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INTERCORPORATE GUARANTIES AND THE LAW OF FRAUDULENT CONVEYANCES: LENDER BEWARE

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I. INTRODUCTION

When a business approaches an institutional lender for financing, a positive credit judgment will be based upon an analysis of the ability of the business as a whole to repay the obligation. If the operations are divided into more than a single corporate entity, however, the primary obligation to repay must be undertaken by one member of the corporate group while the remaining legally distinct entities can be rendered secondarily liable through the execution of guaranties of repayment.¹ The

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¹ The principal obligor-guarantor structure is certainly the most common manner in which to structure such a transaction. One alternative sometimes utilized by financial institutions is to provide for joint and several liability among all the entities in the corporate group. The distinction, however, is illusory because, in the typical case, the loan proceeds and their repayment will be channeled through the parent or dominant corporation in accordance with its financial plan. Thus, the benefits and burdens are not shared equally, and the transaction is subject to the same challenges discussed herein in the context of the obligor-guarantor structure.

Another alternative, with significant substantive distinctions, is for a lender to re-

question then arises whether such guaranties give the lender a right to the assets of the guarantor equal to or, if the guaranty is secured, senior to that of the guarantor's other creditors. There are two principal theories on the basis of which other creditors might defeat such a preference. The guaranty and any supporting security transactions might be avoided under the law of fraudulent conveyances or, in the bankruptcy context, there might be an involuntary subordination of the lender's claim under the bankruptcy doctrine of equitable subordination.² This

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quire the loan proceeds to be distributed among the members of a corporate group *pro rata* and to hold each entity responsible in turn only for the consideration it actually received. This approach is seldom practical, however, because cash needs can vary greatly even among the members of a closely knit corporate group. Moreover, asset distribution among the group's members is often widely disparate, and the lender's credit determination, therefore, will likely emphasize the more substantial entities; it is only on the creditworthiness of the better endowed members that the others can obtain financing at all.

² As a general principle, the Bankruptcy Act provides for equality of distribution in the payment of a bankrupt's creditors. Section 65a of the Bankruptcy Act, 11 U.S.C. § 105(a) (1970), provides that "[d]ividends of an equal per centum shall be declared and paid on all allowed claims, except such as have priority or are secured." Other than § 64a of the Bankruptcy Act, 11 U.S.C. § 104(a) (1970), which specifically sets forth certain types of debts that shall be paid prior to the general creditors, no provisions in the Bankruptcy Act contravene the principle of equal distribution.

Notwithstanding the absence of statutory authority, however, the bankruptcy court can and does subordinate certain claims to others when the surrounding circumstances so warrant. The court's ability to subordinate these claims rests in its status as a court of equity. Section 2a of the Bankruptcy Act, 11 U.S.C. § 11(a) (1970), specifically vests "such jurisdiction at law and in equity as will enable [the courts] to exercise original jurisdiction in proceedings under this Act." (emphasis supplied). Furthermore, the authority of the bankruptcy court to exercise the power of equitable subordination has been recognized clearly by the Supreme Court in *Taylor v. Standard Gas & Elec. Co.*, 306 U.S. 307 (1939).

The scope and purpose of these equitable powers have been stated as follows:

[R]easons of equity may require that a claim or interest be subordinated to all other claims or interests or certain classes of them, such as where the holder is involved in a close interrelationship with the debtor and by some previous inequitable conduct is deemed estopped to claim parity with other claims or interests of the same class. The most common uses of subordination are to nullify the effect of any fraud that a creditor has committed, to prevent unjust enrichment from or redress a wrong arising out of a fiduciary relation, and to make the transactions of officers with a debtor corporation and between parent and subsidiary corporations conform to the realities of the situation before the court. Subordination is a means of regulating distribution results in reorganization by adjusting the respective order of claimants and stockholders to the equitable levels of their comparative claim positions in the proceeding. Its fundamental aim is to undo or offset any inequity in the position of a creditor or stockholder which will produce injustice or unfairness to the other creditors or stockholders in terms of reorganization results.

