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REVISITING THE LEVERAGED BUYOUT: IS CONSTRUCTIVE FRAUD GOING TOO FAR?

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I. INTRODUCTION

Perhaps on a smaller scale than the leverage-frenzied days of the 1980's,[1] the 2005-2007 economic boom nevertheless saw a significant uptick in leveraged buyout transactions.[2] Despite a market brimming with optimism, the recent financial crash caused many newly-formed LBOs to plunge sharply into bankruptcy.[3] This should come as no surprise, as LBOs have *always* been notoriously risky—the more leveraged the transaction, the greater the bankruptcy risk.[4] The key difference between a failed 1980s LBO and a failed LBO today is the judicial resolution to the question of "whether fraudulent conveyance laws should be applied to leveraged buyout [transactions]."[5]

Despite facing significant academic pushback,[6] courts have

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1. Douglas G. Baird, *Fraudulent Conveyances, Agency Costs and Leveraged Buyouts*, 20 J. LEG. STUD. 1, 2 (1991); *see also* Richard M. Cieri et al., *An Introduction to Legal and Practical Considerations in the Restructuring of Troubled Leveraged Buyouts*, 45 BUS. LAW. 333, 333 (1989) (noting that leveraged buyouts (LBOs) emerged in the 1980s as one of the most popular financing techniques for those acquiring businesses).

2. *See* Douglas S. Mintz*, LBOs and Fraudulent Transfers: How Susceptible Are You to Avoidance?*, 22 BNA BANKR. LAW REP. 1, 1 (2010), *available at* http://media.straffordpub.com/products/leveraged-buyout-transactions-under-heightened -scrutiny-in-bankruptcy-2010-05-26/reference-material.pdf (explaining that investors completed 313 LBOs in the United States for approximately $630 billion).

3. *See id.* (noting prominent examples such as Tribune Co. and Lyondell Chemical Co.).

4. *See* Frank H. Easterbrook*, High-Yield Debt as an Incentive Device*, 11 INT'L REV. L. & ECON. 183, 187-89 (1991) ("Debt increases the likelihood of bankruptcy because payouts are compulsory. Firms may suspend dividends; to suspend payment on debt is to precipitate a filing in bankruptcy.").

5. Matthew T. Kirby et al., *Fraudulent Conveyance Concerns in Leveraged Buyout Lending*, 43 BUS. LAW. 27, 28 (1987).

6. *See* Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance*

increasingly held that LBOs should not be exempt from constructive law principles.[7] Additionally, and as will be described further in Section III.B, *infra*, lenders and corporate executives should be on notice for particularly unfavorable factual determinations in abstruse insolvency determinations when courts conduct constructive fraud analysis.[8] Specifically, the very realistic possibility that judges will misapply hindsight bias in making a factual determination puts LBO creditors at significant risk.[9] This danger is especially apparent given the frequency of fraudulent conveyance claims brought before courts in recent years.[10]

In the absence of actual intent to harm the rights of creditors, a trustee in bankruptcy is limited to bringing a constructive fraud action.[11] Constructive fraud offers a solution to those creditors not powerful enough to have bargained for their rights to be protected.[12] Constructive fraud exposes the Target Company's weaknesses—the trustee can attack two flaws: inadequate consideration received by the Target Company and the Target's weak post-LBO financial position.[13]

In an article from 1991, the era from which much of the leveraged buyout academia sprang, Douglas Baird surmised that, "[b]ecause the economy did not experience any significant downturn . . . the outer limits of this area of the law remain

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Law and Its Proper Domain, 38 VAND. L. REV. 829, 835 (1985) (arguing that courts must be careful in deciding where to place the reach of fraudulent conveyance law).

7. *See, e.g.*, Boyer v. Crown Stock Distrib., Inc., 587 F.3d 787, 792-93 (7th Cir. 2009) (disagreeing with other courts and scholars and holding that the Uniform Fraudulent Transfer Act applies to LBOs as well); *see also* Moody v. Sec. Pac. Bus. Credit, Inc., 971 F.2d 1056, 1073 (3d Cir. 1992) (holding that because LOBs present "great potential for abuse," failed LBOs merit "close scrutiny under the fraudulent conveyance laws").

8. *See* Kirby et al., *supra* note 5, at 28 (explaining that if courts apply fraudulent conveyance laws to LBOs, lenders should not assume that they will obtain a favorable outcome).

9. *See In re* Knox Kreations, Inc., 474 F. Supp. 567, 572 (E.D. Tenn. 1979), *aff'd in part & rev'd in part*, 656 F.2d 230 (6th Cir. 1981) (stating that the prohibition against the Target being left with unreasonably small capital was not intended to permit a court to "second guess bona fide business judgments with the benefit of hindsight").

10. Erik Krusch, *Lose the Leverage!: Restructuring LBOs*, THOMSON REUTERS WESTLAW BUS. CURRENTS, Apr. 5, 2010, http://currents.westlawbusiness.com//Article. aspx?id=e5c2b50d-a590-4e12-9142-48bb7b676e0f&cid=&src=&sp=.

11. *See infra* Section II.B. (stating that since proving intentional fraud may be difficult, constructive fraud offers a solution to unsatisfied creditors).

12. *See id.* (listing instances where constructive fraud is appropriate to protect creditors).

13. *See id.* (stating that the Bankruptcy Code codifies constructive fraud, allowing for transfers to be set aside if the debtor receives inadequate consideration or is made insolvent as a result of the transfer).

largely unexplored."[14] However, in the multiple economic downturns since Baird's article, the outer limits of LBO constructive fraud law have been identified, and the analysis cemented: "[s]ome LBOs are legitimate; others are fraudulent conveyances . . . '[the] [f]raudulent conveyance doctrine . . . is a flexible principle that looks to substance, rather than form. . . .'"[15]

Judge Posner's decision is consistent with an increasing number of cases broadly applying fraudulent conveyance law,[16] which square directly with the language of the rules but perhaps result in unintended consequences. Adopting the new, more rigorous approach will adversely affect major lenders for two reasons. First, the bankruptcy judge will almost certainly affirm that the transaction does not satisfy the consideration requirement, because no LBOs are ever conducted for "fair" consideration.[17] Second, the judge will have to deal with an opaque post-LBO financial solvency test, one that runs a significant hindsight risk and involves hyper-complex financial calculations.[18] The import of the rigorous method, as articulated in *Boyer v. Crown Stock Distribution Inc.*,[19] will strip away the ability of both senior and subordinate LBO lenders to enforce the LBO company's loan obligations and their lender's liens and security interests in its assets.[20] As a recent court opined, "[a]n overly leveraged buyout that leaves the target company with unreasonably small capital—where it is reasonably foreseeable that the target will soon thereafter become insolvent—may provide the requisite factual predicate for an avoidance action grounded in fraudulent transfer law."[21]

This Article argues that this process has the effect of placing senior, pre-LBO outside lenders, who have bargained for the risk by securing the assets of the corporation, on par with post-LBO subordinated lenders. As the risk of having their assets unsecured becomes more evident, aggressively applying fraudulent transfer laws to LBO transactions will discourage both LBO financing and

14. Baird, *supra* note 1, at 2.

15. *Boyer*, 587 F.3d at 793 (quoting DOUGLAS G. BAIRD, THE ELEMENTS OF BANKRUPTCY 153-54 (4th ed. 2006)).

16. *See* MFS/Sun Life Trust-High Yield Series v. Van Dusen Airport Servs. Co., 910 F. Supp. 913, 933 (S.D.N.Y. 1995) (explaining that "courts now uniformly hold that fraudulent conveyance laws apply to LBOs").

17. *See infra* Section III.A. ("It is doubtful, however, that any LBO can meet the fair consideration standard.").

18. *See infra* Section II.B.2. (explaining that the test is known as the unreasonably small capital test).

19. *Boyer*, 587 F.3d at 787.

20. Cieri et al., *supra* note 1, at 350.

21. *In re* Jevic Holding Corp., 08-11006 BLS, 2011 WL 4345204, at *9 (Bankr. D. Del. Sept. 15, 2011).

LBOs in general.[22]

Section II first highlights the basics of a leveraged buyout transaction, and then examines the fraudulent conveyance law's origins dating back to the Roman Empire. An extensive analysis of the inner-workings of fraudulent conveyance law and issues unique to LBOs follows in Section III. Section IV argues that due to an inexact fit between the LBO transactional structure and fraudulent conveyance law principles, the aggressive application of said laws, and its resultant shortcomings, will ultimately discourage LBO lending.

