms "per se" and "off the rack" to emphasize that these rules operate to constrain the conduct of parties to a credit transaction in addition to whatever specific terms they may choose to include in the contract relating to the transaction. Baird & Jackson, *supra* note 5, at 831, 836 n.21.

and money to bargain over all aspects of their deal."[15] Fraudulent conveyance statutes should therefore be interpreted to restrain only those types of debtor conduct which creditors, analyzing the terms of their relationship with the debtor in advance of the questioned conduct, would almost always want to prohibit. Professors Baird and Jackson thus ask whether the parties to a consensual credit transaction, operating under ideal circumstances, would normally agree to include in their contract a provision restricting the debtor's ability to engage in a leveraged buyout to the same extent fraudulent conveyance statutes restrict this activity.[16]

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15. Baird & Jackson, *supra* note 5, at 835-36. Judge Posner has described the function of an efficient corporation law in determining the rights of creditors in a similar manner.

> To the extent that the terms implied by corporation law accurately reflect the normal desires of transacting parties, they reduce the cost of transactions. The criterion of an efficient corporation law is therefore whether the terms do in fact reflect commercial realities, so that transacting parties are generally content with them . . . . Thus a corporation law is inefficient if it fails to provide standard implied contract terms that afford creditors the sort of protection against default that they would normally insist upon in an express negotiation.

Posner, *supra* note 13, at 506-07.

As applied to corporate, as opposed to individual debtors, fraudulent conveyance statutes compliment the creditor protection provisions contained in state corporation statues. *See infra* notes 69-74 and accompanying text.

16. Baird and Jackson generally take the position that for purposes of determining the proper scope of per se rules such as the fraudulent conveyance remedy, it is unnecessary to distinguish between the interests of consensual creditors and non-consensual creditors, such as tort claimants and taxing authorities, because "the limits that consensual creditors would impose on investments by a debtor also largely will protect nonconsensual claimants . . . ." Baird & Jackson, *supra* note 5, at 835 n.20. Indeed since a company must always comply with the most stringent terms and covenants contained in any of the contracts governing any of its debt obligations, all creditors, even those consensual creditors who lack significant leverage in negotiating the terms of their credit arrangement with the company and non-consensual creditors, benefit from these covenants. *See* McDaniel, *supra* note 1, at 435. This does not mean that the creditors who are in a position to have the greatest leverage in their negotiations with the debtor have an actual incentive to protect the interests of other creditors. For example, an institutional lender who negotiates a secured position may rely on this security interest to protect itself against loss in the event of default and thus have little interest in negotiating covenants regarding the debtor's overall financial condition. In addition, as a more general matter, it would seem that the interests of non-consensual creditors would be protected by the negotiations of the consensual creditors only to the extent the non-consensual creditors enjoy a position of priority over (or at least parity with) the consensual creditors. Otherwise the priority afforded the consensual creditors would reduce these creditors' risks relative to that to which the non-consensual creditors are exposed and would encourage the consensual creditors to negotiate provisions which would be inadequate to protect the non-consensual creditors.

Under certain circumstances, a creditor aware of risks associated with a particular loan may not explicitly negotiate a contractual covenant in order to protect itself against these risks but may simply negotiate a higher interest rate to compensate for the risk. Such a strategy protects only the creditor who negotiates for the higher rate and may in fact be harmful to the interests of other creditors. *See* Posner, *supra* note 13, at 506. Thus, with respect to the more specific risks to creditors posed by leveraged buyouts, it may be necessary to recognize potential conflicts of interests among different classes of creditors. Baird and Jackson suggest that the identity of interest among creditors of a company involved in a leveraged buyout may

Professors Baird and Jackson conclude that the parties would not generally include such a provision, in spite of the potential for injury to creditors resulting from leveraged buyouts.[17] This conclusion rests on the premise that even under ideal negotiating circumstances creditors do not seek to protect themselves against all debtor transactions that could potentially injure creditors, but only against those transactions which almost always result in injury, such as gratuitous transfers. Because leveraged buyouts are not the types of transactions which creditors are likely to perceive as carrying a high degree of probability of injury to creditors, Professors Baird and Jackson argue that creditors would not seek a contractual provision restricting a debtor's ability to engage in such transactions.[18] Professors Baird and Jackson conclude that creditors would not consistently want to bar debtors from entering into leveraged buyouts because "these transactions do not always seem to be clearly to the detriment of creditors, nor did we always see creditors treating such transactions as events of default in their loan agreements, even before the issue was moved to the domain of fraudulent conveyance law."[19]

This observation misperceives the relationship between "per se" rules such as fraudulent conveyance laws and specifically negotiated contractual provisions. Professors Baird and Jackson also fail to recognize that although the use of the term "leveraged buyout" and the exponential increase in the number and size of leveraged buyouts began in the late 1970's, transactions of this type, and legal challenges to such transactions based on fraudulent conveyance statutes, antedate the current boom. In an earlier era, transactions very much like the leveraged buyouts of the 1970's and 1980's were referred to as "bootstrap acquisitions."[20] Some of these transactions were invalidated on the basis of fraudulent conveyance statutes.[21] In view of this

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be limited to the extent that certain creditors, particularly those having secured claims, may be able to avoid exposure to the risk created by the buyout by ensuring that they are cashed out at the time of the transaction. Baird & Jackson, *supra* note 5, at 854.

17. Baird & Jackson, *supra* note 5, at 853-54.

18. *Id.*

19. *Id.* at 853.

20. *See* Clark, *The Duties of the Corporate Debtor to Its Creditors,* 90 HARV. L. REV. 505, 511 n.18 (1977).

21. *See* Steph v. Branch, 255 F. Supp. 526 (E.D. Okla.), *aff'd,* 389 F.2d 233 (10th Cir. 1968); *In re* Process Manz Press, Inc., 236 F. Supp. 333 (N.D. Ill. 1964), *rev'd on juris. grounds,* 369 F.2d 513 (7th Cir. 1966), *cert. denied,* 389 U.S. 957 (1967); I.G. GLENN, FRAUDULENT CONVEYANCES AND PREFERENCES § 283 (1940).

These earlier "bootstrap" transactions most commonly involved situations in which the selling shareholders provided the leverage necessary for the acquisition by taking a note for a significant portion of the purchase price. In these cases, the corporation's assets were pledged to secure, or used to discharge, the debt owed to the selling shareholders. Courts applied fraudulent conveyance statutes, the doctrine of equitable subordination, or both, to invalidate transfers of corporate assets made in connection with the "bootstrap" transaction and to subordinate the claims associated with these transactions to the claims of other creditors.

history, and in view of the fact that from a creditor's point of view a leveraged buyout is functionally indistinguishable from other types of conduct by corporate debtors which are restricted by other "per se" rules established for the benefit of creditors, the absence of specific contractual provisions restricting leveraged buyout transactions in loan agreements or bond indentures does not support a conclusion that creditors generally do not expect protection from the risks associated with these transactions. Creditors negotiate specific contractual protection, and incur the costs associated with this process, only when they assume that the applicable law—that is, the relevant body of per se rules—does not protect them against a particular risk. To do otherwise would be inefficient and redundant.[22] Thus, the absence of specific contractual provisions restricting leveraged buyouts is as likely to reflect a belief that the per se rules embodied in fraudulent conveyance statutes would normally protect creditors against the risks of a leveraged buyout as a belief that creditors do not desire such protection.

In support of their conclusion that creditors generally would be willing to accept the risk of injury posed by a leveraged buyout, Professors Baird and Jackson observe that a credit transaction creates an inherent conflict of interest between debtor and creditor.[23] The debtor, they reason, is much more inclined to take risks with borrowed money because "[h]e enjoys all the benefits if a risky venture proves successful, but he does not incur all the costs if the venture fails."[24] By contrast, a creditor is adversely affected any time the debtor engages in a transaction which has the effect of exchanging a safe and liquid asset, such as the cash proceeds of a loan, for a more speculative and less liquid asset, such as real property or equipment.[25]

22. *See* Posner, *supra* note 13, at 506.

23. Baird & Jackson, *supra* note 5, at 834. When considering this general conflict of interest between a debtor and its creditors in the context of a corporate debtor, the conflict is between the equity holders (who control management) and the creditors. *See* Smith & Warner, *On Financial Contracting,* 7 J. FIN. ECON. 117, 118 (1979) (They note that with respect to one important class of corporate creditors—bondholders— "management, acting in the stockholders' interest, has incentives to design the firm's operating characteristics . . . in ways which benefit stockholders to the detriment of bondholders.").

24. Baird & Jackson, *supra* note 5, at 834. Once debt is issued, the equity interests have an incentive to choose a riskier investment strategy than anticipated by the debt holder in determining the price at which he was willing to lend to the company at the outset of the transaction. By taking the riskier "high variance project [the equity holder] can transfer wealth from the (naive) bondholders to himself . . . ." Jensen & Meckling, *Agency Costs and the Theory of the Firm,* 3 J. FIN. ECON. 305, 335 (1976).

25. Baird & Jackson, *supra* note 5, at 834. Smith and Warner identify "asset substitution," defined as management decisions to alter the investment of the firm's assets by exchanging low risk assets for riskier investments—that is, assets having a higher "variance rate"—as one of the major sources of conflict of interest between stockholders and creditors. Smith & Warner, *supra* note 23, at 117-19. The other major tensions between the interests of creditors and equity holders revolve around (1) dividend payments, (2) claim dilution through issuance

Thus, debtors and creditors often have different attitudes towards the debtor's undertaking of a particular venture.

Nonetheless, creditors expect a debtor to make investment decisions and to take risks. As Professors Baird and Jackson note, "[c]reditors lend money in the first instance because the debtor has entrepreneurial skills that they do not have."[26] In fact, the debtor must exercise these entrepreneurial skills and take certain risks in order to make the credit transaction a successful one from the creditor's point of view. Suppose, for example, a debtor simply invested the loan proceeds in government securities or placed them in a bank account. Under these circumstances, the creditor faces very little risk of loss of principal. Assuming, however, that the rate of interest paid on these securities in the bank account is less than the interest rate the borrower pays in a commercial lending transaction, the debtor would be unable to cover his interest payments on the loan from the earnings on his investment and this would not be satisfactory from either the debtor's or the creditor's point of view. If the creditor expected to receive only this lower rate of return, he could have purchased government securities or deposited the funds in a bank directly instead of lending them to the debtor. In order to take advantage of the debtor's entrepreneurial skills and earn the higher interest rates typically paid in a commercial lending transaction, the creditor must allow the debtor a certain degree of freedom concerning the manner in which the debtor will invest the borrowed assets and must accept the risk associated with the debtor's investment decisions. As Professors Baird and Jackson put it, "[a] creditor would not want to impose all possible restraints upon a debtor, even if the absence of a restraint exposes that creditor to the risk that the debtor will injure it."[27]

From this premise that creditors willingly accept some degree of risk that transactions by the debtor will adversely affect them, Professors Baird and Jackson argue that a creditor would not favor a contractual provision or "off the rack" rule permitting creditors to invalidate retrospectively any transaction by the debtor which ultimately turned out to be unprofitable. Such a legal constraint, they argue, would paralyze the debtor and render him incapable of exercising his entrepreneurial skills for the benefit of both creditor and debtor.[28] In view of the value of the debtor's risk taking and

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of additional debt of senior or equal rank, and (3) under investment situations in which management has an incentive to reject projects having a positive net present value if, given the firm's financial condition, the benefit from the investment would accrue to the bondholders. This latter risk will occur when the firm has a negative net worth. In determining the price of a bond (or other extension of credit), the bond market (or other type of creditor) makes an estimate of management's probable future investment behavior. Any unanticipated investment strategy occurring after the issuance of the bonds therefore results in a transfer of wealth from the bondholders to the stockholders. *Id.*

26. Baird & Jackson, *supra* note 5, at 834.

27. *Id.*

28. *Id.* at 833-35.

investment activity to both the creditor and the debtor, Professors Baird and Jackson argue that an interpretation of fraudulent conveyance statutes which would permit the creditors of an insolvent debtor to overturn any transactions by the debtor merely upon a showing that such a transaction eventually resulted in the creditors as a group being worse off is overbroad because it prohibits useful and potentially beneficial transactions that creditors would not generally want to preclude.[29] Although Professors Baird and Jackson concede that a leveraged buyout may have an adverse impact on the existing creditors of the company involved in the buyout, they argue that the nature and extent of this risk are no different from that associated with "many ordinary transfers that a debtor makes."[30] Thus, in Professors Baird and Jackson's view, the application of fraudulent conveyance statutes to invalidate the financing transactions underlying a leveraged buyout is unwarranted.