6A COLLIER ON BANKRUPTCY ¶ 9.15, at 259-61 (14th ed. 1972) (footnotes omitted).

The powers of equitable subordination may not be exercised indiscriminately, however; certain "operative facts" must exist before any equitable principle may be used to

defeat an otherwise valid claim. *In re Four Seasons Nursing Centers of America, Inc.*, 483 F.2d 599, 602 (10th Cir. 1973).

What, then, are the circumstances or facts in a given situation that will warrant the equitable subordination of a claim against a bankrupt? The most common uses of subordination, other than in the cases of consensual subordination, occur when:

- (1) A creditor has committed fraud in his dealings with the bankrupt; or
- (2) A creditor has been unjustly enriched by virtue of his fiduciary relationship with the bankrupt; or
- (3) There has been undue influence by a shareholder or officer on a corporate debtor, or improper dealings between parent and subsidiary corporations.

Obviously, the distinctions among these categories are not always drawn clearly, and often a claim will be subordinated as a result of a combination of these factors. Reported case law, however, does not appear to substantiate a claim for subordination under any of these three categories with respect to the claim of a lender, acting in good faith, that attempts to enforce a guaranty given by an affiliate or subsidiary of the borrower. Specifically, no precedent exists for finding either fraud or a fiduciary duty on the part of the lender. Furthermore, no cases indicate that a lender has acted unfairly or inequitably in taking a guaranty. The third category—undue influence upon a debtor by its parent or shareholders—has, interestingly, been judicially reviewed with respect to third-party lenders and is worthy of further discussion.

The idea of subordinating the claim of a parent corporation against a subsidiary corporation when a parent has used its position in a self-serving manner to the detriment of the subsidiary's creditors was first enunciated in *Taylor v. Standard Gas & Elec. Co.*, *supra*, a reorganization proceeding involving a debtor corporation completely controlled through common stock ownership by its parent. The court, after examining the evidence, determined that the unsecured claim of the parent as a creditor of the debtor must be subordinated to the claims of the debtor's preferred shareholders because of the parent's disastrous management of the subsidiary and the self-serving dealings of the parent with the subsidiary. This doctrine, which has come to be known as the "Deep Rock" doctrine (named after the debtor-subsidiary in *Taylor*), has been followed in many cases.

It is important to note, however, that the control of a subsidiary does not in itself require subordination of all claims of the parent against the subsidiary. As the court noted in *International Tel. & Tel. Corp. v. Holton*, 247 F.2d 178 (4th Cir. 1957):

Mere domination of a subsidiary corporation by a parent does not require the subordination of claims by the parent where the subsidiary is properly financed and managed. . . . Where the subsidiary, however, is controlled by the parent for its own purposes and without regard to the interest of the subsidiary, the claims of the parent should be subordinated, and this without proof of fraud or illegality.

Id. at 183 (citation omitted).

Taylor involved a technical parent-subsidiary relationship. The possibility of extending the *Taylor* doctrine was discussed in *Moulded Prods., Inc. v. Barry*, 474 F.2d 220 (8th Cir.), *cert. denied*, 412 U.S. 940 (1973), but rejected:

This case is not a proper one for the exercise of the power to subordinate or for an extension of the "Deep Rock" doctrine. In *Taylor*, the subsidiary was completely controlled by the parent, and the disastrous management decisions came from the parent. Here, the two products which caused Moulded Products' downfall were conceived and undertaken by the management of Moulded Products, which then approached Monsanto for financial backing. Although Monsanto did give financial backing to the project and encouraged Moulded Products to proceed, the evidence does not establish that it was primarily responsible for the financial disaster which occurred. On the contrary, the record reveals that Monsanto, in an effort to avoid anti-trust problems, refrained from involving itself in the management of Moulded Products.

Id. at 223.

It seems clear from this opinion that where a lender is not controlling or managing

Article analyzes the application of fraudulent conveyance law to these intercorporate guaranty agreements.