II. BACKGROUND

A. LBOs

A leveraged buyout, or an "LBO," is an acquisition in which investors or third parties buy the equity in a corporation by borrowing large sums of money.[23] The funds are typically borrowed from institutional lenders, which, unwilling to rely solely on the promises of cash-poor management, agree to lend financing to the new corporation's management by insisting the corporation pledge its assets as security.[24] The economic effect of this transaction is clear: the "assets have not increased and must now service debt the proceeds of which have been transferred to [the] Target's former shareholders, thereby substantially weakening the creditworthiness of [the] Target . . . ."[25] In addition to being fully collateralized, the lenders are attracted by the high interest rates and the potential equity rights available.[26]

Despite the enormous debt, LBOs are generally seen as economically desirable. LBOs "provide a means for present owners to withdraw from their investments without liquidation and [they] transfer control to investors who may be in a better position to undertake management responsibility and realize the potential of the business."[27]

Further, "debt actually proves to be an effective substitute for

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22. *Infra* Section IV.

23. Cieri et al., *supra* note 1, at 333 n.2; *see also* David A. Murdoch et al., *Leveraged Buyouts and Fraudulent Transfers: Life After* Gleneagles, 43 BUS. LAW. 1, 3-4 (1987) (explaining that a LBO contemplates an ambition-rich, but cash-poor management).

24. Cieri et al., *supra* note 1, at 338; *see also* Kevin J. Liss, Note, *Fraudulent Conveyance Law and Leveraged Buyouts*, 87 COLUM. L. REV. 1491, 1493 (1987) (explaining that the Target Company's assets are used as collateral to secure loans).

25. Kirby et al., *supra* note 5, at 34.

26. James F. Queenan, Jr., *The Collapsed Leveraged Buyout and the Trustee in Bankruptcy*, 11 CARDOZO L. REV. 1, 3 (1989).

27. Emily L. Sherwin, *Creditors' Rights Against Participants in a Leveraged Buyout*, 72 MINN. L. REV. 449, 494 (1988).

dividends, something not generally recognized in corporate finance literature."[28] The idea is, by exchanging stock for debt, managers are bound to pay out future cash flows.[29] Conversely, corporate managers maintain significant leeway in deciding whether to issue common stock dividends.[30] The obligation to make debt payments, thus, provides efficiency incentives for the new management.[31]

The leverage comes with increased responsibility, however, since the new management must focus on paying off the enormous debt burden through its cash flow.[32] The value of the new management's equity rises as the debt is being paid off.[33] Correspondingly, the potential payout also rises.[34] Ideally, the creditors' reasonable expectations will not be harmed as long as a company retains a positive net worth and the funds needed to pay its debts and continue its operation.[35]

Having pledged all of its assets away to the secured lender, and holding a reduced cash flow from the selling shareholders who have invariably "cashed out," the LBO is left skating on thin ice.[36] If the corporation is left in an inadequate financial position following the LBO and it plunges into bankruptcy, unpaid creditors can attack LBO parties and unsecure their interests in the Company's assets.[37] Unpaid creditors can allege that transfers made during the LBO transaction were fraudulent—either *intentionally* or *constructively* fraudulent.[38] Because it is nearly impossible to prove that someone intentionally defrauded a creditor,[39] parties seeking to recover have typically relied on constructive fraud statutes.[40]

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28. *See* Michael C. Jensen, *Agency Cost of Free Cash Flow, Corporate Finance, and Takeovers*, 76-2 AM. ECON. REV. 323, 327 (1986) (noting that managers bind their promise to pay out future cash flows, giving shareholder recipients of the debt the right to hold the company accountable); *see also* Easterbrook, *supra* note 4, at 183-86 (discussing that debt means tax shields for the corporation and less registration requirements).

29. Jensen, *supra* note 28, at 327.

30. *Id.*

31. *Id.*

32. Baird, *supra* note 1, at 8.

33. Liss, *supra* note 24, at 1493.

34. Baird, *supra* note 1, at 4.

35. Sherwin, *supra* note 27, at 452.

36. *Id.* at 451; *see also* Queenan, Jr., *supra* note 26, at 2 ("The [LBO] leaves the Company in a weaker position.").

37. Sherwin, *supra* note 27, at 452.

38. Bruce A. Markell, *Toward True and Plain Dealing: A Theory of Fraudulent Transfers Involving Unreasonably Small Capital,* 21 IND. L. REV. 469, 471 (1988).

39. *See* Raymond J. Blackwood, Note, *Applying Fraudulent Conveyance Law to Leveraged Buyouts*, 42 DUKE L.J. 340, 345 (1992) (explaining that since actual intent to commit fraud was hard to prove, courts could presume the existence of fraudulent intent from the circumstances).

40. *See* David M. Stern, *Fraudulent Transfer Litigation: The Shape of*

B. Fraudulent Conveyance Laws

Fraudulent conveyance laws used to attack LBOs date all the way back to the Roman Empire.[41] The Tudor English Parliament revived fraudulent transfer concepts, known as the Statute of Elizabeth, into Common Law in 1571.[42] This statute, from which the Bankruptcy Code derived its fraudulent transfer law provisions, was intended only to apply to intentional fraud.[43] The statute sought to "protect creditors from elusive debtors who dodged their obligations by sham sales of assets to friends."[44] In such cases, the debtor's friends safeguarded the assets until the creditors stopped demanding them.[45]

Nevertheless, proving intentional fraud is quite difficult.[46] Unsatisfied creditors have thus found respite within more amenable constructive fraud statutes.[47] There are three modern statutory repositories of fraudulent transfer law: the Uniform Fraudulent Conveyance act [hereinafter the UFCA];[48] the Uniform Fraudulent Transfer Act [hereinafter the UFTA];[49] and section 548 of the Bankruptcy Code.[50] All three have essentially the same format and objective.[51] Despite the Statute of Elizabeth's

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Things to Come, AM. BANKR. INST. 1, 5 (2010), http://www.abiworld.org/committees/newsletters/litigation/vol7num4/fraudulent.pdf (referencing section 548 of the Bankruptcy Code, the UFTA, and the UFCA).

41. *See* Louis Edward Levinthal, *The Early History of Bankruptcy Law*, 66 U. PA. L. REV. 223, 239 (1918) (stating that acts or forbearances by which an insolvent debtor diminished the amount of his property divisible among his creditors were deemed fraudulent as to his creditors and were rescindable).

42. Jenny B. Wahl & Edward T. Wahl, *Fraudulent Conveyance Law and Leveraged Buyouts: Remedy or Insurance Policy?*, 16 WM. MITCHELL L. REV. 343, 344 (1990).

43. *See* UNIF. FRAUDULENT CONVEYANCE ACT REFS & ANNOS, 7A U.L.A. 430 (1985) (stating that "[t]he statute of Elizabeth condemns conveyances as fraudulent only when made with the intent to 'hinder, delay, or defraud.'").

44. Wahl & Wahl, *supra* note 42, at 344.

45. *Id.*

46. *See* Blackwood, *supra* note 39, at 345 (stating that it is difficult to prove actual intent).

47. *See* Stern, *supra* note 40, at 5 (referencing section 548 of the Bankruptcy Code, the UFTA, and the UFCA); *see also* Bruce A. Markell, *supra* note 38, at 471 (noting that "the 'fraudulent' transfer need not be made with any intent to defraud; indeed, it can even have been made with the purest of motives").

48. UNIF. FRAUDULENT CONVEYANCE ACT § 1, 7A U.L.A. 430 (1985) [hereinafter the UFCA]; *but see In re* S. Rachles, Inc., 131 B.R. 782, 789 (Bankr. D.N.J. 1991) (noting that the Uniform Fraudulent Conveyance Act has in fact been revised, modified and, in certain jurisdictions, repealed by the Uniform Fraudulent Transfer Act).

49. UNIF. FRAUDULENT TRANSFER ACT § 1, 7A U.L.A. 643 (1985 & Supp. 1989) [hereinafter the UFTA].

50. Fraudulent Transfers and Obligations, 11 U.S.C.A. § 548 (West 2012).

51. Queenan, Jr., *supra* note 26, at 6.

application *only* to intentionally fraudulent matters, courts have begun to ignore demonstrable academic pushback[52] as well as initial judicial skepticism[53] in fully enforcing fraudulent transfer law in LBO transactions and, in particular, its constructive law provisions.[54]

Creditors alleging constructive fraud wield scythe-like power, able to pierce and reach nearly any transaction conducted during the LBO.[55] A creditor can completely avoid: (1) The right of the LBO Company's former shareholders to retain proceeds received from the sale of the Company's stock; (2) the right of the LBO Company's former shareholders to enforce claims for deferred portions of the acquisition price; (3) the right of a LBO lender, whether senior or subordinate, to enforce loan obligations owed by the LBO Company; and (4) the validity of a LBO lender's liens and security interests in the LBO Company's assets.[56]

Pre- and post-LBO creditors most directly affect the LBO financier. Indeed, it is the lender "who furnished the funds [to buy the LBO who] is in serious danger of having its loan obligation and security transfers also adjudged fraudulent."[57]

Constructive fraud laws are codified with substantially similar language[58] in three repositories: the Bankruptcy Code [hereinafter the Code], [59] the UFTA,[60] and the UFCA.[61] Section 548(a)(1) of the Code states that "[t]he trustee may avoid any transfer . . . of an interest of the debtor in property . . . incurred by

52. *See generally* Baird & Jackson, *supra* note 6, at 829 (cautioning against the application of fraudulent conveyance laws to LBOs).