II. The Importance of Limiting Circumstances: Insolvency and Fair Consideration

Professors Baird and Jackson's argument is premised on a *laissez faire* approach which views fraudulent conveyance statutes as a paternalistic interference with freedom of contract. They consider such interference inconsistent with the best interests of creditors as well as debtors and conclude that an unfettered creditor would not favor the application of fraudulent conveyance laws to leveraged buyouts. This conclusion rests on an analysis that is incomplete in two important respects. First, Professors Baird and Jackson fail to consider carefully the extent to which the fraudulent conveyance statutes, by limiting the application of the constructive fraud provisions to transfers for inadequate consideration made under circumstances of insolvency, or near insolvency, restrict the statutes' application to transactions which creditors would in fact generally find objectionable. Second, Professors Baird and Jackson fail to analyze the underlying financial dynamics of leveraged buyouts and thus ignore the serious potential for abuse of creditors inherent in leveraged buyouts of financially troubled companies. In short, Professors Baird and Jackson overestimate the restrictive impact of fraudulent conveyance statutes and underestimate the severity of the risks to creditors. A careful analysis of the application of fraudulent conveyance statutes to leveraged buyouts and of the financial impact of such transactions on creditors dictates the conclusion that rational creditors generally would favor the application of fraudulent conveyance laws to leveraged buyouts.

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29. *Id.*
30. *Id.* at 834.

Two factors limit the application of the constructive fraud[31] provisions of the Uniform Fraudulent Conveyance Act (UFCA). First, these provisions apply only to transfers made when a debtor's financial circumstances are exceptionally precarious or become so as a result of the challenged conveyance. Specifically, the constructive fraud provisions apply only to transfers made by a person "who is or will be thereby rendered insolvent"[32] and to transfers made by a person engaging "in a business or transaction for which the property remaining in his hands after the conveyance is an unreasonably small capital."[33] Second, the constructive fraud provisions do not invalidate all transactions made by debtors under these circumstances but only those in which the financially strapped debtor receives less than fair consideration in exchange for the conveyance of property. Thus, the constructive fraud provisions of the UFCA only apply to a limited category of debtor transactions which adversely affect creditors under certain circumstances of financial exigency.

These limitations cannot be overlooked in speculating about what types of per se rules restricting debtor conduct creditors may favor. Although creditors may very well oppose a per se rule which restrains all transactions by a debtor having an adverse impact on creditors, creditors might well have a different response to a per se rule which operates to restrain only

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31. Baird and Jackson apparently have no objection to invalidating the transactions constituting a leveraged buyout if the transaction was undertaken with actual intent to defraud creditors. They object only to the application of fraudulent conveyance statutes to "arms-length" transactions entered "in the ordinary course." *Id.* at 854-55.

32. Section 4 of the UFCA provides that "[e]very 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." UFCA, 7A U.L.A. 427 (1985). The analogous provision of the Bankruptcy Code is section 548 which empowers the trustee to avoid any transfer or obligation made or incurred by a debtor within one year prior to the filing of the petition if the debtor "received less than a reasonably equivalent value in exchange for such transfer or obligation", 11 U.S.C. § 548(a)(2)(A) (1982), and the debtor "was insolvent on the date such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation," 11 U.S.C. § 548(a)(B)(i) (1982). Under section 544 of the Bankruptcy Code, the bankruptcy trustee is also entitled to assert the rights which creditors of the bankrupt would have under the applicable state fraudulent conveyance laws. 11 U.S.C. § 544 (1982). As a result, when the debtor is in bankruptcy, both state law fraudulent conveyance claims and section 548 claims may be made by the trustee.

33. UFCA § 5, 7A U.L.A. 427, 504 (1985). Section 5 of the UFCA provides that:

> 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.

Id. The analogous provision of the Bankruptcy Code is 11 U.S.C. § 548 (a)(2)(B)(ii) (1982), which entitles the trustee to set aside a transfer or obligation if the debtor "was engaged in business, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital." *Id.*

certain types of transactions occurring under the limited circumstances specified in fraudulent conveyance statutes.

The following examples illustrate the point. Any transaction in which a debtor receives less than fair consideration diminishes the total value of a debtor's estate. Although everyone having an interest in the estate, creditor and equity holder alike, may be unhappy about such a development, the creditor's concerns are not likely to be extremely serious so long as the debtor remains solvent. If the debtor is not insolvent at the time of the transfer, or is not left insolvent or inadequately capitalized, the persons owning the residual equity interest in the debtor will bear the more direct impact of any loss associated with the transaction. Although the transaction injures the creditor in the sense that the cushion between the level of debt and the value of the debtor's assets has been diminished somewhat, the debtor still retains assets sufficient to discharge his debts.[34]

For example, suppose a corporation, *D*, has assets of $1,000,000 and liabilities of $250,000. *D* acquires a tract of real estate for $500,000 cash. An independent appraiser's estimate of the property's fair market value is $250,000, but *D* agrees to pay twice that amount because of the recent discovery of valuable mineral deposits on an adjacent tract. The management of *D* believes that if similar reserves are found on this property, its value would be at least $1,000,000. Although this transaction may have an adverse impact on *D*'s creditors by reducing the company's net worth if the estimate of the property's actual value turns out to be erroneous, *D*'s creditors might not want to restrain the company's ability to enter into such a transaction. Under these circumstances, even if the property is ultimately found to be worth only $250,000, *D* would still have sufficient assets to discharge its obligations. The owner of the equity interest in *D* will bear the loss on the real estate transaction. Before the real estate transaction the shareholders' equity was $750,000. After the transaction this equity has been reduced to $250,000. By contrast, of course, if *D*'s management turns out to be correct about the property's actual value, the creditors' position would be improved only in a similarly indirect way. If the property turns out to be worth more than $500,000, the equity holders in *D* would be the principal beneficiaries of the advantageous transaction. Thus, *D*'s creditors are not likely to have a strong interest in deterring this transaction even though it may have some indirect adverse impact on them by reducing the company's net worth.

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34. *See* Bratton, *The Economics and Jurisprudence of Convertible Bonds,* 1984 WIS. L. REV. 667, 733 (noting that one of the reasons the law does not impose on corporate management fiduciary duties to protect the interests of bondholders akin to those owed to equity holders is that "so long as the corporate debtor remains able to repay the debt, creditors' interests have not been impaired sufficiently to justify legal restraints on the corporation's self-interested actions").

Compare, however, the impact of such a transaction on *D*'s creditors if the company were insolvent at the time of the real estate purchase or became insolvent as a result. Assume the facts in the example given above are changed so that at the outset, *D* has $750,000 in liabilities and $775,000 in assets and enters into the real estate transaction described above, borrowing $500,000 cash on a priority secured basis and pledging not only the property being acquired but additional assets as well. Now, if the property purchased turns out to have a value of only $250,000, *D* will have liabilities of $1,250,000, well in excess of the value of *D*'s assets—$1,025,000. Under these circumstances, the adverse impact of the transaction on *D*'s creditors is much more direct and substantial. Although one might reasonably conclude that creditors would not necessarily want to restrain the real estate transaction under the first set of circumstances discussed above, it seems unlikely that creditors would take the same point of view with respect to the latter example.

Changes in the corporation's financial condition which enhance the likelihood of insolvency magnify dramatically the basic conflict of interest between creditor and debtor. For as a corporate debtor's financial situation deteriorates to the point of near insolvency, the holders of the equity interest and the management they control have less and less to lose and therefore may be more inclined to engage in riskier deals. When, for example, a firm has a high debt to equity ratio, stockholders have a greater incentive to invest the firm's assets in high risk projects. In extreme circumstances, stockholders may even have an incentive to pursue an investment strategy which reduces rather than maximizes the net present value of the firm.[35] For example, stockholders may refuse an investment opportunity which promises a safe return of $45 on an initial $40 investment and pursue instead a different, riskier project which costs $40 and offers a risk-adjusted return of $35 (*e.g.*, a project having a 50% chance of paying $60 and a 50% chance of paying only $10). Assuming that the value of the stockholder's equity is relatively small, the stockholders will be attracted by the riskier project because if it succeeds they will receive most of the gain, but if it fails the creditors will bear the brunt of the loss.[36] Under such circumstances, the creditors' perspective may shift in the opposite direction; creditors will become more anxious to restrain risky behavior by the debtor because the creditors will be bearing more and more of the loss. Creditors may also become less sanguine about a debtor's risk-taking under these circumstances because the creditors' expectations with respect to the trans-

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35. *See* Jensen & Meckling, *supra* note 24, at 344-45; McDaniel, *supra* note 1, at 418. *See also* R. Brealey & S. Myers, Principles of Corporate Finance 396-97 (2d ed. 1984). Another numerical illustration of this creditor-stockholder conflict appears in E. Fama & M. Miller, The Theory of Finance 179-80 (1972).

36. Bratton, *supra* note 34, at 733.

action may change. At some point creditors may be less concerned with making a significant profit on the credit transaction than with merely assuring the safe return of principal.

Limiting the application of fraudulent conveyance statutes to circumstances of insolvency reflects a logical assessment of a change in circumstances which transforms the inherent conflict of interest between debtor and creditor present from the outset of every credit transaction into a much more serious conflict. The use of insolvency as a trigger for liability in the fraudulent conveyance statutes represents a determination that under circumstances of insolvency the risk of misconduct by those in control of a corporate debtor becomes so great that it is appropriate to afford creditors the benefit of a per se rule restricting the corporation's conduct.[37] Thus, while a per se rule permitting creditors to invalidate any transaction by a debtor which may have an adverse impact on creditors by reducing the total value of assets available to satisfy their claims may well be overbroad, this conclusion says very little about the "proper scope" of fraudulent conveyance law because it fails to consider the degree to which the requirement of insolvency works to avoid overbreadth. The insolvency threshold limits the application of fraudulent conveyance statutes to precisely those extraordinary circumstances in which creditors are likely to oppose the challenged conveyance before it is made.

In determining whether fraudulent conveyance statutes should be applicable to leveraged buyouts, one cannot overlook the impact that insolvency will have on a creditor's analysis of the cost of constraining debtor conduct of this type as compared to the possible benefit to be derived from such transactions. Creditors will generally desire to restrain a debtor's conduct more tightly under circumstances of insolvency or near insolvency. Thus, even if one accepts Professors Baird and Jackson's basic premise—that fraudulent conveyance doctrine should operate only to invalidate those

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37. *See* McDaniel, *supra* note 1, at 419-20. *See also* Posner, *supra* note 13, at 509 n.22; Williamson, *Corporate Governance*, 93 YALE L.J. 1197, 1211-12 (1984) (arguing that because a corporation's precarious financial posture increases the incentive for the equity interest to engage in risky ventures, holders of the company's debt securities and other long term creditors should under such circumstances be represented on the board so that the creditors may exercise more direct control over the risks to which they are exposed). Jensen and Meckling analogize the risk taking proclivity of the management representatives of the equity interest in a highly leveraged firm to the strategy which would be employed by an individual playing poker on money borrowed at a fixed interest rate, with the player's liability limited to a very small stake. Jensen & Meckling, *supra* note 24, at 334 n.39.

There is at least one case providing dramatic empirical evidence of this gambler mentality. *See In re* Tri-State Paving, Inc., 32 Bankr. 2 (Bankr. W.D. Pa. 1982) (individuals who were the sole officers, directors and stockholders of a nearly insolvent corporation withdrew all funds from the corporation's bank account to finance a trip to Las Vegas in an effort to win enough money to pay the corporation's creditors, and the bankruptcy court rejected the defendants' claims that they were entitled to the funds as salary payments and concluded that the withdrawals were fraudulent transfers).

categories of transactions which creditors would almost always want to prohibit—the application of fraudulent conveyance statutes to encompass all transfers in which the debtor received less than "fair consideration" (as defined by the statute) occurring under the limiting circumstances of financial exigency set out in the statute seems likely to be more consistent with creditors' desires than Professors Baird and Jackson concede.

Professors Baird and Jackson's analysis focuses on the conflict between creditor and equity holder with respect to investment of the company's assets. It is important to note however, that there are other major sources of conflict between equity holders and creditors which may encourage creditors to favor a per se rule restricting leveraged buyouts.[38] These conflicts, like the conflict concerning entrepreneurial decisions, are exacerbated when the corporation's financial condition deteriorates.

Any transaction which results in a distribution of corporate assets, or of the value of such assets, to shareholders is adverse to the interests of creditors because such a transfer reduces the assets otherwise available to satisfy creditors' claims. In addition, such transfers benefit equity holders directly. These decisions, unlike the entrepreneurial decisions discussed above, are not attractive to the equity interests because they have the potential to benefit the equity holders by increasing the value of their residual ownership interest in the firm, but because they permit the equity holder to realize some of this value for personal use. Distributions directly increase stockholders' personal wealth, not just the value of their interest in the firm. Distributions also insulate this wealth from any further exposure to the risk of the corporation's financial performance. Of course, it would be unwise and impractical for creditors to attempt to restrict all distributions. So long as the firm is relatively profitable, the stockholders will be somewhat constrained in declaring distributions by their own self-interested desire to increase the value of the firm.[39]

As in the case of the conflict produced by entrepreneurial decisions, this second conflict between equity holders and creditors is exacerbated if the

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38. *See supra* note 21.