When the principal stockholder of a corporation guaranties repayment of its obligations, and collateralizes the obligation represented thereby by a security interest in the stockholder's assets, such a commitment by the principal protects the integrity and value of the principal's investment. The legal adequacy of the consideration cannot in such a case be seriously questioned, because protection of the value of the assets helps to assure repayment of the principal's direct creditors. Accordingly, no question of constructive or actual fraud on such creditors can be raised without additional allegations, and the obligation on the guaranty will be fully enforceable *pari passu* with the claims of direct creditors whether the "downstream" guarantor is an individual or a corporation. Legal difficulties must be faced, however, in the context of the guaranty by a subsidiary of the obligations of its parent (the "upstream" guaranty)³ or the guaranty by one corporation of the obligations of its affiliate (the "cross-stream" guaranty).⁴ In such a case, the consideration passing to the guarantying entity is not immediate and direct, but at best

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the affairs of a debtor, even if such lender acquires stock of the debtor, its claims may not be subordinated under the "Deep Rock" doctrine. Conversely, however, when a lender apparently has been involved actively in the management of the debtor and that management has been self-serving and disastrous to the debtor, the court will apparently find some form of fiduciary duty on the part of the lender, and its claim will be subordinated. See *In re Process-Manz, Inc.*, 236 F. Supp. 333, 348-49 (N.D. Ill. 1964), *rev'd on other grounds*, 369 F.2d 513 (7th Cir. 1966), *cert. denied*, 386 U.S. 957 (1967).

Research reveals no reported cases in which a lender that has advanced money to the parent of a debtor and has taken the guaranty of the debtor has been deemed to be in control of the debtor for purposes of subordination under the "Deep Rock" doctrine. Arguably, *Moulded Products* precludes subordination under the "Deep Rock" doctrine in the guaranty situation.

³ Typical circumstances in which a lender will require "upstream" guaranties are those in which its lending relationship is with a holding company and the bulk of the assets upon which the lender bases its credit judgment are distributed among the holding company's subsidiaries. In order to be in a position in which it reasonably can anticipate repayment out of the liquidation of those assets, the lender will require the subsidiaries to guaranty the obligation of the holding company and will frequently require that the guaranty of each subsidiary be secured by a security interest in its assets. If practical, the lender can be expected also to require the holding company to pledge the stock of the subsidiaries to it to secure the loan. The pledge of stock is not generally afforded great weight in the lender's credit determination because the subsidiaries' general creditors would still have priority over the lender in the subsidiaries' assets in a bankruptcy situation. A pledge of stock coupled with the "upstream" guaranties and collateral security, however, often gives the lender greater comfort.

⁴ The "cross-stream" guaranty is indicated in the case in which two or more corporations are wholly owned by the same principals, particularly where they are involved in related activities and share a common destiny. Thus, for example, when one entity owns the land and plant from which the operations of another are conducted and both are

subsequent (if some of the loaned funds eventually find their way to the guarantying corporation) and indirect (the guarantying entity may benefit from the strengthened financial position of the group as a whole). In this context, the question whether such subsequent and indirect consideration is legally sufficient to justify the lender's *pari passu* claim with general creditors to the assets of the guarantor, particularly with those general creditors who extended credit prior to the guaranty, is directly raised. The problem is exacerbated, of course, when the guaranty is collateralized by a security interest in all or some of the guarantor's assets, because the lender is then placed ahead of, rather than on a par with, prior, direct, unsecured creditors.

Despite a body of case law that has been developing since the enactment of the Statute of 13 Elizabeth in 1570,⁵ few, if any, cases deal squarely with the problem.⁶ This may be because such cases would tend to arise in a bankruptcy context, and decisions of bankruptcy judges are not officially reported and are generally unavailable;⁷ or because there is an institutional preference for settling rather than risking unfavorable case law; or because lawyers and judges simply have overlooked the issues. Moreover, this dearth of case law is not the only obstacle to reaching a clear conclusion. Although all states have inherited the Statute of 13 Elizabeth as part of their common law, only twenty-four states have adopted the Uniform Fraudulent Con-

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owned by the same person or persons, a cautious lender will require that the nonborrowing affiliate guaranty the obligation of the borrowing entity and, perhaps, collateralize the guaranty with a security interest in, or lien on, the assets of the guarantor.