53. *See generally* Credit Managers Ass'n of S. Cal. v. Fed. Co., 629 F. Supp. 175 (C.D. Cal. 1986) (demonstrating uncertainty as to whether fraudulent conveyance laws even apply to LBOs).

54. *See, e.g.*, *Boyer*, 587 F.3d at 793 (indicating that although the court identified two formal differences to the transaction with respect to a conventional overleveraged LBO, it made no difference whether the transaction was called a legitimate LBO or a fraudulent conveyance); *MFS/Sun Life Trust-High Yield Series*, 910 F. Supp. at 933 (stating that "courts now uniformly hold that fraudulent conveyance laws apply to LBOs").

55. *See* Cieri et al., *supra* note 1, at 350 (noting that "creditor's challenges can completely avoid LBO transfers, rights and obligations").

56. *Id.*

57. Queenan, Jr., *supra* note 26, at 25.

58. Minor differences exist in statute of limitations. *See id.* at 7 (explaining the differences between section 548 of the Bankruptcy Code, the UFCA, and the UFTA). Specifically, Section 548 of the Bankruptcy Code solely governs "transfers or obligations made or incurred within one year prior to the bankruptcy filing." *Id.* However, the statute of limitations for the UFTA is four years. *Id.* Additionally, the UFCA "incorporates the statute of limitations of the particular state, [which is] typically longer than one year." *Id.*

59. 11 U.S.C. § 548.

60. UNIF. FRAUDULENT TRANSFER ACT § 1, 7A U.L.A. 643 (1985 & Supp. 1989).

61. UNIF. CONVEYANCE ACT § 1, 7A U.L.A. 430 (1984).

the debtor that was made."[62] The Code provides that the trustee may avoid a transfer if the debtor "received less than a reasonably equivalent value in exchange for such transfer or obligation, . . . was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation," or the debtor was left with "unreasonably small capital."[63] In other words, a court may set aside a LBO if it leaves the transferor with unreasonably small capital by depleting its assets.[64]

Numerous courts and a few noted bankruptcy scholars have questioned whether constructive fraud law should apply at all in a LBO context.[65] Regarding the anachronistic application of Sixteenth Century principles to modern day transactions, Baird and Jackson note that "[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."[66] However, courts have gradually abandoned their original skepticism in subjecting LBO transactions to constructive fraud law.[67] The provisions detailed below guide courts in their decision making process.

1. Fair Consideration

The consideration requirement in constructive fraud law differs markedly from its contract law relative, in which "the adequacy of consideration will not be examined."[68] In fraudulent

62. 11 U.S.C. § 548(a)(1).

63. *Id.* § 548(a)(1)(B).

64. *See* Markell, *supra* note 38, at 471 (explaining that a court can determine that fraudulent conveyance exists when a LBO leaves a transferor with "insufficient remaining assets").

65. *See, e.g.*, Kupetz v. Wolf, 845 F.2d 842, 846 (9th Cir. 1988) (distinguishing between a LBO and a fraudulent conveyance, indicating that the former involves a situation where the parties fully intend to disadvantage the creditors and advantage the shareholders, while the latter is a transfer made by an insolvent debtor without fair consideration); *Credit Managers Ass'n of S. Cal.*, 629 F. Supp. at 182 (defining a fraudulent conveyance as a transfer made without fair consideration and which left the transferor with "unreasonably small capital"); Wieboldt Stores, Inc. v. Schottenstein, 94 B.R. 488, 500-01 (N.D. Ill. 1988) (clarifying that although fraudulent conveyance laws are generally applied to LBOs, a debtor cannot use these laws for avoid LBO transfers); Baird & Jackson, *supra* note 6, at 832-33 (discussing the issue of identifying the "reach" of fraudulent conveyance law to leveraged buyouts); Sherwin, *supra* note 27, at 505 (arguing that leveraged buyouts do not fit into the structure of fraudulent conveyance laws).

66. Baird & Jackson, *supra* note 6, at 852.

67. *See, e.g.*, *Boyer*, 587 F.3d at 793 (applying fraudulent transfer law to what the parties termed a LBO transaction); *MFS/Sun Life Trust-High Yield Series*, 910 F. Supp. at 933 (stating that most courts apply fraudulent conveyance laws to LBOs).

68. *See* Queenan, Jr., *supra* note 26, at 8 (explaining that contract law does

transfer law, the debtor cannot have "received less than a *reasonably equivalent value* in exchange for such transfer or obligation."[69] The creditor seeking to set aside the conveyance as fraudulent generally carries the burden of proof on this issue.[70]

In a LBO, the new management buys the Target Corporation from the selling shareholders.[71] The acquired company pledges all of its assets away as security (a guaranty) for the loan incurred by the new management.[72] Thus, the old shareholders receive a dividend for selling their shares in the company and the new management (shareholders) receives a new company for their payment.[73]

Giving a guaranty constitutes an "obligation incurred" under the Code, the UFTA, and the UFCA.[74] Likewise, granting the primary LBO lender a security interest in the Target's assets is a "conveyance" under the UFCA, or "transfer of interest" under both the UFTA and the Code.[75] Thus, the corporation's actions fall within the *direct language* of the fair consideration provisions.[76]

Whether any LBO can satisfy the fair consideration provisions is a different matter. Scholars and courts alike have seriously questioned whether the Target actually derives *any* direct quantifiable benefit from the transaction, let alone a *reasonably equivalent* benefit.[77] The effect of the LBO transaction on the corporation is clear—"the Target's assets have not increased and must now service debt the proceeds of which have been transferred to Target's former shareholders, thereby substantially weakening the creditworthiness of the Target."[78] Ubiquitous skepticism notwithstanding, some courts have weighed whether some *indirect* benefits of a LBO transaction can satisfy

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not measure consideration).

69. 11 U.S.C. § 548(a)(1)(B)(i) (emphasis added); *see also* UFCA § 3, 7A U.L.A. 430 (imposing a good faith requirement).

70. *MFS/Sun Life Trust-High Yield Series*, 910 F. Supp. at 936-37.

71. *Boyer*, 587 F.3d at 791-92.

72. *Id.*

73. *See id.* at 791 ("Just prior to the closing, old Crown transferred $590,328 from its corporate bank account to a separate bank account so that it could be distributed to Crown's shareholders as a dividend.").

74. Robert J. Rosenberg, *Intercorporate Guaranties and the Law of Fraudulent Conveyances: Lender Beware,* 125 U. PA. L. REV. 235, 240-41 n.13 (1976).

75. *Id.*

76. 11 U.S.C. § 548; UFCA § 3, 7A U.L.A. 430. *See also* UFTA 7A U.L.A. 643 (setting forth the requirements that must be met in order for a transfer to have reasonably equivalent value).

77. *Moody*, 971 F.2d at 1065; Mellon Bank v. Metro Commc'ns, Inc., 945 F.2d 635, 646-47 (3d Cir. 1991); Sherwin, *supra* note 27, at 497; *see, e.g.*, Mellon Bank v. Metro Commc'ns, Inc., 95 B.R. 921, 934 (Bankr. W.D. Pa. 1989) ("[S]uch circular logic merely begs the question, because all the debtor really received was the opportunity to incur an additional . . . debt").

78. Kirby et al., *supra* note 5, at 34.

the fair consideration standard.[79]

2. *Insolvency and Unreasonably Small Capital*

The second prong of the constructive fraud analysis examines the Target Corporation's financial condition in the wake of the LBO. The Code assesses whether the Company "was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation."[80]

Although the Code and the UFTA differ slightly from the UFCA,[81] all three statutes "measure asset values against total liabilities."[82] Illiquid assets, however, are generally valued notably less than their liquid counterparts.[83] As such, in *United States v. Tabor Realty Corp.*,[84] the court found the Target insolvent where it sustained losses in the years before the sale and the value of the assets were predicated on sales that would require years to consummate.[85]

Of course, a company could show $1.00 on its balance sheet and be deemed sufficiently solvent to pass the financial condition test.[86] In light of this obvious deficiency, the "unreasonably small capital test" was generated.[87] According to *Boyer*, "the difference between insolvency and 'unreasonably small' assets in the LBO context is the difference between being bankrupt on the day the LBO is consummated and having at that moment such meager assets that bankruptcy is a consequence both likely and

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79. *See infra* Section III.A. (discussing courts' refusal to find that "indirect benefits" can constitute fair consideration).