39. Specifically, management attentive to stockholder interests will have an incentive to distribute to stockholders, in the form of a cash dividend or other distribution or a stock redemption or repurchase, the value of all assets which may be invested elsewhere for a higher rate of return than the corporation is able to earn on these assets. By contrast, bondholders and other creditors would favor the corporation's retention of all capital which it could invest for even a small positive return, regardless of whether such capital could be invested more profitably elsewhere. *See* Bratton, *supra* note 34, at 668 n.3.

Stockholder and creditor interests with respect to the reinvestment as opposed to the distribution of the firm's earnings in the enterprise are nonetheless fairly congruent so long as the net present value of projected returns on the company's investment exceeds the cost of capital raised from an external source. *Id.* at 756. *See also* Brudney, *Dividends, Discretion and Disclosure,* 66 VA. L. REV. 85 (1980); Fischel, *The Law and Economics of Dividend Policy,* 67 VA. L. REV. 699 (1981).

firm encounters financial difficulties.[40] As the possibility of insolvency grows, the likelihood that shareholders will be able to invest the value of their equity elsewhere for a greater return increases. As a result, the shareholders' incentive to cause the corporation to make distributions increases at the same time that the adverse impact of such transfers on creditors is magnified.[41] When the corporation's financial condition worsens, creditors therefore may become especially anxious to restrict this self-interested conduct by the equity holders, and the conflict between creditors and equity holders, with respect to distributions is heightened. Although a per se rule prohibiting any distributions to shareholders if the firm had outstanding liabilities would be overbroad, a per se rule which prohibits distributions when the corporation is insolvent or on the brink of insolvency reflects a determination that under these extreme circumstances, the interests of the equity holders and the creditors have become so divergent that the power of the equity holders to control the corporation's decisions in this area should be circumscribed.[42] In recognition of this increased tension, "per se" rules embodied in state corporation laws[43] generally proscribe distributions to shareholders under these circumstances.

From a creditor's point of view, a leveraged buyout is indistinguishable from a distribution to shareholders. Although most analyses of leveraged buyouts focus on the benefits accruing to management insiders who purchase the company's stock in a leveraged buyout and the extent to which these transactions carry a risk of unfairness to the selling shareholders,[44] in the context of a leveraged buyout involving a financially troubled corporation, the benefits to the *selling* shareholders which are, in effect, purchased at the expense of existing creditors, cannot be ignored. As a result of the leveraged buyout transaction, selling shareholders receive the cash proceeds of borrowings secured by the corporate debtor's assets.

A leveraged buyout does not involve a debtor's decision to invest in a new venture, new equipment or property. It is different, not just in degree, but in character from the ordinary transfers and investment decisions made by the corporate debtor's management. A leveraged buyout may in fact be

40. Smith & Warner, *supra* note 23, at 135. When the net present value of the firm's anticipated earnings falls below the cost of external financing, as is likely to occur with a seriously troubled endeavor, the interests of creditors and stockholders conflict directly "with noninvestment and dividends promoting the stockholders' interests and retained earnings and investment promoting the [creditors'] interests." Bratton, *supra* note 34, at 736.

41. Assuming an absence of legal constraint, under extreme circumstances "[t]here is no easier way for a company to escape the burden of debt than to pay out all of its assets in the form of a dividend, and leave the creditors holding an empty shell." Black, *The Dividend Puzzle*, 2 J. PORTFOLIO MGMT. 5, 7 (1976).

42. *See* Williamson, *supra* note 37, at 1211-12.

43. *See, e.g.*, REV. MODEL BUS. CORP. ACT § 6.40 (1984) [hereinafter RMBCA]. *See also infra* notes 45-55 and accompanying text.

44. *See supra* note 2.

viewed as a corporate decision to invest its assets (by borrowing against them) for the personal benefit of both the old and new equity owners. Considered in this perspective, leveraged buyouts have something of a topsy-turvy, Alice-in-Wonderland character in that the normal relationship between a corporation and its equity owners, involving the owners' investment of personal assets in the corporation, is inverted. In a leveraged buyout, a corporation invests its assets to finance the equity owners' purchase of control of the company's assets.

A per se rule which restrains an insolvent debtor from entering into a leveraged buyout is not a rule which limits the debtor's general entrepreneurial decisionmaking. The risk posed to a creditor by a leveraged buyout involving an insolvent debtor or a debtor who becomes insolvent or undercapitalized as a result of a leveraged buyout is not simply the risk of a debtor's bad business decision, but the risk of a transaction which benefits the selling shareholders at the expense of a deeply indebted corporate entity and its creditors. Professors Baird and Jackson's argument fails to acknowledge the relevance of this latter type of risk to the determination whether creditors would desire to apply the per se rules embodied in fraudulent conveyance statutes to leveraged buyouts. Professors Baird and Jackson ignore the strong personal incentive that equity holders of a financially troubled debtor will have to sell their interest in the company in a leveraged buyout as a means of withdrawing their capital from exposure to total loss in the event the company becomes bankrupt. Although the price paid to the selling shareholders under such circumstances may not be very high, in a typical leveraged buyout, the stock price may not reflect all existing debts. In fact, the price the selling shareholders receive in a leveraged buyout may often be higher than the price they would receive if they sold their interest to a buyer who invested its own funds. In the course of a leveraged buyout, the selling shareholders' equity interest, which represents a claim against the corporate assets subordinate to that of the company's creditors, is not just transferred but transformed into a claim which may take priority over other debts of the company.

This priority may enable the seller to receive a premium over the price which would have been paid in a non-leveraged acquisition in which the buyer would only pay a price reflecting the value of the equity interest in the company. Consider for example a leveraged buyout of a barely solvent corporation. In such a case, the price to be paid may often be a function of the amount a lender is willing to loan to finance the transaction rather than the product of negotiations between buyer and seller. In making this determination, a lender may have little concern with the amount of the company's other debt. To the extent the leveraged buyout lender customarily assumes a senior, secured position vis-a-vis other creditors, the buyout lender's principal concern will be to assure that the company will be able to repay the buyout debt. Thus, a leveraged buyout lender is not likely to be seriously concerned with the question whether the debtor is insolvent at the time of the transaction or becomes insolvent as a result of the transaction so long as the value of the assets pledged to secure the acquisition debt appears sufficient to repay this debt in the event of default.

In the absence of constraints of the type provided by fraudulent conveyance laws, a leveraged buyout may be attractive to buyer, seller and third party lender precisely because it allows all parties to the buyout to shift some portion of the risk of loss associated with their investment in the company to the only "investors" in the company who are not involved in the buyout—the other creditors. It is only logical to suppose that rational creditors will desire some form of protection from a transaction with such strong lures to the equity holders and lender alike.

Although, as Professors Baird and Jackson suggest, a management buyout of a public company may benefit a corporate debtor by reducing operating costs associated with compliance with federal securities laws,[45] a creditor may well be more concerned about other implications of a going private transaction. A management buyout, for example, does not really give the insolvent or near insolvent debtor "new" management; it simply alters the relationship of those managing the debtor from the status of employee to owner. Advocates of leveraged buyouts suggest that this change in status may give managers increased incentive to operate the firm more profitably and imply that creditors should therefore welcome the change.[46] Although much has been made of the enhanced management incentives and efficiency expected to accrue to a company following a leveraged buyout as a result of management's ownership of a more significant percentage of the new venture's equity,[47] this should not obscure the fact that the new shareholders'

45. Baird & Jackson, *supra* note 5, at 853. Although reduction in securities reporting and compliance costs is frequently cited as one of the motivations for leveraged buyouts of public companies, in view of the transaction costs associated with large buyouts, it is unlikely that this is a significant motivating factor in larger transactions. As Professor Lowenstein has noted, "[s]urely, a billion dollar company does not go private in order to save legal fees and the other routine expenses of having publicly traded securities. The fees and expenses in connection [with a large leveraged buyout] would pay for a generation of compliance costs." *Management Buy-outs, supra* note 1, at 743 (footnote omitted). *See also* Brudney, *A Note on "Going Private,"* 61 VA. L. REV. 1019, 1032-34 (1975) (questioning whether reduction of securities compliance costs is a legitimate motive even in smaller transactions).

46. *See Small Leveraged Buyouts Are Big Business Now*, BUS. WK., Dec. 10, 1984, at 140 (following a management buyout, "[m]anagement is simply more committed to the company").

47. *See, e.g.,* DeAngelo, DeAngelo & Rice, *Going Private: Minority Freezeouts and Stockholder Wealth,* 27 J.L. & ECON. 367, 371-74 (1984); Easterbrook & Fischel, *Corporate Control Transactions,* 91 YALE L.J. 698, 706 (1982); Jensen & Ruback, *The Market for Corporate Control: The Scientific Evidence,* 11 J. FIN. ECON. 5, 9-22 (1983). Wholly apart from the particulars of any specific leveraged buyout transaction, the leveraged buyout boom has been touted as a way to improve national economic performance by unleashing America's entrepreneurial energies. As some have noted however, it seems implausible that the mere change in an individual's status would alter individual productivity sufficiently to explain why

total equity investment is generally quite small in proportion to the company's total capitalization. As noted above, a significantly increased debt to equity ratio may increase management's propensity to engage in risky endeavors[48] and thereby increase creditors' risk of loss.

Indeed, the extent to which the new owner-managers actually have an increased personal stake in the corporation's financial success is debatable. In a management buyout of a large public company, the value of the new owner's equity investment in the surviving privately held corporate entity, although representing a significant percentage of the company's equity capital, may be a smaller percentage of an individual manager's personal net worth than the amount the individual had previously invested in the public company.[49] Thus, while the manager's control over the company's management strategy may have been less complete in a publicly held venture where he was accountable to a larger outside shareholder interest, the value

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institutional lenders and investors are willing to pay such high premiums to acquire mature, even mundane, businesses in highly leveraged transactions. *See Management Buy-outs, supra* note 1, at 749; Sloan, *supra* note 1, at 41.

The argument that the buyout phenomenon represents a fundamental reorientation of the American economy toward entrepreneurial ownership is also severely challenged by evidence that many public companies which go private do not stay private for very long. Indeed in many cases the return to public ownership is anticipated at the outset of the leveraged buyout of a public company. In most larger leveraged buyout transactions, the financial plan anticipates a substantial reduction in leverage during the first five to six years following the buyout. The initial employment agreements which often assure management of extraordinary compensation in the years immediately following the buyout often expire at about the same time. Thus, if all goes as anticipated and the stock market appears favorable, it is highly likely that the company will once again become publicly owned in less than a decade after the initial buyout. Thus, even if private ownership brings with it the increased efficiencies and productivity which advocates suggest, the nature of large leveraged buyouts suggests that these improvements are likely to be short lived. *Management Buy-outs, supra* note 1, at 765-66.

48. *See* notes 31-37 and accompanying text.

49. Professor Lowenstein provides an interesting illustration of this phenomenon drawn from the 1981 management buyout of Fred Meyer, Inc. Prior to the buyout, senior management of the company owned approximately 1.6% of the equity. In connection with the buyout, these shares in the original company were sold for approximately $5.5 million cash. Management's stake in the new venture comprised 9% of the equity. This interest was purchased, however, without any substantial investment of personal assets by the individual managers. At closing, the managers actually purchased only about one-quarter of the shares they would beneficially own; the balance of their equity interest took the form of stock options. The consideration paid for the shares actually purchased at closing consisted of $3,000 cash and almost $1.6 million in notes payable in installments beginning five years after closing. As a result, following the buyout, the managers had received a substantial amount of cash from selling their interest in the old company and did not put any significant portion of their personal assets at risk in the new venture despite their substantial equity position in the new company. Under such circumstances, the managers, while naturally hopeful that the new venture will succeed (and that they will ultimately be able to sell their equity interest in the new company for a sum sufficient to pay off their notes and still make a handsome profit) have virtually nothing to lose should events prove otherwise. *Management Buy-outs, supra* note 1, at 745. Professor Lowenstein cites a number of other buyouts in which management, despite receiving substantial sums as sellers of their equity interest in the old company, reinvested very little in the new venture. *Id.* at 748 n.63.

to him of his personal stake in the venture, may have been just as great or greater.