⁵ 13 Eliz. c. 5 (1570). For an interesting discussion of the evolution of the law of fraudulent conveyances, see 1 G. GLENN, *FRAUDULENT CONVEYANCES AND PREFERENCES* §§ 58-62b (rev. ed. 1940).

⁶ The only case found that involves the "upstream" guaranty problem is *Zellerbach Paper Co. v. Valley Nat'l Bank*, 13 Ariz. App. 431, 477 P.2d 550 (1970). The court found that the mortgage given to secure both the indebtedness of the corporation and the corporation's guaranty of its sole stockholder's indebtedness constituted a fraudulent conveyance for lack of fair consideration. In comparing the value of the mortgage to the amount of the indebtedness, however, the court simply ignored the guaranty of the stockholder indebtedness: "The corporation's only 'antecedent debt' to the bank was the \$11,000. The \$47,500 personal debt of [the shareholder] is not to be considered in deciding whether West-Coast received fair consideration. The \$47,500 [shareholder] debt is neither a 'present advance' nor an 'antecedent debt' of West-Coast." *Id.* at 435, 477 P.2d at 554. Interestingly, therefore, the court focused only on the mortgage and ignored the guaranty, without ever directly confronting the question whether the guaranty, as opposed to the mortgage, could withstand attack as a fraudulent conveyance.

⁷ Decisions are selectively and unofficially reported in *CCH Bankruptcy Law Reports* (Commerce Clearing House) and *Bankruptcy Court Decisions Reporter* (Corporate Reorganization Reporter, Inc.).

veyance Act (UFCA) first promulgated in 1918.⁸ Thus, to the extent it is relevant, the nonconforming law of any number of other states must be consulted. Furthermore, the UFCA, a sparse, twelve-section statute, itself provides for the retention of prior law for the many situations that it does not cover.⁹ Finally, to complicate matters further, Congress adopted a slightly different version of the UFCA for incorporation into the Bankruptcy Act of 1898.¹⁰ The Bankruptcy Act, however, also subrogates the trustee to the rights of an existing creditor with standing to set aside a fraudulent conveyance under state law;¹¹ the trustee, therefore, typically will have his choice of proceeding under federal or state law.

With the preceding complications in mind, this analysis will focus on the UFCA and the Bankruptcy Act. The most frequently invoked substantive provisions of the fraudulent conveyance statute, in both the UFCA and Bankruptcy Act versions, will be analyzed for their effect upon intercorporate guaranties. Special attention will be paid to the definitions provided in the two statutes. The examination will then turn to the operation of a saving clause that may be available to the lender once a fraudulent conveyance is proved. Finally, some limited solutions for minimizing the probability of attack will be suggested.

II. CONVEYANCES AND OBLIGATIONS WITHOUT FAIR CONSIDERATION THAT RENDER THE GUARANTOR INSOLVENT

The first and most important substantive provision of the UFCA states: "Every conveyance made and every obligation in-

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⁸ UNIFORM FRAUDULENT CONVEYANCE ACT, in 7 UNIFORM LAWS ANN. (master ed. supp. 1976) [hereinafter cited as UFCA].

The UFCA has been adopted in the following jurisdictions: Ariz. (1919); Cal. (1939); Del. (1919); Idaho (1969); Md. (1920); Mass. (1924); Mich. (1919); Minn. (1921); Mont. (1945); Nev. (1931); N.H. (1919); N.J. (1919); N.M. (1959); N.Y. (1925); N.D. (1943); Ohio (1961); Okla. (1965); Pa. (1921); S.C. (1919); Tenn. (1919); Utah (1925); V.I. (1957); Wash. (1945); Wis. (1919); Wyo. (1929). 7 UNIFORM LAWS ANN. 269 (master ed. supp. 1976).

⁹ UFCA, *supra* note 8, at § 11.