80. 11 U.S.C. § 548(A)(1)(b)(ii).

81. Under the UFCA a person is insolvent "when the present fair salable value of his assets is less than the amount that will be required to pay his probable liability on his existing debts as they become absolute and matured." UFCA § 2(1), 7A U.L.A 442.

82. *See* Queenan, Jr., *supra* note 26, at 14 (noting that there are two definitions of insolvency: insolvency in the bankruptcy sense and insolvency in the equity sense). In a recent decision, a court utilized insolvency in the bankruptcy sense, holding that "[a] person is insolvent when the present fair salable value of his assets is less than the amount that will be required to pay his probable liability on his existing debts as they become absolute and matured." *In re* Jacobs, 394 B.R. 646, 672 (Bankr. E.D.N.Y. 2008). Courts sometimes also use insolvency "in the equity sense, which is a general inability to pay debts as they mature in the ordinary course." Queenan, Jr., *supra* note 26, at 13.

83. S.E.C. v. Enter. Trust Co., 559 F.3d 649, 650-51 (7th Cir. 2009).

84. United States v. Tabor Realty Corp., 803 F.2d 1288 (3d Cir. 1986).

85. *Id.* at 1303-04.

86. *See* Lee B. Shepard, Note, *Beyond Moody: A Re-Examination of Unreasonably Small Capital*, 57 HASTINGS L.J. 891, 894-95 (2006) (providing examples where a company is deemed sufficiently solvent but in which its creditors encounter a possibly unreasonably high risk).

87. *Id.*

foreseeable."[88] The unreasonably small capital requirement has played a significant role in cases in which courts have deemed transfers fraudulent.[89] Alternatively, creditors can attack a transaction as fraudulent by asserting that the LBO transaction left the corporation in dire financial straits.[90] The Code and the UFCA use substantially similar language, while the UFTA provides that the "remaining assets of the debtor . . . [must be] unreasonably small in relation to its business."[91] The essential purpose of the statute is to "prevent an undercapitalized Company from being thrust into the market place to attract unwary creditors to inevitable losses."[92]

The insolvency test above is clear. If after the LBO the Company's current liabilities exceed its current assets, the LBO can be set aside.[93] However, determining a company's financial position in light of the fraudulent conveyance laws is onerous and not always accurate in the majority of LBOs. With respect to most LBOs, "it is very difficult to determine the adequacy of the LBO company's financial condition for purposes of the fraudulent conveyance laws."[94] The tests used to determine the reasonability of post-LBO capital have been extraordinarily varied,[95] and opaque,[96] and a nettlesome task for a court, indeed.

Generally, courts emphasize a company's ability to generate enough capital to pay the debt from the LBO and to continue its operations.[97] Typically, "[w]hether a transfer was fraudulent when made depends on conditions that existed when it was made, not on what happened later to affect the timing of the company's

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88. *Boyer*, 587 F.3d at 794.

89. Markell, *supra* note 38, at 500.

90. *See infra* Section III.B. (discussing the unreasonably small capital test).

91. UFTA § 4, 7A U.L.A. 643; *compare* 11 U.S.C. § 548 and UFCA § 5, 7A U.L.A. 430, *with* UFTA § 4, 7A U.L.A. 643 (noting the differences between the language used).

92. Barrett v. Cont'l Ill. Nat'l Bank & Trust Co., 882 F.2d 1, 5 (1st Cir. 1989) (citing Wells Fargo Bank v. Desert Bldg. Supplies, 475 F. Supp. 693, 696 (D. Nev. 1978), *aff'd*, 633 F.2d 225 (9th Cir. 1980)).

93. *Boyer*, 587 F.3d at 794.

94. Cieri et al., *supra* note 1, at 364.

95. *See, e.g.*, Kupetz v. Cont'l Ill. Nat'l Bank & Trust Co., 77 B.R. 754, 761-63 (C.D. Cal. 1987), *aff'd*, *Kupetz*, 845 F.2d at 842 (illustrating a solvency analysis); *Credit Managers Ass'n of S. Cal.*, 629 F. Supp. at 183-88 (using a cash flow analysis); *Wells Fargo Bank*, 475 F. Supp. at 697 (utilizing a working capital depletion evaluation); Steph v. Branch, 255 F. Supp. 526, 532 (E.D. Okla. 1966) (evaluating capital depleted below a reasonable level, although debtor not insolvent), *aff'd*, 389 F.2d 233 (10th Cir. 1968).

96. *See Boyer*, 587 F.3d at 794 (referencing Judge Posner's use of the term "fuzzy").

97. *See* Queenan, Jr., *supra* note 26, at 18 (quoting the definition commonly used by courts when defining fraudulent transfers).

collapse."[98] In a landmark case, *Moody v. Security Pacific Business Credit, Inc.*,[99] the court examined the pre-LBO projection and decision-making forethought when assessing if there was unreasonably small capital.[100] In *Moody*, the court noted that projections need to be measured for reasonableness against a company's actual performance because they "tend to be optimistic."[101] To satisfy the standard for reasonableness, the projections need to account for potential obstacles that may arise such as "interest rate fluctuations and general economic downturns, and otherwise incorporate some margin for error."[102]

Leading bankruptcy scholar, Bruce Markell,[103] noted that a company is left with unreasonably small capital after a transfer if its inability to pay its creditors was a reasonably foreseeable consequence of the failure to retain an adequate amount of assets to satisfy its creditors' claims.[104] Another test for solvency involves evaluating a company's "*present ability* to pay [its] debts as they mature,"[105] and the "ability to pay [its] debts in the ordinary course, not inability to raise the money for them in the ordinary course."[106] Put differently, the court must decide whether the Company was able to continue its operations in the same manner after the transfer as it had before the transfer.[107]

98. *Boyer*, 587 F.3d at 795 (citing *Moody*, 971 F.2d at 1073); *In re* Morse Tool, Inc., 148 B.R. 97, 133-34 (Bankr. D. Mass. 1992).

99. *Moody*, 971 F.2d at 1056.

100. *See id.* at 1069-71 (providing an evaluation of a company's solvency at the time of the LBO, as well as a capital assessment).

101. *Id.* at 1073.

102. *Id.* (citation omitted).

103. Bruce Markell is now the Honorable Bruce Markell, U.S. Bankruptcy Judge, District of Nevada. *Judge Bruce A. Markell*, U.S. BANKR. COURT DIST. OF NEV., http://www.nvb.uscourts.gov/judges/chambers/markell/ (last visited Dec. 26, 2012).

104. *See* Markell, *supra* note 38, at 499 (explaining how capital can be determined to be unreasonably small based on existing case law).

105. United States v. Gleneagles Inv. Co., 565 F. Supp. 556, 578 (M.D. Pa. 1983) (citation omitted).

106. Fid. Trust Co. v. Union Nat'l Bank of Pittsburgh, 313 Pa. 467, 480 (1933); *but see generally Wells Fargo Bank*, 475 F. Supp. at 693 (holding transaction invalid where sole shareholder of a corporation caused corporation to borrow funds on a secured basis, only to remove funds for private reasons). The *Wells Fargo Bank* court further noted the marginal profits, and determined that the incurrence of the secured loan not only reduced the pool of unsecured assets, but prevented the corporation from expanding and was thus invalid. *Id.*

107. *Barrett*, 882 F.2d at 5.

III. CONSTRUCTIVE FRAUD ISSUES IN A LBO CONTEXT

A. Fair Consideration

As bankruptcy scholars Baird and Jackson noted, "[e]ven under the narrowest view of fraudulent conveyance law, the leveraged buyout may be a fraudulent conveyance."[108] The first reason in support of why a leveraged buyout may be an invalid transfer is that the LBO must have been conducted for fair consideration.[109] It is doubtful, however, that any LBO can meet the fair consideration standard.[110] Courts have long held that transfers made to benefit third parties are not made for fair consideration.[111] Nevertheless, defendants have consistently asserted creative and unorthodox arguments in support of their proposition.