A leveraged buyout may free management from the confines of a corporate strategy dictated by public shareholders' demands for current high earnings, but the enormous financial demands of the debt incurred in connection with the buyout, despite the extraordinary tax advantages historically associated with such transactions, may place similar constraints on management's strategy.[50] Leveraged buyouts do not, for example, ordinarily free cash otherwise required for payment of dividends to be used for capital expenditures required for expansion or modernization. Indeed, companies with significant projected capital expenditures are generally considered poor candidates for leveraged buyouts because the significant debt burden created by the buyout would make it difficult to generate cash internally or to raise from external sources the funds needed for capital expenditures.[51] As yet, the evidence appears insufficient to support a conclusion that leveraged buyouts produce real economic gains in terms of corporate productivity or management efficiency.[52] The improved financial results associated with leveraged buyouts do not generally reflect increases in operating income but are primarily a function of the fact that the buyout reorganizes the corporation's capital structure so as to maximize the after-tax value of the company's cash flow.[53]

In addition, a management buyout, by altering the creditor's debt relationship with a public company into a debt relationship with a private venture may also remove other constraints and monitoring mechanisms[54] which the creditor may have relied upon in constructing the terms of his original relationship with the debtor. For example, the creditor may have relied upon the required public proxy statement disclosure of management compensation and transactions with directors. Of course, all of these effects accompany any leveraged buyout and creditors would probably not want to restrict all leveraged buyouts because of them. However, the limited marginal category of buyouts involving insolvent entities, or entities which become insolvent as a result of a leveraged buyout, involves a significantly enhanced likelihood of a direct injury to creditors and a substantially more

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50. As Professor Lowenstein observes, "[d]ebt-equity ratios of four to one, six to one, and even higher may put a usefully cash-hungry wolf at the door, but they also limit flexibility." *Id.* at 731.

51. *See* Adkins, *supra* note 10, at 34; *Management Buy-outs, supra* note 1, at 757-58.

52. *Management Buy-outs, supra* note 1, at 764-67.

53. *Id.* at 759-64.

54. Items 7 and 8 of Schedule 14A, which prescribes the information required in a proxy statement of a public company subject to the reporting requirements of the Securities Exchange Act of 1934, require disclosure concerning management experience and compensation and a complete description of transactions between the company and directors, officers or members of their families. *See Regulation S-K*, 6 Fed. Sec. L. Rep. (CCH) ¶¶ 70,950, 71,041-44 (1988); *Exchange Act-Proxies*, 3 Fed. Sec. L. Rep. (CCH) ¶¶ 24,001, 24,038-40 (1988).

serious conflict between creditors' interests and the interests of equity holders who control the debtor's decision to enter into the transaction. A per se rule restricting leveraged buyouts under these circumstances would appear, therefore, to be entirely consistent with Professors Baird and Jackson's guideline that such rules should affect only transactions that creditors would almost always want to prohibit.

III. The Risk of Error in Determining Insolvency and Fair Consideration

With respect to constructive fraud, the language found in fraudulent conveyance statutes limits the application of such statutes to transactions involving insolvent entities and a lack of fair consideration. Professors Baird and Jackson argue that these limiting factors are insufficient to keep the reach of the fraudulent conveyance statutes from being too broad because of the uncertainty inherent in determining both insolvency and lack of fair consideration.[55] Although the risk of an erroneous determination with respect to either of these matters is present whenever a court applies the constructive fraud provisions of fraudulent conveyance statutes, Professors Baird and Jackson conclude that this cost is not excessive if the fraudulent conveyance statutes are narrowly limited to sham and gratuitous transfers. In the case of the former, the costs associated with the risk of an erroneous determination of insolvency are offset by the fact that the challenged transaction is often suspected of being animated by an actual intent to hinder, delay or defraud creditors. Since the strong circumstantial evidence of an impermissible motive is the underlying reason for the application of the fraudulent conveyance statute, and since transactions involving actual intent to defraud may be invalidated under the statutes without any specific determination that a debtor was insolvent or received less than fair consideration, the risk of an erroneous determination of insolvency or fair consideration with respect to such a transaction is thought acceptable.[56]

In the case of completely gratuitous transfers, there is of course no difficulty in determining the value of the consideration received by the debtor because by definition the transferror receives no consideration in exchange for a gift.[57] In addition, imposing the risk of an erroneous determination of insolvency on the recipient of a gratuitous transfer might be seen as an acceptable allocation on the grounds that as between the

55. Baird & Jackson, *supra* note 5, at 840-42, 851.
56. *Id.* at 830-31.
57. *Id.* at 832.

donee and the creditor who parted with value, the latter is to be preferred.[58] Where a leveraged buyout is concerned, there is no greater risk of an erroneous determination of fair consideration than in the case of a gratuitous transfer. As Professors Baird and Jackson acknowledge, a leveraged buyout involves a transaction in which the corporate debtor pledges valuable assets "without getting anything in return" because the loan proceeds are used to pay the selling shareholders.[59]

It is true that there may be some indirect, intangible and, as noted above, highly speculative benefits to the corporate entity itself resulting from the transaction—that is, new management or new incentives for management and decreased legal costs following a going private transaction. However, it may be that under peculiar circumstances an outright gift by a debtor may indirectly bring him rewards as well. For example, a gift to a customer or client may indirectly improve a business relationship and ultimately benefit the debtor. Nonetheless, these types of intangible benefits have not generally been perceived as sufficient to remove a gift from the province of fraudulent conveyance statutes.[60] With respect to the issue of allocating

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58. Under section 548 of the Bankruptcy Code, the bankruptcy trustee bears the burden of proof on the issues of insolvency and lack of fair consideration. *See, e.g., In re* Nacol, 36 Bankr. 566, 568 (Bankr. M.D. Fla. 1983); *In re* Emerald Hills Country Club, Inc., 32 Bankr. 408, 420 (Bankr. S.D. Fla. 1983); *In re* Thames, 21 Bankr. 704, 706 (Bankr. S.C. 1981). Under the UFCA as interpreted in a number of jurisdictions, different rules apply. In Pennsylvania, for example, when a creditor establishes that the grantor was indebted at the time of the conveyance, the burden of proof shifts to the grantee to prove, by clear and convincing evidence, either that the grantor was solvent at the time of the challenged transfer and was not rendered insolvent thereby or that the grantor received fair consideration in exchange for the value transferred to the grantee. Stinner v. Stinner, 446 A.2d 651 (1982); *cf.* United States v. Gleneagles Inv. Co., 565 F. Supp. 556, 576 (M.D. Pa. 1983) (holding that under Pennsylvania law, once a creditor shows that the conveyance was made without fair consideration, the burden is on the transferee to prove that the debtor was solvent).

Other jurisdictions also shift the burden of proof or the burden of going forward with evidence on the issues of fair consideration and insolvency to the transferee. *See, e.g., In re* Colandrea, 17 Bankr. 568 (Bankr. Md. 1982) (Maryland law); *In re* Tabala, 11 Bankr. 405 (Bankr. S.D.N.Y. 1981) (New York law); Neumeyer v. Crown Funding Corp., 56 Cal. App. 3d 178, 128 Cal. Rptr. 366 (1976) (California law); Tri-State Vehicle Leasing, Inc. v. Dutton, 461 A.2d 1007 (Del. 1983) (Delaware law).

59. Baird & Jackson, *supra* note 5, at 851.

60. *See* I.G. GLENN, *supra* note 21, § 264, at 451-52 (noting that where personal transfers are concerned intangible valuables such as love and affection have not historically been deemed to constitute valuable consideration for purposes of fraudulent conveyance statutes). *See also* Rosenberg, *Intercorporate Guaranties and the Law of Fraudulent Conveyances: Lender Beware,* 125 U. PA. L. REV. 235, 243-45 nn.19, 20, 23 (1976). *See also, e.g.,* United States v. West, 299 F. Supp. 661, 666 (D. Del. 1969) (natural love and affection is not fair consideration).

The fair consideration required to save a conveyance by an insolvent from the reach of the fraudulent conveyance statutes is a more stringent requirement than that imposed by the requirement of consideration in the law of contracts. This reflects the purpose of the consideration requirement which is to protect against depletion of the insolvent's estate. Consideration which will be of no value to the creditors is thus disregarded. *See* Carl, *Fraudulent Transfer Attacks on Guaranties in Bankruptcy,* 60 AM. BANKR. L.J. 109, 120 (1986); Comment, *Good Faith and Fraudulent Conveyances,* 97 HARV. L. REV. 495, 506 n.60 (1983).

the risk of inaccuracy in determining insolvency in the context of a leveraged buyout, there are a number of important per se rules which constrain a corporation's conduct only under circumstances of insolvency. One example is the restraints on stock dividends and repurchases contained in state corporation laws.[61] The accounting in any particular circumstance may be difficult, but as a practical matter many important types of debtor and lender conduct and rights are determined by reference to the concept of insolvency.

Professors Baird and Jackson do not suggest that there are any particular factors which increase the risk of an erroneous determination of insolvency or fair consideration in the context of the application of the fraudulent conveyance statutes to leveraged buyouts. As the discussion above indicates, with respect to the cost, as distinguished from the likelihood, of such an error, the social utility of leveraged buyouts appears sufficiently debatable to counter any argument that the cost of an erroneous determination of insolvency or fair consideration in connection with the application of fraudulent conveyance statutes to leveraged buyouts is simply unacceptable as a matter of public policy.

IV. "Arms-Length" Transactions and Constructive Fraud

At bottom, Professors Baird and Jackson's argument against the application of fraudulent conveyance statutes to leveraged buyout transactions rests on a perception that such transactions are "strikingly different"[62] from

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61. *See, e.g.*, RMBCA, *supra* note 43, § 6.40(c). After extensive consideration, the ABA Committee on Corporate Laws determined to retain in the Model Act both the equity and the balance sheet tests for determining insolvency acknowledging that:

> [w]hile there are sound arguments for the balance sheet test's elimination (many of which center upon the soft, illiquid and oftentimes ephemeral character of various types of assets that can be found on a balance sheet), the committee believes that, in view of the difficulties frequently encountered in the practical application of the equity insolvency test, the objectivity of the balance sheet test and the demonstrability of compliance with it yield benefits that should be preserved.

The Committee on Corporate Laws, *Changes in the Model Business Corporation Act—Amendments Pertaining to Distributions,* 42 Bus. Law. 259 (Nov. 1986).

The New Uniform Fraudulent Transfer Act (UFTA) also retains both insolvency tests. Unif. Fraudulent Transfer Act § 2, 7A U.L.A. 643, 648 (1985). The use of the term "balance sheet test" to refer to the definition of insolvency by comparison of a debtor's assets and liabilities is somewhat misleading because it suggests the use of historical valuations—that is, book value of assets as appearing on a corporation's balance sheet—while the fraudulent conveyance statutes tend to value assets for purposes of determining insolvency by reference to their current fair market or salable value. *See, e.g.,* 11 U.S.C. § 548 (1982) (referring to the "present fair salable value" of the debtor's assets); UFTA § 2, 7A U.L.A. 643, 648 (1985) (referring to the "fair valuation" of the debtor's assets). The courts have emphasized that this value may be more or less than accounting book value. *See, e.g.,* Rubin v. Manufacturers Hanover Trust Co., 661 F.2d 979, 995-96 (2d Cir. 1981).

62. Baird & Jackson, *supra* note 5, at 833.

the types of transactions historically affected by fraudulent conveyance statutes. This perception appears to derive in part from a simple observation that since leveraged buyouts have been so widely publicized and discussed as a new phenomenon, these types of transactions simply couldn't have been within the contemplation of the drafters of the original sixteenth century statutes or in the minds of those who composed the UFCA in the early twentieth century. According to Professors Baird and Jackson, the only types of transactions, apart from transactions involving actual intent to hinder, defraud or delay creditors, which were traditionally and legitimately encompassed within the grasp of fraudulent conveyance statutes fell within two distinct categories.

The first category consisted of sham transfers occurring under circumstances "in which the possibility of a deliberate effort to hinder, delay or defraud was high."[63] Although the application of a constructive fraud rule to these types of transactions may be overbroad in the sense that it may sometimes result in the invalidation of transactions in which the debtor was not actually trying to hinder, delay or defraud creditors, the rule is justified on the grounds that with respect to these types of transactions "[t]he costs to society of setting aside legitimate transfers should be offset by the elimination of costs associated with proving actual fraudulent intent in cases in which the chances of fraud are very high."[64] At its core, this category of transactions would include those involving circumstances, such as intra-family transactions, and conduct such as retention of possession, which, prior to the inclusion of the constructive fraud provisions in the fraudulent conveyance statutes, were historically considered to create a presumption of fraud.[65]

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63. *Id.* at 832.

64. *Id.* at 831.

65. Prior to the inclusion of specific statutory provisions dealing with transactions by insolvents for less than fair consideration, most of the fraudulent conveyance statutes prohibited only transactions undertaken with intent to hinder, delay, or defraud creditors. A significant body of law relating to these statutes was concerned with matters of evidence concerning what facts and circumstances would be deemed sufficient to create a presumption that a transaction was motivated by the required intent to injure creditors. *See* O. BUMP, BUMP ON FRAUDULENT CONVEYANCES 31-59 (1872); McLaughlin, *Application of the Uniform Fraudulent Conveyance Act*, 46 HARV. L. REV. 404, 407-09 (1932-33). Circumstances such as inadequate or no consideration and the debtor's retention of possession or substantial control over the property were typically found to be "badges of fraud." The drafters of the UFCA intended the adoption of the constructive fraud provisions to remove:

> all possibility of a presumption of law as to intent . . . . Certain conveyances which the courts have in practice condemned, such as a gift by an insolvent, are declared fraudulent irrespective of intent. On the other hand, while all conveyances with intent to defraud creditors . . . are declared fraudulent, it is expressly stated that the intent must be "actual intent," as distinguished from intent presumed as a matter of law.