¹⁰ Bankruptcy Act § 67d, ch. 541, 30 Stat. 564 (1898), *as amended*, 11 U.S.C. § 107(d) (1970).

¹¹ Bankruptcy Act § 70e(1), 11 U.S.C. § 110(e)(1) (1970). Even assuming identical substantive law, proceeding under § 70e rather than § 67d gives the trustee the benefit of both the state statute of limitations, rather than the one-year limitation in § 67d, and the clear application of the principle of *Moore v. Bay*, 284 U.S. 4 (1931). Under this principle, the trustee may avoid a transaction *in toto* for the benefit of the estate even though the creditor to whose rights he is subrogated may have been able to avoid the transaction only in part had he exercised his state-created rights in his own behalf. No case considers whether *Moore* is applicable to a § 67d cause of action, although consistency of result would compel an affirmative response.

curred 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."¹² The Bankruptcy Act contains a similar provision.¹³ Giving a guaranty is unquestionably an "obligation incurred,"¹⁴ and granting a security interest in assets to collateralize that guaranty is unquestionably a "conveyance" within the meaning of the statutory provisions.¹⁵ The crucial inquiry, then, concerns the meaning of "fair consideration" and "insolvency."

Because the reconstruction of a corporation's actual financial condition as of a prior specific relevant date presents obviously enormous difficulties to the trier of fact, decisions based on the foregoing provision inevitably analyze first whether fair consideration was given for the obligation incurred or property transferred. Only in the absence of fair consideration does the

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¹² UFCA, *supra* note 8, at § 4.

¹³ (2) Every transfer made and every obligation incurred by a debtor within one year prior to the filing of a petition initiating a proceeding under this Act by or against him is fraudulent (a) as to creditors existing at the time of such transfer or obligation, if made or incurred without fair consideration by a debtor who is or will be thereby rendered insolvent, without regard to his actual intent; . . .

Bankruptcy Act § 67d(2)(a), 11 U.S.C. § 107(d)(2)(a) (1970).

¹⁴ *Thomason v. Crane*, 73 F. 327 (C.C.D. Nev. 1896); *Cating Rope Works, Inc. v. Johnson*, 22 Misc. 2d 284, 200 N.Y.S.2d 673 (Sup. Ct. 1960); *see Zellerback Paper Co. v. Valley Nat'l Bank*, 13 Ariz. App. 431, 477 P.2d 550 (1970); *Roxbury State Bank v. The Clarendon*, 129 N.J. Super. 358, 324 A.2d 24, *cert. denied*, 66 N.J. 316, 331 A.2d 16 (1974); *Chase Nat'l Bank v. United States Trust Co.*, 236 App. Div. 500, 260 N.Y.S. 40 (1932), *aff'd*, 262 N.Y. 557, 188 N.E. 63 (1933); *Everdell & Longstreth, Some Special Problems Raised by Debt Financing of Corporations Under Common Control*, 17 Bus. Law. 500 (1962).

¹⁵ "Conveyance" includes . . . the creation of any lien or incumbrance." UFCA, *supra* note 8, at § 1; *see Zellerback Paper Co. v. Valley Nat'l Bank*, 13 Ariz. App. 431, 477 P.2d 550 (1970); *Roxbury State Bank v. The Clarendon*, 129 N.J. Super. 358, 324 A.2d 24, *cert. denied*, 66 N.J. 316, 331 A.2d 16 (1974).

The Bankruptcy Act departs from the language of the UFCA by utilizing the word "transfer" in place of "conveyance." Bankruptcy Act § 67d(2), 11 U.S.C. § 107(d)(2) (1970). Section 1 of the Bankruptcy Act defines "transfer" as follows:

(30) "Transfer" shall include the sale and every other and different mode, direct or indirect, of disposing of or of parting with property or with an interest therein or with the possession thereof or of fixing a lien upon property or upon an interest therein, absolutely or conditionally, voluntarily or involuntarily, by or without judicial proceedings, as a conveyance, sale, assignment, payment, pledge, mortgage, lien, encumbrance, gift, security, or otherwise; the retention of a security title to property delivered to a debtor shall be deemed a transfer suffered by such a debtor . . .