The Bankruptcy Code, the UFTA, and the UFCA all mandate that in order for constructive fraud principles to apply, the debtor (the LBO Company) must receive less than the reasonably equivalent value.[112] Specifically, the issue is whether the "transaction conferred realizable commercial value on the debtor reasonably equivalent to the realizable commercial value of the assets transferred."[113] *Mellon Bank v. Metro Communications, Inc.*[114] addressed this issue.[115] There, the Target, Metro Communications Inc., filed a bankruptcy petition under Chapter 11 a year after the LBO transaction.[116] As in all LBOs, the Target Company received no direct benefits "from extending the guaranty

108. *See* Baird & Jackson, *supra* note 6, at 851 (advancing the proposition that a LBO may be an invalid transaction).
109. *See supra* Section II.A. (explaining the fair consideration requirement for a valid LBO).
110. *See, e.g.*, Cieri et al., *supra* note 1, at 354 (explaining that LBOs have difficulty satisfying the fair consideration standard since LBO transactions consist of three parties and under fraudulent conveyance laws, benefits to third parties fall short of qualifying as fair consideration); Sherwin, *supra* note 27, at 497 (casting doubt on whether a LBO can meet the fair consideration standard).
111. *See* Liss, *supra* note 24, at 1499 (citing *In re* Christian & Porter Aluminum Co., 584 F.2d 326, 337 (9th Cir. 1978)) (stating that courts have recognized that transfers made to benefit third parties do not meet the fair consideration standard); *In re* Ohio Corrugating Co., 70 Bankr. 920, 925 (Bankr. N.D. Ohio 1987) (stating that leveraged buyouts were not exempt from the Uniform Fraudulent Conveyance Act); *see also* 5 COLLIER ON BANKRUPTCY ¶ 548.07 (15th ed., rev. 1996) (stating that a third party cannot be the sole beneficiary to the transaction).
112. *See Supra* Section II.A. (discussing the Bankruptcy Code, the UFTA, and the UFCA).
113. *Mellon Bank*, 945 F.2d at 647.
114. *Id.*
115. *Id.*
116. *Id.* at 638.

and security interest collateralizing that guaranty."[117] Of course, as in a standard LBO, the "Target incur[red] an obligation and the consideration received [was] immediately conveyed to Target's shareholders or other parties."[118]

In an attempt to shield the LBO from constructive fraud, creative and prescient lawyers in the 1980s devised structural changes to the LBO transactional form. They created a scheme in which "the proceeds go first to the Target who, with the knowledge and consent of the lender, immediately pays them to the buyers or sellers in a dividend, stock redemption or merger."[119] Essentially, the Target becomes a cash conduit, passing through the Target to the selling stockholders.

One could argue that no fraudulent transfer occurred because the Target has received the full proceeds of the loan. In *Wieboldt Stores Inc. v. Schottenstein*,[120] a case where the defendants contended that the transactions were a series of discrete transfers, the defendants adopted a similar approach in successfully shielding their transaction from judicial scrutiny.[121] The court in *Kupetz v. Wolf*[122] also ratified the approach, as the judges conceded that they "[we]re influenced by the formal structure of the LBO."[123]

According the defendants due deference in this case would result in a finding that "no fraudulent transfer or obligation [] occurred because Target ha[d] received the full amount of its loan."[124] In fact, that is precisely what the Ninth Circuit held in *Kupetz*.[125] However, approaching the transaction realistically, whether the shareholders receive their payment directly from the lender or from the Target should not matter as the end result is the same—the target is left in a dire financial condition.[126] Courts have increasingly agreed that defendants cannot shield

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117. *Id.* at 646.

118. Kirby et al., *supra* note 5, at 34.

119. Queenan, Jr., *supra* note 26, at 26; *accord* Telefest Inc. v. VU-TV Inc., 591 F. Supp. 1368, 1380 (D.N.J. 1984) (holding that upstream and cross-stream guaranties withstood fraudulent conveyance attack). Upstream and cross-stream guaranties are liabilities on a subsidiary's or a parent's (respectively) financial statements in which the subsidiary or parent guarantees the Company's debt. *Id.*

120. *Wieboldt Stores, Inc.*, 94 B.R. at 488.

121. *See generally id.* at 488 (treating the transfers as distinct transactions and finding for the defendants).

122. *Kupetz*, 845 F.2d at 842.

123. *See id.* at 850 (holding that the LBO did not violate fraudulent conveyance laws).

124. Queenan, Jr., *supra* note 26, at 26.

125. *See generally Kupetz*, 845 F.2d at 842 (shielding the LBO from constructive fraud law).

126. *See* Queenan, Jr., *supra* note 26, at 26-27(explaining how the end result in either situation impairs the Target's financial outlook).

themselves from fraudulent conveyance claims by hiding behind the transaction's formal structure.[127] In *Boyer*, Judge Posner agreed, holding that "whether one calls it a LBO or not is not critical . . . [s]ome LBOs are legitimate; others are fraudulent conveyances . . . . [The] fraudulent conveyance doctrine . . . is a flexible principle that looks to substance, rather than form."[128]

Moreover, despite that a LBO *may* be structured to possibly decrease the risk of liability, the *Wieboldt* court suggested that intentionally trying to evade constructive fraud provisions could constitute actual fraud.[129] Courts have thus collapsed the separate transactions into one, noting that they "will not allow the labels that interested parties place on their own transactions to control the rights of third parties."[130]

Again, despite almost uniform rejection of a LBO transaction's ability to satisfy the fair consideration requirement, assertive lawyers have highlighted the *indirect* benefits conferred to the Target Company.[131] If the Company can prove that the indirect benefits it realized were "reasonably equivalent" to its pledge as a guaranty, the first prong of constructive fraud would generate a finding of legitimacy.[132] Indirect benefits include: access to working capital, synergistic effects of new corporate relationships, benefits accruing from arrival of a new management team, and the availability of additional credit to the Company after the transaction if it demonstrated it facilitates additional business opportunities for the Target.[133] The Target Company may

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127. *See Wieboldt*, 94 B.R. at 502-03 (specifying that courts should not rely on a LBO's formal structure, but rather on the knowledge of the parties at the time of the LBO).

128. *Id.* at 793 (internal quotation marks omitted).

129. *Wieboldt*, 94 B.R. at 504.

130. *Kupetz*, 845 F.2d at 847 n.6 (internal citation omitted); *see, e.g.*, Orr v. Kinderhill Corp, 991 F.2d 31, 35 (2d Cir. 1993) (internal quotations and citations omitted) ("Thus, an allegedly fraudulent conveyance must be evaluated in context; where a transfer is only a step in a general plan, the plan must be viewed as whole with all its composite implications."); Official Comm. of Unsecured Creditors of Nat'l Forge Co. v. Clark (*In re* Nat'l Forge Co.), 344 B.R. 340, 347 (W.D. Pa. 2006) (citations omitted) ("It is now widely accepted that multilateral transactions may under appropriate circumstances be 'collapsed' and treated as phases of a single transaction for purposes of applying fraudulent conveyance principles."); *accord* Baird & Jackson, *supra* note 6, at 851 (explaining that courts consider all of the various parts of a LBO transaction as one transaction rather than many, and that they will not permit the "labels that interested parties place on their own transactions to control the rights of third parties").

131. *See Mellon Bank*, 945 F.2d at 646-48 (explaining that indirect benefits can support a finding that the requirement that there must be reasonably equivalent value has been satisfied).

132. *Id.* at 646-47.

133. *Id.* at 647.

also accrue significant tax benefits.[134] Bankruptcy scholar and former Judge, James Queenan, noted that, "[i]f Target was previously a public Company which paid dividends, they can point to the tax benefit which Target derives from the substitution of deductible interest payments for non deductible dividends."[135]

Citing various reasons, including the difficulty of quantifying such indirect benefits, courts have repeatedly rejected indirect benefit arguments.[136] The court in *Mellon Bank* noted that the Target "receives no direct benefit to offset the greater risk of now operating as a highly leveraged corporation."[137] Moreover, the court in *Moody v. Security Pacific Business Credit, Inc.*,[138] held that while "[a]ccess to working capital is valuable, . . . it is not fair consideration."[139] Lastly, in a trilogy opinion, the Middle District of Pennsylvania held that consideration must have monetary value and that the addition of new management does not qualify as fair consideration.[140] Thus, academics have warned that there is no consideration when lenders are aware that a loan's proceeds will be utilized to execute a buyout.[141]

B. Insolvency and Unreasonably Small Capital

A transfer "which renders a transferor insolvent may be attacked by any of the transferor's then-existing creditors, but not by creditors whose debts arise after the transfer."[142] However, future creditors can attack a transfer that results in the transferor retaining an unreasonably small amount of capital.[143] Unsecured

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134. *See, e.g.*, *MFS/Sun Life Trust-High Yield Series*, 910 F. Supp. at 937 (providing an example of a LBO causing Target to receive tax benefits); Baird, *supra* note 1, at 6 (arguing the changes in corporate and individual rates in 1986, and the abolition of capital gains deduction may have made the tax benefit of leverage substantially more attractive than they were before); Peter C. Canellos, *The Overleveraged Acquisition*, 39 TAX LAW 91 (1985) (describing the possible tax benefits resulting from a LBO).

135. Queenan, Jr., *supra* note 26, at 10.

136. *See generally Tabor Realty Corp.*, 803 F.2d at 1288 (finding insufficient consideration to constitute an indirect benefit); *Credit Managers Ass'n of S. Cal.*, 629 F. Supp. at 175 (finding that undercapitalization is a crucial factor in the indirect benefits argument); *Gleneagles*, 565 F. Supp. at 578 (finding new management to be irrelevant).