UFCA, 7A U.L.A. 427, 428 (1985) (Prefatory Note).

A second category of debtor conduct the constructive fraud provisions of the UFCA were intended to constrain, according to Professors Baird and Jackson, consisted of donative transfers.[66] These transfers were prohibited not because it was believed that they were more often than not a smoke screen for a debtor's intentional fraud, but because the drafters of the statute found them to be "inherently objectionable."[67] This objection has been explained as an essentially normative constraint on debtor conduct designed to promote extensions of credit by giving primacy to obligations derived from such relationships. By prohibiting gifts by insolvent debtors, fraudulent conveyance statutes express society's directive to an insolvent to be just before being generous.[68] The prohibition of gifts is not targeted at conduct which is suspected of being improperly motivated by fraud or deceit and would therefore be objectionable under any circumstances.

In fact, this rule affects conduct which, under circumstances other than insolvency, might be deemed quite socially desirable. The prohibition of gifts merely bars those who are by definition incapable of satisfying all their legal obligations from making gratuitous transfers. Although the examples and cases cited most often to illustrate the application of fraudulent conveyance statutes to gratuitous transfers by insolvent debtors involve gifts to family members,[69] these situations do not present an entirely clear picture of the policy involved because these types of gifts inevitably raise the question whether the debtor's apparent generosity may in fact mask some self-interest. The prohibition of donative transfers by an insolvent applies not only to bar gifts to the debtor's family and friends, but also prohibits the insolvent from making a donation to the most laudable public charity.[70] For example, an insolvent's donation to the Society for the Prevention of Cruelty to Animals is just as voidable by his creditors as a gift to his mother. This example illustrates more clearly the point that even though a donative transfer might be the product of unsullied generosity and public spirit and would be perceived as laudable behavior by the debtor if he were solvent, once insolvent, certain types of behavior are restricted. Unlike the first category of transfers affected by the constructive fraud provisions, the prohibition of gifts, and the more general prohibition of transfers for inadequate consideration which may be seen as partial gifts, is not justified primarily by a focus on the inherently objectionable quality of the debtor's behavior or by a presumption of collusion between debtor and transferee.

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66. Baird & Jackson, *supra* note 5, at 831-32.

67. *Id.* at 832.

68. I.G. GLENN, *supra* note 21, § 264, at 451. The phrase also appears without citation to authority in Clark, *supra* note 20, at 510.

69. *See, e.g.*, I.G. GLENN, *supra* note 21, §§ 264-264a, at 451-52; Clark, *supra* note 20, at 509-11.

70. I.G. GLENN, *supra* note 21, § 264a, at 452.

Rather, this prohibition reflects a primary concern for the impact of the transaction on creditors.[71]

Although Professors Baird and Jackson contend that leveraged buyouts are "arms-length" commercial transactions which fall into neither of the categories discussed above and thus should be excluded from the proper scope of fraudulent conveyance laws, a close analysis of leveraged buyouts involving insolvent or nearly insolvent corporate debtors suggests that such transactions may be much closer in character to time-honored schemes to defraud and to "gifts" than to ordinary arms-length transactions.[72] Viewed solely in terms of the lending transactions involved, it is true that the leveraged buyout does not normally involve any special relationship between the lender and the corporate borrower which would suggest that the transfer involves the type of collusion traditionally policed by fraudulent conveyance statutes. Nonetheless, the leveraged buyout has a significant potential for self-interested misbehavior by the debtor, or to be more precise, for abuse of the corporate form by the shareholders in control of the debtor's conduct.[73] In the course of a leveraged buyout the selling shareholders cause the corporate debtor to act in such a way that they are personally benefitted

71. As Professors Baird and Jackson acknowledge, "[a] birthday gift of cash by an insolvent debtor injures creditors just as much when his intentions are innocent as when they are not, and one can presume creditors would ban them if they could." Baird & Jackson, *supra* note 5, at 832.

72. Commentators have traditionally considered transactions involving transfers of corporate assets to shareholders, such as dividends, as comparably suspicious to intra-familial transfers. *See, e.g.*, I.G. GLENN, *supra* note 21, § 265a, at 454 (observing that from the perspective of creditors, a gift by a natural person is identical to "the payment of dividends, or distributions of capital, by an insolvent corporation"). Similarly, Professor Clark observes that the prohibitions of gifts by an insolvent represents a determination that a debtor entity (whether natural or legal person) has a "moral duty in transferring his property to give *primacy* to so-called legal obligations, which are usually the legitimate, conventional claims of standard contract and tort creditors, as opposed to the interests of self, family, friends, shareholders and shrewder or more powerful bargaining parties." Clark, *supra* note 20, at 510.

In a footnote Professor Clark notes that, in the context of a corporate debtor, fraudulent conveyances of the sort under discussion may be buried amid obscuring factors and it thus requires "judicial imagination to see through the disguises." *Id.* at 511 n.18. *See also In re* Tri-State Paving, Inc., 32 Bankr. 2, 4 (Bankr. W.D. Pa. 1982) (noting that "[c]orporation-director transfers are analogous to intrafamilial transfers: the relationship of the parties encourages collusion and concealment").

73. In assessing whether transactions involving corporate as opposed to individual debtors implicate the policies traditionally enforced by fraudulent conveyance laws, one should recall Jensen and Meckling's observation that although the law considers a corporation a legal person, the "personalization of the firm" can be an obstacle to understanding the motives and dynamics of the firm's conduct. Jensen & Meckling, *supra* note 24, at 311. "*The firm is not an individual.* It is a legal fiction which serves as a focus for a complex process in which the conflicting objectives of individuals (some of whom may 'represent' other organizations) are brought into equilibrium within a framework of contractual relations." *Id.* The legal system and the per se legal rules operate to constrain the contractual freedom of the different interested parties. *Id.* n.14.

at the expense of the corporate entity and its creditors. The leveraged buyout allows them to liquidate their investment in the operation without paying off the corporation's creditors first, as would be required if the company were liquidated.[74]

The traditional policies underlying fraudulent conveyance statutes are entirely consistent with a per se rule which would prohibit those individuals in control of the corporation, the equity holders, from causing the corporation to act in ways beneficial to themselves in preference to the payment of obligations owed to the creditors of the corporation.[75] Where an insolvent corporation is involved, fraudulent conveyance statutes have traditionally operated in conjunction with the statutory restrictions on distributions to shareholders contained in state corporation laws to constrain corporate transfers for the benefit of shareholders in preference to the discharge of obligations owed to the corporation's creditors.[76] Although state corporation statutes and the Revised Model Business Corporation Act (RMBCA) have recently moved toward the abandonment of the concept of legal capital which traditionally limited the permissible sources of funds used to pay dividends or other distributions to shareholders, corporation laws continue to circumscribe a corporation's power to make any such dividends or distributions, or to engage in certain other types of transactions in which corporate assets are transferred to shareholders, under circumstances of insolvency.[77] For example, under the RMBCA, a corporation is prohibited from paying a cash dividend or making any other "distribution" to shareholders if, immediately following the dividend or distribution, the corporation would be insolvent. The statute defines "distribution" to include the transfer of money or other assets in connection with a repurchase and the incurrence of indebtedness for the benefit of shareholders in connection with a repurchase.[78] Thus, under the RMBCA a corporation could not

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74. The basic ideal of fraudulent conveyance law commands those in control of a corporate debtor to act so that transfers to shareholders do not disable a corporation from discharging its obligations to its creditors. Clark, *supra* note 20, at 510 n.16.

75. As Professor Clark notes, these statutory restrictions on distributions to shareholders are a "straightforward expression of fraudulent conveyance principles." *Id.* at 555.

76. Statutory restrictions on the payment of dividends based upon legal capital concepts have, as a practical matter, traditionally provided creditors with little protection against self-serving actions by shareholders because such constraints could easily be circumvented. *See* RMBCA, *supra* note 43, § 6.40 Official Comment. *See also* Clark, *supra* note 20, at 555-57.

77. Section 6.40(c) of the RMBCA prohibits any distribution to shareholders if after giving effect to the distribution the corporation would be insolvent applying either the balance sheet or equity test.

78. Section 1.40(6) of the RMBCA defines "distribution" to include any:

> direct or indirect transfer of money or other property (except its own shares) or incurrence of indebtedness by a corporation to or for the benefit of its shareholders . . . [whether] in the form of a declaration or payment of a dividend; a purchase, redemption, or other acquisition of shares; a distribution of indebtedness; or otherwise.

RMBCA, *supra* note 43, § 1.40(6).

simply sell or mortgage its assets for cash and use the proceeds to pay a dividend to shareholders or to repurchase or redeem its shares if the corporation was insolvent or became insolvent as a result. This type of per se statutory restriction on the conduct of an insolvent corporate debtor illustrates that while creditors generally are not protected against a corporation's decision to use its assets for distributions to shareholders, insolvency triggers a per se rule aimed at protecting creditors against such transfers. From the point of view of a corporation's creditors a leveraged buyout is identical to such a share repurchase or redemption. In both cases, corporate assets otherwise available for the payment of the corporation's debts have been exchanged for cash which has been transferred to the shareholders. In the course of these transfers, the corporation itself has received nothing of tangible value.

Professors Baird and Jackson point out correctly that from the point of view of a corporation's creditors a leveraged buyout is functionally indistinguishable from the simple case in which the firm issues new preferred debt and then uses the proceeds to pay a dividend to its shareholders.[79] They argue that this conduct is often restricted in credit agreements but that if a creditor fails to restrict such conduct, there should be no per se rule protecting his interest.[80] This argument overlooks corporation law per se rules that limit distributions to shareholders when the transaction involves an insolvent corporation or a corporation that becomes insolvent as a result of the transaction. Although the per se rules embodied in state corporation laws would not bar an insolvent corporate entity from incurring new senior debt, the distribution restrictions would prohibit the use of the proceeds of this debt to pay dividends to shareholders. Thus, creditors do rely on per se rules to protect themselves against these types of transactions when they occur under circumstances most likely to cause serious injury to creditors. The application of fraudulent conveyance statutes to leveraged buyouts merely affords creditors an identical range of protection against the impact of a functionally equivalent transaction.

A comparison of a leveraged buyout financed by a third party lender and a corporate stock repurchase in which the corporation issues its notes as consideration to the shareholders illuminates the degree to which a blanket exception to the fraudulent conveyance laws for leveraged buyouts would undermine the policies of creditor protection embodied in state corporation laws. The fact that the leveraged buyout involves a sale of stock to new shareholders, and not to the company itself, is not a significant distinction between the two transactions because, by definition, in a leveraged buyout, the new shareholders' equity investment is extremely modest by comparison

79. Baird & Jackson, *supra* note 5, at 853.
80. *Id.* at 853-54.

to the debt obligations incurred by the corporation in connection with the acquisition. In the case of an installment stock repurchase, the RMBCA provides that a corporation may not issue indebtedness to a shareholder in connection with a stock repurchase if, as of the date the indebtedness is issued, the company would be unable to satisfy the solvency tests set forth in the statute.[81] Applying fraudulent conveyance statutes to invalidate leveraged buyouts involving financially troubled companies merely protects a creditor from a transaction in which the corporation incurs a debt obligation to a third party and the proceeds are immediately used to pay the selling shareholders for their stock. From the perspective of a creditor, the transactions are identical; they both involve a corporate debtor's incurring additional debt solely for the purpose of allowing the shareholders to liquidate their equity investment in the company. In both cases, debt replaces substantial amounts of equity. The leveraged buyout is perhaps even more injurious to existing general creditors because in the course of the leveraged buyout, the equity is generally replaced by significant amounts of senior, secured debt, whereas in the installment repurchase transaction, the claims of the selling shareholders rank, under the RMBCA, *in pari passu* with the claims of unsecured creditors.[82]

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81. RMBCA, *supra* note 43, § 6.40. The statute contemplates one exception to this prohibition. Section 6.40(g) of the RMBCA, added in late 1986, provides that in determining the solvency of a corporation under the solvency tests set forth in section 6.40(c), indebtedness of the company, including indebtedness issued as a distribution, is not considered as a liability if the terms of such indebtedness provide that payment of principal and interest are to be made only if and to the extent that a distribution could then be made to shareholders under section 6.40. Thus, under the RMBCA indebtedness could be issued to a shareholder in connection with a repurchase even if the total amount of the deferred purchase price represented by such indebtedness exceeds the net worth of the corporation, so long as the corporation is obligated to make payments with respect to such indebtedness only if at the time of the proposed payments, the corporation meets both the solvency tests included in the statutes. The Official Comment indicates that this exception was designed to permit share repurchases by "businesses in early stages of development or service businesses whose value derives principally from existing or prospective net income or cash flow rather than from net asset value." Where indebtedness is issued as a distribution under these types of circumstances, the statute provides that each payment of principal or interest with respect to such indebtedness shall be considered a distribution, and that the solvency tests shall be applied with respect to each such distribution on the date the payment is actually made. The practical utility of the kind of debt instrument contemplated by this statutory language seems highly questionable.