Bankruptcy Act § 1(30), 11 U.S.C. § 1(30) (1970) (emphasis supplied); *see Corn Exch. Nat'l Bank & Trust Co. v. Klauder*, 318 U.S. 434 (1943); *United Towing Co. v. Phillips*, 242 F.2d 627 (5th Cir.) *cert. denied*, 355 U.S. 861 (1957); *In re Farm & Home Co.*, 84 F.2d 933 (6th Cir. 1936).

trier of fact proceed to a consideration of the financial situation of the transferor on the relevant date.

A. *Fair Consideration*

The UFCA contains the following definition:

Fair consideration is given for property, or obligation,

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

(b) When such property, or obligation is received in good faith to secure a present advance or antecedent debt in amount not disproportionately small as compared with the value of the property, or obligation obtained.¹⁶

The Bankruptcy Act version of the UFCA contains a substantively identical definition, although it is presented in a somewhat different order.¹⁷ The provision contains separate measures of fair consideration for two different types of transfer: the first part covers outright transfers and assumptions of obligations, while the second part refers to transfers for security. When an outright transfer or assumption of an obligation occurs, the transferor must receive "a fair equivalent" for there to be fair consideration. When, however, the property is given as security, the advance to the transferor or the transferor's antecedent debt need only be "not disproportionately small" as compared to the value of the property transferred.¹⁸ The different language seems to allow considerably more leeway, in terms of discrepancy of value, in the security transfer than in the outright transfer context. In the context of the issue at hand, this means that, if sufficient consideration is found to support the guaranty, it

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¹⁶ UFCA, *supra* note 8, at § 3.

¹⁷ d(1). For the purposes of, and exclusively applicable to, this subdivision d . . . (e) consideration given for the property or obligation of a debtor is "fair" (1) when, in good faith, in exchange and as a fair equivalent therefor, property is transferred or an antecedent debt is satisfied, or (2) when such property or obligation is received in good faith to secure a present advance or antecedent debt in an amount not disproportionately small as compared with the value of the property or obligation obtained.

Bankruptcy Act § 67d(1)(e), 11 U.S.C. § 107(d)(1)(e) (1970).

¹⁸ The distinction is simply an acknowledgment of commercial practice. *See, e.g., Epstein v. Goldstein*, 107 F.2d 755 (2d Cir. 1939); 4 COLLIER ON BANKRUPTCY ¶ 67.33 (14th ed. 1975).

should be relatively easy to insulate the security interest from attack for lack of fair consideration by limiting the collateral taken to an amount that is only in "reasonable" excess of the value of the guaranteed obligation.

1. Consideration for the Guaranty

Thus, the threshold question is whether consideration passing to a third party guarantor is sufficient under the above definition to support an "upstream" or "cross-stream" guaranty. A simple hypothetical will be useful. Suppose that P wishes to borrow money from Bank, but Bank requires that the loan be guaranteed by S, an insolvent subsidiary of P, and that the guaranty be collateralized by either a security interest in, or hypothecation of, the assets of S. Does S under these circumstances receive "fair consideration" in exchange for its guaranty and lien or hypothecation?

One line of cases supports the proposition that while the agreement of a creditor to extend a debtor's time for payments, or to forbear suing on the claim, constitutes a "valuable" consideration for the promise of a third party to pay a debt, such "valuable" consideration is not synonymous with "fair" consideration under the statute.¹⁹ Such cases interpret the language of the definition literally. Either property must be conveyed to the transferor or an antecedent debt of the transferor must be satisfied for there to be fair consideration. Such a literal reading requires receipt of a balance sheet asset or cancellation of a balance sheet liability to qualify as fair consideration. Under this interpretation, probably no guaranty, except perhaps a "downstream" guaranty, in the situation described could be given for fair consideration. Therefore, any guaranty could withstand attack only to the extent that the guarantor was solvent at the point that the obligation of guaranty was incurred.