137. *Mellon Bank*, 945 F.2d at 646; *see also In re Metro Commc'ns, Inc.*, 95 B.R. at 934 (holding that "such circular logic merely begs the question, because all that debtor really received was the opportunity to incur an additional . . . debt.").

138. Moody v. Sec. Pac. Bus., 127 B.R. 958 (W.D. Pa. 1991).

139. *Id.* at 992.

140. *Gleneagles*, 565 F. Supp. at 576.

141. Sherwin, *supra* note 27, at 497.

142. Markell, *supra* note 38, at 492.

143. *See id.* at 493 (explaining that it is a long-held rule that future creditors can attack a transfer that leaves the transferor with unreasonably small capital because they "were the target of the malign intent").

creditors have the ability to set aside a LBO transaction to vault themselves on par with secured creditors.[144] Because post-LBO creditors attack under the unreasonably small capital test, an examination of insolvency is unnecessary.[145] Further, lawyers have increasingly moved toward relying on the unreasonably small capital standard, as it avoids proof of insolvency and avoids issues of standing.[146]

Recent developments suggest that the current approach is to now avoid the solvency issue and contend that the LBO left the debtor with unreasonably small capital.[147] Unreasonably small capital, however, is an unclear standard by which to assess financial viability.[148] In light of clear judicial hesitancy to ever find that a LBO was conducted for fair consideration, "the impairment of a loan repayment obligation (or grant of security) may depend upon disrupted contentions of asset and liability values and projected financial performance."[149] As Judge Posner noted in *Boyer*, this test "is fuzzy, and in danger of being interpreted under the influence of hindsight bias."[150] Hindsight bias could prejudice a judge into post-hoc affirming the insolvency of a LBO even though the correct standard is to assess the adequacy of the financial diligence and capital projections pre-LBO.[151] Nevertheless, the risk that a court will be influenced by "20-20 hindsight" is

144. *See* Markell, *supra* note 38, at 471 (describing how creditors can seek to set aside constructively fraudulent transfers).

145. *See* Queenan, Jr., *supra* note 26, at 21-22 (describing "[w]here a transaction lacking adequate consideration leaves the debtor with unreasonably small capital, UFCA section 5 and UFTA section 4 expressly give creditors whose claims arise thereafter the right to avoid the transaction."). "Section 548 accomplishes the same result by giving avoidance rights to the trustee in bankruptcy, who represents the estate for the benefit of all creditors holding claims on the date of the bankruptcy . . . ." *Id.* However, the insolvency provisions of the UFCA and UFTA afford no rights to creditors who are owed debts that arose after the transaction occurred because "an insolvent debtor is unable to obtain further credit." *Id.*; *see also* Stern, *infra* note 147 and accompanying text (describing how solvent or not the debtor is left with unreasonably small capital).

146. *See* Markell, *supra* note 38, at 494 (noting that the case law allows for good faith arguments for expanding a cryptic view of the law).

147. *See* Stern, *supra* note 40, at 5, 7 (explaining that the Seventh Circuit in *Boyer* may have altered the focus of such cases by shifting it to whether or not there was unreasonably small capital).

148. *See Boyer*, 587 F.3d at 794 (describing the test as "fuzzy").

149. Kirby et al., *supra* note 5, at 28.

150. *See Boyer*, 587 F.3d at 794 (noting that "one is tempted to suppose that because a firm failed it must have been inadequately capitalized"); *accord* Cieri et al., *supra* note 1, at 364 (describing how "[i]n most LBOs it is very difficult to determine the adequacy of the LBO Company's financial condition for the purposes of the fraudulent conveyance laws.").

151. *See* Queenan, Jr., *supra* note 26, at 19 (describing how there is a danger in judges using hindsight to answer the question, and hindsight should not be used).

significant.[152]

Moreover, lenders must attempt to choose a valuation method that is supported by case precedent due to the lack of any uniform judicial approach in valuing a company's assets and liabilities or any clear statutory definitions.[153] The defendant Company, selling shareholders, and possibly main financiers of the transaction all carry the burden of proving the opaque question of whether the debtor remained solvent in light of the LBO.[154] Various tests could yield various and unpredictable results.[155] Moreover, beyond the test's opacity and hindsight bias, secured lenders should also be wary of the likelihood of a set-aside due to a significant number of LBO transactions in which the Company virtually pledges the entirety its assets away.[156] The substantial debt load "require[s] a reduction in costs, or necessitate[s] divestiture of some assets."[157] It is difficult to imagine a Company that would pledge all of its assets away to finance a loan and have significant and robust working capital remaining.[158]

Assessing whether the amount of property retained is

152. *See* Baird, *supra* note 1, at 364 (describing how "even when an LBO participant makes a thorough pre-closing analysis of the target company's financial condition, there is no question that a court might employ 20-20 hindsight and evaluate financial condition at the time of closing in light of events subsequent to closing."); *see also In re Knox Kreations, Inc.*, 474 F. Supp. at 572 (stating that the prohibition against the Target being left with unreasonably small capital was not intended to permit a court to "second guess bona fide business judgments with the benefit of hindsight"); Sherwin, *supra* note 27, at 502 (describing how "the lenders' problems in applying any of the three financial standards are complicated by the courts' tendency to rely on hindsight in evaluating a transferor's financial condition.").

153. *See* Kirby et al., *supra* note 5, at 40 (explaining the difficulty in choosing a valuation method).

154. *MFS/Sun Life Trust-High Yield Series*, 910 F. Supp. at 938.

155. *See generally* Markell, *supra* note 38, at 494-95 (arguing for a synthesis of the varying insolvency tests).

156. *See, e.g.*, *Mellon Bank*, 945 F.2d at 645-46 (stating that lenders normally have a more senior and secure status as compared to other creditors and are only at risk "to the extent that the loan is under-collateralized"). However, if the company is in a bankruptcy proceeding evaluating a constructive fraud argument, the likelihood that the loan was under-collateralized necessarily rises as a predicate necessity to the argument. *Id.*; *see generally Kupetz*, 845 F.2d at 842 (holding that there must be an indication of an intent to defraud before a creditor can have standing to sue under the law of fraudulent conveyances); *Credit Managers Ass'n of S. Cal.*, 629 F. Supp. at 175 (explaining that if there is no limit to whether a creditor can sue to set aside a transfer, "[c]redit could liberally be extended to such companies regardless of their assets or cash flow with the knowledge that the buyout could always be attacked later if the company folded").

157. Cieri et al., *supra* note 1, at 364.

158. *See infra* note 186 and accompanying text (explaining that a company is left with unreasonably small capital if it pledges away all of the Company's assets).

unreasonably inadequate is a question of fact.[159] Bruce Markell summarized the test as follows: "non-payment of the plaintiff's claim was a *reasonably foreseeable effect* given the amount of the transferor's remaining and reasonably foreseeable cash resources; and that in at least a 'but for' sense, the lack of adequate resources caused the non-payment."[160]

Thus, the question of whether the Target has been left unreasonably capitalized is determined in light of the circumstances existing at the time of the LBO.[161] A court must determine whether the pre-LBO projections were prudent, and not simply study what happened to the company.[162] Courts disagree over how to best examine the reasonableness of the consideration, however, as a plethora of variables often lead to disparate results. First, as a result of the LBO, the Target is often left with little or no working capital.[163] As discussed in Section II.A, *supra*, the consideration is immediately passed to Target's shareholders or third parties.[164] Likewise, "because the Company's assets have been pledged as collateral, the buyer will have little flexibility to finance working capital or capital expense requirements."[165] This substantial amount of debt that a company has following a LBO can affect its cash flow.[166] Moreover, despite the ability of the Target to trade on credit as a result of the LBO,[167] "a debtor will not be considered solvent under the act merely because he is still able to trade on credit or has assets with a fair market value which would permit him to pay his debts at some future time upon a liquidation of his business."[168] Of course, a noted problem that

159. 5 COLLIER ON BANKRUPTCY ¶ 548.05[3] (15th ed., rev. 1996).

160. Markell, *supra* note 38, at 497 (emphasis added).

161. *See* Queenan, Jr., *supra* note 26, at 19 ("Although the LBO might have been a contributing or prime cause of the collapse, it does not necessarily follow that the collapse was likely at the time of the sale, any more than causation determines negligence in tort law").

162. *Credit Managers Ass'n of S. Cal.*, 629 F. Supp. at 187.