For a brief overview and discussion of section 6.40(g), see The Committee on Corporate Laws, *supra* note 61, at 261, 267-68.

82. Section 6.40(f) of the RMBCA provides that indebtedness created to acquire the corporation's shares or issued as a distribution is on a parity with the indebtedness of the corporation to its general, unsecured creditors except to the extent subordinated by agreement. The Official Comment to this section observes that under its terms:

> [g]eneral creditors are better off in these situations than they would have been if cash or other property had been paid out for the shares or distributed which is proper under the statute [assuming, of course the solvency tests are met], and no worse off than if cash had been paid out to the shareholders, which was then lent back to the corporation, making the shareholders [or former shareholders] creditors.

RMBCA, *supra* note 43, § 6.40(f) Official Comment 8(c).

Although large scale leveraged buyouts may be a new financial phenomenon, these transactions are not significantly different from transfers historically encompassed by fraudulent conveyance laws. Leveraged buyouts enable the owners of a corporate debtor's equity to transfer the value of the corporation's assets to themselves in preference to the claims of the corporation's creditors. The traditional policies embodied in fraudulent conveyance laws dictate the prohibition of such a self interested transaction when the corporation is insolvent. Exempting leveraged buyouts of insolvent corporations from the application of fraudulent conveyance statutes would not represent a decision to restrain fraudulent conveyance laws to their traditional domain. Such an exemption would instead represent an illogical lacuna in the application of the statutes and create an irrational inconsistency between fraudulent conveyance statutes and state corporation laws.

V. *United States v. Gleneagles*: Illustrating a Leveraged Buyout's Potential for Damage to Creditors

The degree to which a leveraged buyout involving a failing venture bears all the indicia of a self-interested, creditor abusive transaction traditionally constrained by fraudulent conveyance laws is vividly illustrated by the transaction involved in *United States v. Gleneagles Investment Co.*[83] *Gleneagles* was a suit to enforce liens created as a result of delinquent federal income taxes owed by Raymond Collieries Co., a Pennsylvania corporation which, along with a number of wholly owned subsidiaries, was engaged in coal mining and sales operations. Prior to the leveraged buyout described below, Raymond Collieries was a closely held company owned by two families, the Gillens and the Clevelands.[84]

Raymond Collieries' financial problems began shortly after its 1966 acquisition of an anthracite subsidiary, Blue Coal Corporation.[85] In 1967, Pennsylvania environmental authorities forced Blue Coal to begin a costly process of converting its mining operations from deep mining to strip mining. The costs of conversion, coupled with depressed conditions in the

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83. The district court issued three separate opinions in *United States v. Gleneagles Inv. Co.*: United States v. Gleneagles Inv. Co., 565 F. Supp. 556 (M.D. Pa. 1983) (Gleneagles I); United States v. Gleneagles Inv. Co., 571 F. Supp. 935, (1983) (Gleneagles II); United States v. Gleneagles Inv. Co., 584 F. Supp. 671 (1984) (Gleneagles III). On consolidated appeal, the Third Circuit affirmed in part and remanded in part under the name U.S. v. Tabor Court Realty Corp., 803 F. 2d 1288 (3d Cir. 1986).

For a complete chronology of the transactions giving rise to this complicated litigation, see Murdoch, Sartin & Zadek, *Leveraged Buyouts and Fraudulent Transfers: Life After* Gleneagles, 43 Bus. Law. 1 (1987).

84. *Gleneagles I*, 565 F. Supp. at 563.

85. The purchase price for Blue Coal was $6 million, of which Raymond paid $500,000 in cash and delivered a note to the seller, Glen Alden Corporation, for the remainder. The note was secured by a mortgage on the Blue Coal properties. *Id.*

coal industry, created chronic financial difficulties for the Raymond companies from the late 1960's through the early 1970's.[86] During this period, Raymond Collieries and its subsidiaries were not only chronically delinquent in the payment of trade accounts, but also seriously delinquent in the payment of property taxes and federal income taxes.[87] Throughout this period, the companies suffered operating losses and relied upon income from sales of surplus coal properties to fund operations.[88] The deteriorating financial condition of the Raymond companies led to friction among the stockholders and in 1972 the Gillens and Clevelands decided to seek a buyer for the companies.[89] The consolidated income statement for the Raymond companies' fiscal year ended June 30, 1973, reflected a net loss of more than $2 million.[90]

In November 1973, the Gillens and Clevelands sold their stock in Raymond Collieries to Great American Coal Company in a leveraged buyout.[91] As is common in these types of transactions, Great American was a holding company formed specifically to acquire the Raymond stock; Great American had no assets or operations prior to its acquisition of the Raymond stock.[92] Institutional Investors Trust ("IIT"), a New York real estate investment trust, provided $8.5 million in financing for the buyout. In connection with the buyout, the Raymond companies were divided into two categories, the "borrowing companies" and the "guarantor companies."[93] At the closing, the borrowing companies received, albeit temporarily, $7 million[94] in proceeds from the IIT loan and executed first mortgages on all their assets in favor of IIT. The guarantor companies executed agreements guaranteeing the repayment of the IIT loan by the borrowing companies and mortgaged their assets to IIT to secure these guarantees. The loan agreement provided additional security to IIT by a provision granting IIT a priority lien on any proceeds received by any of the Raymond companies from land sales.[95] This

86. *Id.* at 564.
87. *Id.*
88. *Id.*
89. *Id.* at 565.
90. *Id.*
91. The transaction was a management buyout. James Durkin, Sr. who had been President of Raymond Collieries for a number of years prior to the buyout owned 40% of the stock of Great American. Teamsters union figure James R. Hoffa, Sr. held 50% of the Great American stock and the remaining 10% was held by an investor recruited by Hoffa to help arrange the loan for the transaction. The purchasers unsuccessfully sought to obtain financing for the buyout from the Teamsters' Central States Pension Fund. *Id.*
92. *Id.*
93. *Id.* at 566.
94. The remaining proceeds of the IIT loan were deposited in an "interest reserve account." The funds in this account were to be used to pay the interest on the IIT loan because it was apparent to IIT that the Raymond companies would not have sufficient income to cover the debt service from operating revenues. *Id.* at 566, 574, 581.
95. *Id.* at 579-80.

provision effectively deprived Raymond of the cash flow upon which it had depended for working capital.

Immediately upon receipt of the proceeds of the IIT loan, the borrowing companies transferred slightly more than $4 million of the money received from IIT to Great American in exchange for Great American's promissory note.[96] Great American then used this $4 million, along with approximately $3.5 million in additional funds borrowed by Great American and its stockholders from other sources, to pay the Gillens and the Clevelands the $7 million purchase price for the stock of Raymond Collieries.[97]

Prior to the buyout, Raymond had outstanding approximately $8 million dollars in delinquent obligations, including delinquent federal income tax liabilities extending as far back as 1966, as well as delinquent property taxes, pension fund obligations, and obligations owed to state mining authorities for land reclamation and employee welfare funds.[98] Although some of these obligations were repaid at the time of the buyout, many remained outstanding following the transaction. Following the closing, the assets of the Raymond companies were charged with obligations totalling approximately $20 million.[99] The desperate financial situation of the Raymond companies was apparently evident to all involved in the closing of the sale of the Raymond Collieries stock to Great American. Pursuant to last minute negotiations, the Gillens and the Clevelands agreed to use $500,000 of the cash they received from the sale to make a loan to Raymond Collieries in order to provide the company with minimal working capital.[100] Nonetheless, the financial condition of the Raymond companies was so poor in the immediate aftermath of the buyout that the companies were unable to pay their utility bills.[101] The borrowing companies were in default under the terms of the IIT loan requiring maintenance of specified ratio of current assets to current liabilities from the date the loan agreements were signed.[102] Within three months after the buyout, all mining operations of the Raymond companies ceased. Thereafter, the companies were engaged in a de facto liquidation; their activities consisted solely of sales of coal properties and mining equipment.[103]

The district court, applying the Pennsylvania fraudulent conveyance statute, which follows the UFCA and defines insolvency in terms of an excess of liabilities over the "present fair salable value" of the debtor's assets, concluded that the Raymond companies were rendered insolvent by the

96. *Id.* at 570.
97. *Id.* at 567, 578; *Gleneagles II,* 571 F. Supp. at 938-39.
98. *Gleneagles I,* 565 F. Supp. at 572.
99. *Id.* at 578.
100. *Id.* at 570.
101. *Id.* at 572.
102. *Id.* at 569.
103. *Id.* at 572.

buyout transaction.[104] Viewed from the perspective of the creditors who were owed approximately $8 million by the Raymond companies at the time of the leveraged buyout, the transaction had extremely adverse consequences. Although the Raymond companies' financial condition was precarious prior to the buyout, the facts found by the district court indicate that prior to the buyout, revenue reasonably anticipated from land and equipment sales might have been sufficient to pay off the companies' matured debts.[105] If the Raymond companies had been liquidated at this point, the claims of the companies' creditors might have been almost completely satisfied but there would probably have been little or nothing remaining for the equity holders.

By effecting a leveraged buyout, followed by the de facto liquidation of the companies' assets, the equity holders' situation was improved dramatically at the direct expense of the companies' creditors. The equity holders received approximately $7 million in cash at the time of the closing of the leveraged buyout; $4 million of this sum derived directly from the proceeds of the IIT loan secured by a first lien on the Raymond companies' assets.[106] Under the terms of the loan agreement with IIT, proceeds received from the sales of Raymond assets following the buyout were to be used to discharge the indebtedness owed to IIT; an obligation incurred for the benefit of the shareholders and not for the benefit of the companies. The buyout produced exactly the type of situation the fraudulent conveyance laws were designed to prevent. The transaction advanced the personal self interest of the corporate debtor's shareholders and did so at the expense of the corporation itself which was left unable to discharge its obligations.[107]

VI. Remedial Incongruities: Fraudulent Conveyance Statutes and Three-Party Transactions

The conclusion that the application of fraudulent conveyance laws to protect creditors against the adverse impact of a leveraged buyout is consistent with the policies underlying the fraudulent conveyance statutes and consistent with creditors' reasonable expectations does not fully respond to all of the concerns underlying Professors Baird and Jackson's argument that the fraudulent conveyance remedy is "needlessly crude."[108] Even if one

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104. *Id.* at 578-80.

105. The matured obligations of the Raymond companies prior to the buyout totalled approximately $8,700,000. *Id.* at 578. The Raymond companies' equipment sales proceeds following the buyout totalled $8,676,984. *Id.* at 582.

106. *Id.* at 570.

107. The court concluded that the transactions surrounding the leveraged buyout of the Raymond companies violated not only the prohibitions of constructively fraudulent transfers contained in the Pennsylvania fraudulent conveyance statute, 39 Pa. Cons. Stat. Ann. §§ 354, 355, but also the intentional fraud provisions contained in 39 Pa. Cons. Stat. Ann. § 357.

108. Baird & Jackson, *supra* note 5, at 843.

were to conclude that leveraged buyouts are in fact the type of transactions against which creditors generally expect to be protected by the application of per se rules, there could be other reasons to limit the application of fraudulent conveyance laws to these transactions. For example, if, under the peculiar circumstances of a leveraged buyout the remedy prescribed by fraudulent conveyance statutes carries a risk of producing a peculiarly incongruous and inequitable result, one might well conclude that the cost of protecting creditors against the adverse consequences of a leveraged buyout by invalidating the corporation's obligations to the third-party lender who financed the buyout was simply too high.

There are in fact important differences between the way in which the fraudulent conveyance statutes remedy the adverse consequences of the leveraged buyout as compared to the remedies applied by corporation laws in the analogous situations discussed above. Although as noted above, leveraged buyouts are analogous in their effect on creditors of the corporation involved in the buyout to other types of transactions which are restricted by provisions contained in corporation laws,[109] such statutes remedy these comparable injuries by directly affecting the transfer of assets from the corporation to the shareholders. Thus, in the example considered above in which the proceeds of an issuance of preferred debt are used to pay dividends, if the corporation were insolvent, the state corporation statute would typically permit recovery from directors and shareholders of the sums improperly paid as dividends but would not directly affect the validity of the corporation's issuance of the preferred debt or the rights of the third-party holders of such debt.[110] By contrast, the application of fraudulent conveyance statutes to the loans made by third-party lenders in leveraged buyout transactions brings with it a remedy which imposes the cost of redressing the injury to the corporation's net worth on the third-party lender.