163. *See supra* notes 36-37 and accompanying text (discussing the possible consequences of pledging away all of the company's assets); *accord* Murphy v. Meritor Sav. Bank (*In re* O'Day Corp), 126 B.R. 370, 393 (Bankr. D. Mass. 1991) (stating that "[f]air consideration is given when in good faith, as a fair equivalent, and in exchange, property is conveyed or an antecedent debt is satisfied . . . ."). Additionally, "[f]air equivalence only requires that the value of the consideration be reasonably equivalent rather than exactly equivalent in value to the property transferred or obligation assumed." *Id.*

164. *Supra* Section II.A.

165. ALLEN MICHEL & ISRAEL SHAKED, THE COMPLETE GUIDE TO A SUCCESSFUL LEVERAGED BUYOUT 246 (McGraw-Hill School Education Group 1988).

166. Cieri et al., *supra* note 1, at 347.

167. *See Mellon Bank*, 945 F.2d at 647 (3d Cir. 1991) (noting that the availability of additional credit to the Company after the transaction if it demonstrated it facilitates additional business opportunities for the Target).

168. *Gleneagles*, 565 F. Supp. at 578.

all LBOs face is that they are in a poor position to withstand temporary financial setbacks since debt demands enjoy less flexibility than equity interest.[169]

The availability of working capital, sufficient for the defendants to prove a reasonable amount, has proved difficult to demonstrate.[170] The LBO leaves the Company in a weaker financial position, with a weaker net worth, lower profits, and a lower cash flow due to debt payments.[171] In *Murphy v. Meritor Savings Bank (*In re *O'Day Corp.)*,[172] the court subordinated the secured LBO lender's claims on a constructive fraud theory.[173] In finding that the LBO left the Target with unreasonably small capital, the court relied upon the fact that "O'Day gave literally millions of dollars of liens to Meritor and encumbered virtually all of its existing assets in exchange for $1,344.00 in proceeds."[174] But this is typical in a LBO.[175] As in *O'Day*, the court in *Mellon Bank* also utilized the reasonably foreseeable balance sheet examination, and in doing so concluded that the Target "guaranteed and secured the acquisition loan with substantially all of its assets."[176]

Of course, there is a significant risk of abuse in leveraged buyouts.[177] One way a post-LBO Company in a bankruptcy proceeding can demonstrate the Company was adequately capitalized is to highlight the Target's post-LBO survival for an extended period of time.[178] Theoretically, a Company that was able to stay on its feet for an extended period of time could assert prima facie evidence that it was not left with unreasonably small capital.[179] Historically, courts accepted an (approximately) one-

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169. *Metro Commc'ns*, 945 F.2d at 647.

170. *See supra* text accompanying notes 137-38 (reiterating how determining a company's viability based on capital funding is not always accurate); *see also Boyer*, 587 F.3d at 794 (noting that the term unreasonably small as it concerns working capital is "fuzzy").

171. *See* Queenan, Jr., *supra* note 26, at 2 (explaining how a LBO can weaken a company's financial standing).

172. *Murphy*, 126 B.R. at 370.

173. *Id.* at 412-13.

174. *Id.* at 394.

175. *See* Markell, *supra* note 38, at 488 (describing many cases where a pledge of a company's assets leaves the transferor with diminished capital).

176. *Mellon Bank*, 945 F.2d at 638; *see also MFS/Sun Life Trust-High Yield Series*, 910 F. Supp. at 931 ("VDAS was left with insufficient working capital after the LBO. He noted that it had roughly 245k in capital at a time when it was doing more than 50 million in businesses annually.").

177. *Moody*, 971 F.2d at 1073.

178. *See* Daley v. Chang (*In re* Joy Recovery Tech. Corp.), 286 B.R. 54, 76 (Bankr. N.D. Ill. 2002) (showing that Joy was still viable post-LBO because its 1994 cash flow was adequate to finance operations).

179. *See Moody*, 971 F.2d at 1074 (explaining that there was no unreasonably low capital since the company's creditors were paid for twelve months after transaction).

year interval between inception and bankruptcy as sufficient to insulate the Company from a set-aside.[180]

In *Boyer*, however, the court held it was "skeptical of cases that can be read to suggest that ten or twelve months is a long enough interval to create a presumption that the terms of the LBO were not responsible for the Company's failure."[181]

Judge Posner reasoned that "[a]n inadequately capitalized Company may be able to stagger along for quite some time, concealing its parlous state . . . ."[182] Thus, Companies hoping to rely on the year-long interval defense should heed current judicial skepticism.

Target Companies and secured lenders are at risk of losing their interests by way of the unreasonably small capital test. The standards and valuation methods described above are markedly indefinite, and "are not standards that a lender can apply with certainty to determine the validity of corporate transfers in a buyout."[183] Lastly, the prospect of hindsight bias, coupled with *Boyer*'s elimination of the one-year insulation period, could have the effect of setting aside numerous LBO transactions. The consequences of these risks will now be addressed in detail.

IV. BROADLY APPLYING CONSTRUCTIVE FRAUD LAW WILL UNFAIRLY ALLOW FUTURE UNSECURED CREDITORS TO ATTACK THE LBO TRANSACTION AND WILL DISCOURAGE LBO LENDING

A. Broad Constructive Fraud Application Will Lead to More Set Asides

The days of judicial abstention from subjecting LBOs to constructive fraud laws appear long gone despite the *Mellon Bank* court's opinion that "it seems difficult to reconcile the original purpose of the fraudulent conveyance laws with what has become a common, arms-length transaction—the leveraged buyout . . . ."[184] In the mid-1980s, Judge James Queenan argued that constructive fraud principles should apply "when a leveraged buyout so ravages the corporation that it is left insolvent or with a capitalization that

180. *See id.* (explaining that there was no unreasonably low capital because the company's creditors were paid for twelve months after transaction); *MFS/Sun Life Trust-High Yield Series*, 910 F. Supp. at 944 (reasoning that creditors were paid for eight months after the transaction); *In re* Ohio Corrugating Co., 91 B.R. 430, 440 (Bankr. N.D. Ohio 1988) (explaining creditors were paid for ten months following the buyout); *Credit Managers Ass'n of S. Cal.*, 629 F. Supp. at 184 (predicting high sales for twelve months after the buyout was not unreasonable).

181. *Boyer*, 587 F.3d at 795.

182. *Id.*

183. *See* Sherwin, *supra* note 27, at 502 (describing the financial condition standards of constructive fraud).

184. *Mellon Bank*, 945 F.2d at 645.

makes insolvency likely in the future."[185]

In order for a court to find that the transaction was constructively fraudulent, however, it does not appear that leveraged buyouts have to ravage the corporation. This is particularly so given that "a pledge of all or substantially all of a company's assets *ipso facto* leaves the transferor with unreasonably small capital."[186] The expansion of fraudulent transfer laws could now subject companies that were merely risky and unlucky, particularly since companies with unreasonably small capital are already skating on thin ice. This new definition is a direct result of the inability of the LBOs to satisfy the fair consideration test and the difficulty inherent in an opaque and refractory capital sufficiency test.[187] Given the fact that the defendants must face judges with a proclivity to apply 20-20 hindsight, and that they may no longer seek refuge in the one-year interval rule, the number of constructive fraud claims should increase going forward.[188] Additionally, the number of claims should only increase further given the "number and size of leveraged transactions in the years leading up to the Great Recession . . . ."[189] and the "sheer frequency of recent fraudulent conveyance claims and rulings."[190]

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185. *See* Queenan, Jr., *supra* note 26, at 1 (asserting that causes of action can be raised for fraudulent transfers under corporate law).

186. *See* Markell, *supra* note 38, at 488 (remarking how one line of cases "has expanded the scope of the unreasonably small capital action in unjustifiable ways.").

187. *See* discussion *supra* Section III.A, III.B. (analyzing fair consideration and insolvency and unreasonably small capital in the leveraged buyout context).

188. *See, e.g.*, *In re* Taylor, Bean & Whitaker Mortg. Corp., 3:09-BK-7047-JAF, 2012 WL 2369342, at *4 (Bankr. M.D. Fla. Mar. 22, 2012) (sustaining two of three constructive fraud claims); *In re* Jevic Holding Corp., 2011 WL 4345204, at *14 (refusing to dismiss some of the fraud claims); Wing v. Horn, 2:09-CV-00342, 2009 WL 2843342, at *6 (D. Utah Aug. 28, 2009) (declining to dismiss the plaintiff's first amended complaint containing claims of fraudulent transfer); *In re* Motorwerks, Inc., 371 B.R. 281, 297 (Bankr. S.D. Ohio 2007) (allowing the amendment of counterclaims concerning fraudulent transfers so that they contain the requisite specificity).

189. *See* Stern, *supra* note 40, at 643 (reporting a rise in litigation); *see also* Liz Moyer, *Year Of The Deal*, FORBES.COM (Nov. 17, 2006, 3:25 PM), http://www.forbes. com/2006/11/17/mergers-lbos-deals-biz cx lm 1117deals.html (reporting that "[f]ifteen of the 20 largest LBOs ever have been announced since early 2005 . . . .").

190. *See* Krusch, *supra* note 10, at 1 (noting that LBOs are often settled during reorganization); *accord Metro Commc'ns*, 945 F.2d at 645-46 (stating that "[t]he level of risk facing the newly structured corporation rises significantly due to the increased debt to equity ratio, and [t]his added risk is borne primarily by the unsecured creditors, those who will most likely not be paid in the event of bankruptcy.").

B. Allowing Post-LBO Creditors Set-Aside Rights Unfairly Places the Burden on the Main Lender

Expanding constructive fraud application in the LBO arena places unduly broad potential liability to independent lenders that finance leveraged buyouts.[191] As one court noted, "[a]n LBO may be attractive to the buyer, seller, and lender because the structure of the transaction could allow all parties to the buyout to shift most of the risk of loss to other creditors of the corporation if the provisions of section 548(a)(2) were not applied."[192] Creditors can now use fraudulent conveyance law to go beyond the principal parties in a buyout and set aside transfers to an outside lender that financed the transaction.[193] The standards and principles to be applied, along with the savings provisions, not only preclude lenders from predicting a case's outcome, but also fail to protect them from judgments that are "reasonable but erroneous."[194]

The *Kupetz* court refused to give avoidance rights to post-LBO creditors and was reluctant to apply constructive fraud law.[195] The court correctly reasoned that, "the LBO [was] a public event which gave all creditors the opportunity to gain the knowledge of [Target's] financial status and its heavy debt structure prior to extending credit to it."[196] On the contrary, Judge Posner in *Boyer* affirmatively rejected the judicial reluctance in applying constructive fraud law to LBOs, thus opening the door for future creditors to attack LBO transactions.[197] Therefore, the Third Circuit's concern that "fraudulent conveyance laws would [transform] into a form of insurance providing unsecured creditors complete protection against the failure" of the Target Company LBO appears to have been a salient premonition.[198] Post-LBO

191. *See* Sherwin, *supra* note 27, at 505 (stating that a lender's advance to finance a LBO has been considered not to be either fair consideration or reasonably equivalent value).

192. *Metro Commc'ns*, 945 F.2d at 646.

193. *Id. See also* Roxbury State Bank v. The Clarendon, 324 A.2d 24, 30 (N.J. Super. Ct. App. Div. 1974) (stating that a corporation cannot a challenge the transaction "when all the shareholders have agreed to it and the rights of corporate creditors are not affected").

194. *See* Sherwin, *supra* note 27, at 505 (proposing limitations on fraudulent conveyance statutes as applied to LBOs).

195. *See generally Kupetz*, 845 F.2d at 842 (holding that sale of corporation two and one-half years prior to bankruptcy was not a fraudulent conveyance).

196. *See* Queenan, Jr., *supra* note 26, at 22 (citing *Kupetz*, 845 F.2d at 849) (explaining that the *Kupetz* court refused to void any portion of the transaction since all debts owed when the LBO occurred had been paid).

197. *See Boyer*, 587 F.3d at 792-93 (determining that fraudulent conveyance laws are applicable to LBOs even when the underlying transaction was the purchase of a corporation's assets rather than the purchase of a corporation's stock).

198. *MFS/Sun Life Trust-High Yield Series*, 910 F. Supp. at 933 (citing *Wieboldt Stores Inc.*, 94 B.R. at 500).

lenders receive undue protection—rather than bargain for security (assets), they can demand high interest rates on cash hungry and tenuously solvent Companies and feel relatively confident that they will not be subordinated if the Company goes under. Moreover, future creditors could receive an added bonus from pre-LBO creditors, who could likewise attack the transaction and have security interests set aside.

As the *Credit Managers* court noted, there is no reason for the post-LBO lenders to have the right to attack the LBO because they lacked any substantial stake in the Target Company when the buyout occurred.[199] The court further notes that if *anyone* should be able to attack the transaction as fraudulent, it should be someone who did not have the ability to make a post-buyout assessment.[200] A lender that, in complete absence of any intentional fraud, has indisputably bargained for the risk assumed should not be placed on par with a post-LBO lender that is gifted with the ability of taking a demonstrably more calculated risk.[201] Senior secured lenders should not be subject to bankruptcy proceedings, as they have already explicitly bargained for protection (security) in the event their gamble turns sour.[202]

C. LBO Transactions Will Be Discouraged

The significant possibility that the original lender's security will be set aside in a bankruptcy proceeding engenders "the risk that lenders and sellers will become guarantors of risky transactions."[203] "[T]he upshot of such a guaranty arrangement may be the marginal deterrence of many promising, but risky, transactions that would otherwise take place."[204] The advantages of a LBO are as evident as the disadvantage of subjecting them to broad fraudulent transfer law—legitimate buyout transactions may be discouraged.[205]

Because the main lenders now stand a significant chance of

199. *Credit Managers Ass'n of S. Cal.*, 629 F. Supp. at 180.

200. *Id.*

201. *See* Andrew J. Pitts, *Prudent Lenders Need Not Fear O'Day: A Case Comment on the Application of Fraudulent Conveyance Law to LBO Lenders*, 74 B.U. L. REV. 171, 196-97 (1994) (explaining that post-LBO creditors are the only ones who have knowledge regarding the company's debt burden when determining whether or not to lend money).

202. *See Mellon Bank, N.A.*, 945 F.2d at 646 (stating that unsecured lenders are least likely to get paid in bankruptcy, whereas the only risk faced by secured lenders is the extent to which the loan is under collateralized).

203. *See* Wahl & Wahl, *supra* note 42, at 354 (explaining the risks of applying fraudulent conveyance law to LBOs).

204. *Id.*

205. *See* Sherwin, *supra* note 27, at 494 (explaining how leveraged buyouts are beneficial because they can serve other useful purposes besides the enrichment of shareholders).

losing priority in a bankruptcy proceeding, lenders seeking protections have several options, none of them particularly attractive. The first option is for the lender to increase monitoring of the firm to ensure the corporation maintains solvency.[206] While the prophylactic effect of a higher monitoring standard is unclear, law and economics scholar Judge Easterbrook noted that lenders do not need more monitoring costs as "high-yield debt greatly concentrate[s] the equity claims in the firm" and the equity-rich management already has a significant incentive to monitor their investment.[207] Thus, lenders *also* placing high monitoring costs on outside lenders would be inefficient as well as inequitable, as the management has not only the best ability to monitor their own firm, but also possesses an equally high incentive.[208]

Lenders, faced with their security in the Target Company's assets being set aside, could execute the LBO in an unsecured transaction. However, if "the Company's asset base is small and cannot be used as collateral, the transaction will be unsecured . . . the senior but unsecured lender will want a subordinated debt and equity cushion."[209] The equity cushion could "dilute management's interest and control, and that the equity investor's desire for a quick and high rate of return could result in policies detrimental to the Company's long-term potential."[210]

Alternatively, lenders could simply refuse to enter the business altogether. The legitimate fear that the lenders undoubtedly fervently bargained for security interest in the Target's assets could be set aside given the current state of fraudulent conveyance law should play a key factor going forward. Ultimately, this would be inefficient as LBOs "transfer scarce resources to higher valued uses, and stimulate effective corporate management," among other efficiencies.[211] Discouraging re-management of select corporations, often those who have "low growth prospects [but] high potential for generating cash flows,"[212]

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206. *See* MICHEL & SHAKED, *supra* note 165, at 247 (explaining the steps the company must take to ensure solvency).

207. *See* Easterbrook, *supra* note 4, at 189 (explaining that because persons of a certain wealth hold larger proportions of the remaining equity, that fact alone makes it more worthwhile for the equity claimants to monitor).

208. *See In re* Greenbrook Carpet Co., Inc. 722 F.2d 659, 661 (11th Cir. 1984) (holding that a lending institution should not be responsible for the use of the loan proceeds as long as it advances money to an entity whose obligations it holds).

209. *See* MICHEL & SHAKED, *supra* note 165, at 247 (explaining the reasons for wanting an unsecured transaction).

210. *Id.*

211. *See* Queenan, Jr., *supra* note 26, at 5 (explaining that a LBO adds value to the economy because it allows the corporation to operate with less capital and a higher debt to equity ratio).

212. *See* Jensen, *supra* note 28, at 325 (explaining that desirable leveraged buyout candidates are those firms that have stable business histories).

should be wholly undesirable.

V. CONCLUSION

In conclusion, it is clear that LBOs can no longer escape judicial scrutiny and will be subjected to fraudulent transfer laws in bankruptcy proceedings. Lenders should be particularly wary of set aside risks and should adequately protect themselves well in advance of the transaction. Whether lenders will be completely discouraged from leveraged deals going forward is yet to be seen, but the eminent risks at play will certainly have a significant impact on the debt market.