The reason for this difference between the way in which related per se rules remedy the injury done to the creditors may best be understood by noting that the dividend restrictions and related constraints contained in state corporation laws operate on two-party transactions—the transfer of assets directly from the corporate entity to the shareholders. By contrast, a typical leveraged buyout involves multiple parties—the selling and buying shareholders, the corporate entity whose stock is involved in the transaction, and the leveraged buyout lender.

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109. *See supra* notes 75-82 and accompanying text.

110. *See, e.g.*, RMBCA, *supra* note 43, § 8.33 (providing that directors who vote for or assent to a distribution made in violation of section 6.40 shall be personally liable to the corporation for the sums improperly distributed). Under the RMBCA, directors held liable for an unlawful distribution may seek contribution from any shareholder who accepted the improperly distributed amounts while "knowing" that the distribution violated the statute. *Id.* § 8.33(b). *See also* Del. Gen. Corp. Law §§ 172, 174.

The fraudulent conveyance remedy is essentially a prescription for rescission but it does not contemplate a multi-party, as distinct from a two-party, transfer. In the case of a simple exchange between two parties, the fraudulent conveyance remedy of invalidating a transfer made by the debtor remedies the injury done to the debtor's creditors by cancelling the unjust enrichment of the transferee. Thus, in the classic situation in which an insolvent or nearly insolvent debtor simply gives property to another, the transfer is voided in its entirety and the property (or the value of the property) recovered for the benefit of creditors of the transferor.[111] Under the circumstances of a simple two-party transfer, the remedy of invalidating the transfer and any accompanying obligation incurred by the debtor, works equitably to place both parties in exactly the same position they occupied before the transfer.[112] By contrast, in a multi-party transaction such as a leveraged buyout, simply invalidating the corporation's obligation to the leveraged buyout lender may not always place all the parties in the position that they would have occupied had the fraudulent transfer not occurred.

In a simple two-party exchange the debtor is injured precisely to the extent that the transferee is "unjustly" enriched. By contrast in a multi-party transaction such as a leveraged buyout, the injury to the debtor's estate occurs not because the lender/transferee receives a value in exchange for the loan proceeds which exceeds the value of those loan proceeds—that is, not because the lender gets something for nothing—but because the debtor does not receive the value of the consideration provided by the lender in exchange for incurring the obligation to the lender.[113] Unlike the

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111. Section 548(a) of the Bankruptcy Code empowers the trustee to "avoid" fraudulent conveyances with the result that the transferee is defeased of his claim to the property. Section 9 of the UFCA provides a creditor having a matured claim the right to "[h]ave the conveyance set aside . . . to the extent necessary to satisfy his claim" or to "[d]isregard the conveyance and attach or levy upon the property conveyed." 11 U.S.C. § 548(a) (1982). The UFTA, authorizes a creditor to "recover judgment for the value of the asset transferred . . . or the amount necessary to satisfy the creditor's claim, whichever is less." UFTA § 8, 7A U.L.A. 643, 662 (1985). When a transfer is made for inadequate, as opposed to no, consideration the remedy is appropriately limited. *See* 11 U.S.C. § 548(c)(1982). Section 9(2) of the UFCA limits the remedy of a creditor in a similar manner and allows the transferee who acted in good faith to retain the benefit of the transfer to the extent of value given to the debtor. UFCA § 9(2), 7A U.L.A. 427, 578 (1985). Section 8(d) of the UFTA provides that a good faith transferee is entitled to retain the benefit of the challenged conveyance to the extent of the value given to the debtor. UFTA § 8(d), 7A U.L.A. 643, 662 (1985).

112. *See, e.g.,* Newman v. First Nat'l Bank of East Rutherford, 76 F.2d 347 (3rd. Cir. 1935); Damazo v. Wahby, 305 A.2d 138, 142 (Md. Ct. App. 1973) (relief from fraudulent conveyance should place injured creditor " 'in the same or similar position he held with respect to the fraudulent transferor prior to the fraudulent conveyance' " (quoting Miller v. Kaiser, 164 Colo. 206, 210, 433 P.2d 772, 775 (1967))); O. Bump, *supra* note 65, at 485 (the purpose of avoiding a fraudulent conveyance is to restore the parties to their original position).

113. The fraudulent conveyance problem presented by a leveraged buyout is thus analogous to that presented by corporate guaranties. In the case of an "upstream" or "cross-stream" guaranty, a corporation incurs an obligation to a lender, but the proceeds of the loan are

two-party transaction in which the debtor is injured precisely to the extent that the lender is unjustly enriched, in a three-party transaction it is the third party, (the third party in the case of a leveraged buyout being the shareholders, both the buyers and the sellers) who is the principal beneficiary of the debtor's conveyance to the lender. It is the shareholders, not the lender, who receive the benefit of the corporation's transfer to the lender.

In short, in this three-party transaction, it is not the *leverage* but the *buyout* that produces the adverse impact on the corporation's net worth and causes the injury to the creditors. By permitting the imposition of the costs of remedying the injury suffered by creditors on the third-party lender, the application of fraudulent conveyance statutes to leveraged buyouts could theoretically produce a result which is at odds with the basic restitutional premise of the statute. When the transactions comprising a leveraged buyout are viewed in isolation and the transfer of the loan proceeds to the shareholders is considered apart from the loan transaction, the application of the fraudulent conveyance laws to invalidate the security interest held by the lender and any accompanying obligations owed to it could result in leaving the parties to the loan transaction in circumstances quite different from those they were in prior to the buyout. Ignoring the possible avenues available to the corporation and the lender for recovery of the sums received by the shareholders,[114] the application of the fraudulent conveyance statutes to invalidate the obligations and security interests held by the lender appears to run the risk of unfairly penalizing the lender and creating a potential windfall for the parties whose conduct is perhaps most suspect—the shareholders.

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received by the corporation's parent or affiliate. Thus, the corporate guarantor fails to receive "fair consideration" for incurring the obligation and if the guarantor is insolvent the guaranty may be deemed a fraudulent conveyance. The application of fraudulent conveyance laws to corporate guaranties has been the subject of an extensive literature. *See* Carl, *Fraudulent Transfer Attacks on Guaranties in Bankruptcy,* 60 AM. BANKR. L.J. 109 (1986); Coquillette, *Guaranty of and Security for the Debt of a Parent Corporation by a Subsidiary Corporation,* 30 CASE W. RES. 433 (1980); Littman, *Multiple Intent, Veil-Piercing, and Burdens and Benefits: Fraudulent Conveyance Law and Multiparty Transactions,* 39 U. MIAMI L. REV. 307 (1984); Ragusin, *Brother Sister Corporate Guaranties: Increased Legal Acknowledgement of Business World Realities,* 11 J. CORP. L. 391 (1986); Rosenberg, *Intercorporate Guaranties and the Law of Fraudulent Conveyances: Lender Beware,* 125 U. PA. L. REV. 235 (1976); Note, *Guarantees and Section 548(a)(2) of the Bankruptcy Code,* 52 U. CHI. L. REV. 194 (1986); Note, *Good Faith and Fraudulent Conveyances,* 97 HARV. L. REV. 495 (1983); Comment, *Avoidability of Intercorporate Guarantees Under Sections 548(a)(2) and 544(b) of the Bankruptcy Code,* 64 N.C.L. REV. 1099 (1986).

114. Sums transferred to selling shareholders in connection with the buyout might be recovered on behalf of the corporation pursuant to state corporation laws. *See supra* note 107. Creditors of the company might also seek to recover these sums from the selling shareholders under the fraudulent conveyance statutes. *See, e.g., In re* Anderson Indus., 55 Bankr. 922 (W.D. Mich. 1985). As a practical matter, remedies directed at recovery of sums from the selling shareholders are likely to prove impractical where a large publicly held concern is involved and inadequate even in many cases involving buyouts of privately held companies.

Consider for example a not implausible scenario in which the leveraged buyout lender is by far the most significant creditor of the insolvent corporation. Invalidation of the obligation owed to this lender could produce a situation in which the assets in the debtor's estate are more than sufficient to pay all other claims. Under such circumstances, if the lender has no claim against the residual assets of the company and this value is paid to the equity holders, the result would be bizarre and entirely inconsistent with the restitutional premise underlying the fraudulent conveyance remedy.

The generally equitable character of the fraudulent conveyance remedy is illustrated by statutory provisions which preserve the transferee's right to retain in part a fraudulent transfer or obligation to the extent the debtor received value from the transferee and the transferee was found to have acted in good faith. Section 548(c) of the Bankruptcy Code provides that:

> a transferee or obligee . . . that takes for value and in good faith . . . 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.[115]

Responding to concern that the application of fraudulent conveyance statues to invalidate an obligation to a third-party lender incurred in connection with a leveraged buyout could produce inequitable results, Professor David Carlson has argued that this statutory good faith defense should be applicable to a third-party leveraged buyout lender who transfers loan proceeds in good faith even where the loan proceeds are not received by the corporation which is the target of the buyout.[116] This argument treats the explicit language of the statute which requires that the value given by the transferee be "received by the debtor" as a "drafting error."[117] The rationale given for disregarding this express requirement is twofold. First, Professor Carlson argues that this particular phrase does not appear in the analogous section of the UFCA and therefore should be disregarded in the interests of construing the trustee's remedy under the Bankruptcy Code as consistent with that available under state law.[118] This reasoning appears to overlook the fact that although the "received by the debtor" language does not appear in the UFCA, courts and commentators addressing this analogous section have consistently understood it to require that the debtor receive the benefit of the value exchanged by the transferee.[119] Thus, if one assumes

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115. 11 U.S.C. § 548(c) (1982).

116. Carlson, *supra* note 1, at 86-89 (stating that "the LBO lender who acts in good faith should have a defense against fraudulent conveyance attacks").

117. *Id.* at 86.

118. *Id.* at 86-87.

119. *See* I.G. GLENN, *supra* note 21, at 473 (stating that "a consideration which by the very nature of the transaction does not pass into the estate at all, is not fair value"). In cases

that the intent of section 548(c) was to create a remedy essentially congruent with that available under the UFCA, the addition of the phrase "received by the debtor" is entirely consistent with that purpose.

Professor Carlson also argues that the phrase "received by the debtor" should be ignored because if the requirement were applied, parties to a leveraged buyout could always take advantage of the section 548(c) defense merely by structuring the buyout so that the proceeds of the loan passed through the hands of the target entity on their way to the shareholders.[120] For example, assume that the buyout is structured so that the loan proceeds are paid directly to the purchasing entity—usually a holding company formed expressly for this purpose—with the target company providing guarantees of the new parent's debt secured by pledges of its assets to the lender. Since the target entity never received any of the proceeds, the defense provided by these types of statutory provisions would not be available. This type of transaction is, however, essentially identical to one in which the loan is made directly to the target entity which then, as in *Gleneagles,* advances the funds in the guise of a loan, a dividend or stock redemption to finance the sale and purchase of the target company's stock.

Professor Carlson argues correctly that there should be no difference between the application of the fraudulent conveyance laws to these two different structures. To treat them differently would, as he suggests merely "create a trap for the unwary."[121] But in concluding that the defense provided by section 548(c) and the UFCA would be available to the lender in the latter circumstance he is assuming, erroneously, that the courts will and should give the lender the benefit of this defense if the loan proceeds merely pass through the target entity even if the proceeds are not used for the benefit of the entity but merely to finance a change in equity ownership.

In applying fraudulent conveyance statutes to transactions involving corporations and insiders such as shareholders and directors, courts look to

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involving guaranties, courts applying section 67(d) of the old bankruptcy law which did not explicitly refer to consideration "received by the debtor," refused to consider the lenders advance of loan proceeds to the principal obligor as constituting fair consideration with respect to a guarantor. The courts allowed the lender to enforce the guarantee obligation against the guarantor or its assets only when the court could find some benefit to the guarantor itself or when, through an analysis similar to that used in cases involving the alter ego doctrine, the court concluded that the affairs of the principal obligor and the guarantor were so commingled that their separate legal existences should be disregarded, thus sums received by the obligor were considered to result in benefit to guarantor. *See, e.g.,* Mayo v. Pioneer Bank & Trust Co., 270 F.2d 823 (5th Cir. 1959); Williams v. Twin City Co., 251 F.2d 678, 681 (9th Cir. 1958); Mandel v. Scanlon, 426 F. Supp. 519, 523-24 (W.D. Pa. 1977); *In re* Winslow Plumbing, Heating and Contracting Co., 424 F. Supp. 910 (D. Ct. 1976); McNellis v. Raymond, 287 F. Supp. 232, 239 (N.D.N.Y. 1968); Hofler v. Marion Lumber Co., 233 F. Supp. 540, 543 (E.D.S.C. 1964).

120. Carlson, *supra* note 1, at 87.

121. *Id.*

the substance, not the formal structure of the transaction.[122] *Gleneagles* itself illustrates that in view of the fact that the determination that a transfer is a fraudulent conveyance rests on the damage done to the debtor's net worth and thus to its creditors, the court will find that the debtor received value only when that value is retained in or used for the benefit of the debtor's estate. The actual structure of the leveraged buyout in *Gleneagles* was one in which the loan was made directly to the acquired entity and this entity in turn lent the proceeds to the acquiring entity, receiving in return a note from the purchaser.[123] Since the acquiring entity had no assets and no source of income other than the assets and revenues to be derived from its ownership of the company being acquired in the leveraged buyout, this note was worthless to the acquired entity.[124] The court concluded that the target company's temporary receipt of the loan proceeds could not be considered receipt of fair consideration for the challenged transfer to the leveraged buyout lender.[125] The *Gleneagles* transaction illustrates that courts are unlikely to exalt form over substance in applying the fraudulent conveyance laws to leveraged buyouts. Since under any transaction structure, the receipt of the loan proceeds by the target will be virtually simultaneous with the distribution of those proceeds to the shareholders for the purpose of effecting the transfer of the company's stock, the ephemeral presence of the loan proceeds in the debtor's hands is unlikely to be deemed receipt of the proceeds for purpose of satisfying the statutory requirements that the debtor receive fair consideration.

The purpose of section 548(c) and similar provisions contained in state fraudulent conveyance laws is to avoid an inequitable or punitive result on the transferee in a two party context. These provisions assure that in the absence of an intentionally fraudulent transfer, the recovery of the injured creditors is limited to the amount necessary to restore the debtor's estate to its status quo prior to the injury caused by the fraudulent transfer.[126]

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122. *See, e.g., In re* Checkmate Stereo and Electronics, Ltd, 9 Bankr. 585 (Bankr. N.Y. 1981) (where challenged transfer is only a step in a larger transaction, transaction must be viewed as an entirety with all of its implications in assessing impact on creditors); Arnold v. Dirrin, 398 N.E.2d 442 (Ind. App. 1979) (series of contemporaneous transactions considered single transfer for purpose of applying fraudulent conveyance statutes).

123. As the district court noted the IIT loan proceeds "merely passed through the borrowers to Great American and ultimately to the selling stockholders and cannot be deemed consideration received by the borrowing companies." *Gleneagles I*, 565 F. Supp. at 575.

124. Since covenants contained in the IIT loan documents restricted the payment of dividends by Raymond Collieries until such time as the IIT loan was repaid, Great American in fact had no source of income until the IIT loan was repaid and had no way to repay the note given to Raymond Collieries. *Id.* at 571.

125. *Id.* at 575.

126. *See* Clark, *supra* note 20, at 516. Clark states:

> [I]t does not seem unduly harsh to ask an innocent transferee to disgorge the amount by which he has beat the market when he paid less than fair value for transferred property, given that the transferor's innocent creditors would otherwise lose that amount, to go further would be punitive and unfair.

Id.

When, for example, a transferor grants a lender a security interest far in excess of the value necessary to secure the amount of a loan, or pays an inflated price for property, these provisions expressly permit the transferee to retain the security interest or the purchase price to the extent the lien or the purchase money constitutes fair consideration for what the debtor received. Under these circumstances, the transferor and its creditors are in fact injured only to the extent the value transferred to the transferee exceeds that received by the transferor, and the transfer is invalidated only to that extent.

These statutory provisions contemplate a direct exchange between two parties and their application in the context of a three-party transaction such as a leveraged buyout would be incongruous. Assuming there is no independent question concerning whether the value of the security interest granted by the target was substantially in excess of the loan proceeds, to assume that these provisions would apply to leveraged buyouts would not mean that the leveraged buyout financing would be only partially as opposed to totally invalidated, but would mean that so long as the value of the lien was not unreasonable as compared to the size of the loan, the lender would retain its claim in its entirety, even though the debtor's estate had not received any tangible benefit from the loan proceeds. These sections are designed to assure fairness to the transferee where the debtor received some value in exchange for the challenged transfer and the transaction actually injured creditors only to the extent of a discrepancy in value between that which the debtor transferred and that which it received. These provisions are not meant to protect a transferee in the context of a three-party transaction merely because, in exchange for the challenged transfer by the debtor, the transferee gave value to a third party. In this circumstance, the debtor gets nothing and is injured to the full extent of the transfer it makes to the transferee, even though the transferee is not unjustly enriched.

To the extent one takes the position suggested above—that the constructive fraud provisions of the fraudulent transfer statutes do in fact have as their proper domain prohibition of transfers which adversely affect the net worth of an insolvent or which render a previously solvent debtor insolvent—one must take as a corollary the position that the remedy resulting from the application of fraudulent conveyance statutes must be consistent with this purpose. That is to say, the remedy should be an equitable one designed to place the parties to the transfer in the position they would have occupied had the improper transfer not occurred. If the invalidation of the leveraged buyout lender's claim under the fraudulent conveyance statutes produces a result which runs the risk of unjustly enriching the shareholders involved in the buyout and imposing an inequitable loss on the lender, such an incongruous and inequitable result might warrant excepting these transactions from the scope of the fraudulent conveyance statutes. Such an exception involves, however, a significant cost in terms of creating a loophole in a web of statutory protections generally afforded to creditors of insolvent corporate entities. This cost is justifiable only if the cost of potential inequity to the lender is deemed to be unavoidable.

In fact, that is not the case. Professor Carlson's tortured construction of section 548(c) is all the more unpersuasive because it is unnecessary to ignore the plain language of this statutory provision to avoid a result which might unjustly enrich the shareholders of the company at the expense of the third party leveraged buyout lender. There is ample authority to support a bankruptcy court's power to assure that the fraudulent conveyance remedy produces an equitable result in the context of a leveraged buyout transaction. Fraudulent conveyance statutes have traditionally invalidated fraudulent transfer only to the extent necessary to remedy the injury.[127] Fraudulent transfers are voidable at the insistence and for the benefit of the grantor's creditors. They are not void as between grantor and grantee.[128] Thus, invalidation of a fraudulent conveyance for the benefit of creditors does not rescind the transfer insofar as the parties to the conveyance are concerned. As between the grantor and grantee, the grantee retains his interest in the transferred property.[129] Where the fraudulently transferred property is sold to satisfy the claims of the defrauded creditors, it is the grantee who retains the equitable right of redemption and in the event there is any surplus remaining from the proceeds of the sale after satisfying the creditors' claims it belongs to the grantee.[130]

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127. *See* A/S Kreditt-Finans v. Cia Venetico De Navigacion, 560 F. Supp. 705, 711 n.15 (E.D. Pa. 1983), *aff'd,* 729 F.2d 1446 (3d Cir. 1984) (creditor must be injured by the conveyance it seeks to invalidate). Where the state fraudulent conveyance remedy is involved, an injured creditor is generally permitted to set aside a conveyance only to the extent necessary to satisfy his own claim. *See also In re* Swan-Finch Oil Corp., 279 F. Supp. 386 (S.D.N.Y. 1967); Buckley Petroleum Prods., Inc. v. Goldman, 28 A.D.2d 640, 641, 280 N.Y.S.2d 876 (1967). In a bankruptcy proceeding, the doctrine of Moore v. Bay, 284 U.S. 4 (1931), empowers a trustee to set aside a fraudulent transfer in toto for the benefit of all creditors of the estate even though the creditor to whose rights the trustee is subrogated may have had only the right to avoid the transaction in part under state law.

128. *See* O. BUMP, *supra* note 65, at 443 (fraudulent conveyance statutes are "designed solely to protect the rights of creditors and, consequently, it renders a fraudulent transfer void only as against them, and makes no provision whatsoever in regard to its effect between the parties"); I.G. GLENN, *supra* note 21, § 114, at 225 (a transfer made in fraud of the donor's creditors is good against the donor and his privies, a fraudulent conveyance is actually a conveyance with all the natural consequences); Kirby, McGuiness & Kandel, *Fraudulent Conveyance Concerns in Leveraged Buyout Lending,* 43 BUS. LAW. 27, 31 n.18 (1987) (stating that "as between the debtor and his transferee or obligee, the transfer or obligation is valid"). *See also* Drake v. Thompson, 14 F.2d 933 (8th Cir.), *cert. denied,* 273 U.S. 744 (1926); Ahmanson Bank & Trust Co. v. Tepper, 269 Cal. App. 333, 74 Cal. Rptr. 774 (1969); Stratton v. Edwards, 174 Mass. 374, 54 N.E. 886 (1899); Delgado v. Delgado, 42 N.M. 528, 82 P.2d 909 (1938).

129. A creditor's judgment subjecting property fraudulently conveyed by the debtor to the payment of the debt does not have the effect of revesting title in the fraudulent grantor. West v. Baker, 109 Ariz. 415, 510 P.2d 731 (1973); Meletio Elec. Supply Co. v. Martin, 437 S.W.2d 927 (Tex. Civ. App. 1969).

130. *See* Pacific Fin. v. Donald, 286 S.W.2d 260 (Tex. Civ. App. 1955) (excess in value of

Thus, the "windfall" problem is really illusory. A determination that the financing transactions associated with a leveraged buyout violated the fraudulent conveyance statutes does not deprive the leveraged buyout lender of any claim against the estate of the bankrupt corporation. Under traditional fraudulent conveyance principles, a leveraged buyout lender will retain a claim against any assets of the corporate debtor remaining after payment of the obligations owed to other creditors.[131] The result is analogous to the application of the doctrine of equitable subordination. Where for example, shareholders or former shareholders assert claims against the corporation as creditors with respect to indebtedness issued by the corporation in connection with a redemption or repurchase of stock, a bankruptcy court may subordinate such claims to the claims of other creditors. The analogy demonstrates again that to create a blanket exception to the fraudulent conveyance statutes for leveraged buyout transactions would create an anomalous loophole in the legal doctrines of creditor protection.[132]

CONCLUSION

There is no sound reason for courts to create a blanket exception to the fraudulent conveyance laws for leveraged buyouts. The application of fraudulent conveyance statutes to leveraged buyouts does not represent an extension of these statutes beyond the original policies served by the prohibition

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the property fraudulently conveyed over the debts properly chargeable against the same passes to vendee and not vendor); O. BUMP, *supra* note 65, at 448-50 (the right to redeem property sold under an execution belongs to the grantee and not to the debtor; any surplus remaining after the satisfaction of an execution belongs to the grantee); 37 AM. JUR. 2d, Fraudulent Conveyances § 111 (1968) (as between a fraudulent grantor and grantee, it is the fraudulent grantee who is entitled to any excess in the property over and above the amount necessary to satisfy the creditors).

The doctrine of *Moore v. Bay,* discussed *supra* note 126, does not render this rule inapplicable in the context of a bankruptcy proceeding. *Moore* empowers the trustee to invalidate the fraudulent conveyance on behalf of all creditors of the estate and in this respect the fraudulently conveyed property may be considered to become property of the estate for purposes of satisfying those creditors' claims. However, nothing in the doctrine of *Moore* suggests that in the event the estate is not entirely depleted by payment of these claims, the original debtor-transferor would recover title to the remaining assets as against the transferee.

131. The holding in *Gleneagles* is not to the contrary. Although the Third Circuit invalidated the mortgage liens associated with the leveraged buyout of the Raymond Collieries in their entirety, this ruling was premised not on the fraudulent conveyance laws but on section 9-504 of the Uniform Commercial Code. The district court found that the foreclosure sales of the Raymond properties were commercially unreasonable sales of collateral. The Third Circuit held that under Pennsylvania law such a sale creates a presumption that the indebtedness was completely extinguished. *See* United States v. Tabor Court Realty Corp., 803 F.2d 1288 (3rd Cir. 1986).

132. *See* Kirby, McGuiness & Kandel, *supra* note 128, at 31 n.18 ("[T]he fraudulent transferee or obligee should have precedence over the shareholders of the debtor to distributions from the debtor's estate. . . . [T]he principal sanction imposed against the fraudulent transferee or obligee should be subordination to claims of other creditors.").

of fraudulent conveyances. Where corporate debtors are concerned, the application of fraudulent conveyance laws to leveraged buyouts serves as an essential complement to the statutory protections afforded to corporate creditors by restrictions on shareholder distributions contained in the corporation laws. Unless one is prepared to argue for the abolition of statutory restrictions on distributions to shareholders as inconsistent with creditors' desires and best interests, there is no reason to believe that creditors do not consistently and rationally desire to limit leveraged buyouts of insolvent or nearly insolvent companies. Whatever the evidence may ultimately indicate concerning the economic benefit of leveraged buyouts generally, the limited marginal categories of buyouts involving financially ailing ventures, and of buyouts of otherwise healthy companies which are so highly leveraged in the course of the buyout as to threaten the company's solvency are probably not so beneficial that the traditional policies of creditor protection embodied in the fraudulent conveyance laws should be sacrificed.