The narrow definition of fair consideration discussed above may be brittle and may not accord with financial realities. In the context of a group of closely held corporations, some courts have shown a willingness to ignore the technical separateness of the entities in deciding whether fair consideration has been received, particularly in the situation in which recovery is sought from a

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¹⁹ *Davis v. Hudson Trust Co.*, 28 F.2d 740, 742-43 (3d Cir.), *cert. denied*, 278 U.S. 655 (1928); *see In re B-F Bldg. Corp.*, 312 F.2d 691 (6th Cir. 1963); *Edward Hines W. Pine Co. v. First Nat'l Bank*, 61 F.2d 503 (7th Cir. 1932); *Bennett v. Rodman & English, Inc.*, 2 F. Supp. 355 (E.D.N.Y.), *aff'd mem.*, 62 F.2d 1064 (2d Cir. 1932).

transferee who originally supplied the funds—a lender.²⁰ Such an approach, however, has been based upon a finding that even though the loan or property given went to a specific entity, all of the legally separable, but factually inseparable, parts of the entity benefited thereby.²¹ This approach, then, has not advanced beyond the inadequate general rule, and, ironically, the lender's position may vary inversely with the degree to which the borrowing entities observe the legal niceties of separation of operations.²² It may be questioned whether such a result leads to sound

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²⁰ See, e.g., *Mayo v. Pioneer Bank & Trust Co.*, 270 F.2d 823 (5th Cir. 1959), *cert. denied*, 362 U.S. 962 (1960). The court was careful to point out, however, that "usually a diversion of corporate assets for the benefit of a third person . . . is a transfer without 'fair consideration.'" *Id.* at 829 (footnote omitted).

²¹ The Sixth Circuit in *Mayo* gave the following explanation for its finding of fair consideration:

There was such a degree of identity and commingling of affairs between Twin City and Gray that the corporation and its sole stockholder cannot be regarded as separate legal entities, insofar as the \$50,000 loan is concerned. Gray was the sole stockholder. The corporate resolutions authorized Gray to act for Twin City in whatever way he saw fit, and authorized the Bank to honor Twin City checks drawn by Gray to pay personal debts. The loan was made on Gray's credit, but the proceeds inured immediately to Twin City's credit and the ostensible purpose of the loan, as stated to the bank, was to enable Gray to do business as Twin City Construction Company instead of W.A. Gray Construction Company. The hidden purpose was to enable Gray to obtain a performance bond in the name of Twin City that Twin City was not entitled to on the state of its finances and that Gray could not obtain on the state of his finances. After this object was accomplished, and before Twin City could even begin a separate existence, Twin City, through Gray, paid back the identical money lent to Gray and deposited in the corporate account only twelve days before. From the beginning to the end of the transaction Gray as Gray, or Gray as Twin City, made no effort to separate himself from his corporation—so far as the bank is concerned. To the extent that Gray is separable from Twin City, the loan was for the benefit of Twin City; if the loan was for the benefit of Gray, the bank had no alternative, under the language of the resolutions, to honoring Gray's signature and instructions.

It is one thing to observe the corporate fiction as if the fiction were the truth—when the fiction is not abused. It is quite a different thing when the sole stockholder either ignores the corporation as a separate entity or uses the corporate fiction as an instrument of deceit. Here, the corporation and the individual owner were two sides of a single false coin.

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The requirement of "fair consideration" is aimed at preventing a bankrupt depleting his estate just preceding his bankruptcy either by improvidence or by action intended to defeat creditors or favor friends. As we read the statute in the light of its purpose, we think that the voidable transfer provisions were never intended to apply to this case.

Id. at 830.

²² As an illustration, in an integrated multisubsidiary corporate structure, the dominant parent corporation may funnel its product through a myriad of different entities in the distribution chain. Different products ultimately may be marketed by any number of legally distinct subsidiaries or subsidiaries of subsidiaries, all wholly owned, under different brand names. In fact, production and financial planning occurs only at

lending practices or strikes an appropriate balance among the various claimants to the estate of the borrower and guarantor, for it tends to recognize financial reality only when it is highlighted through legal laxity.

Several other courts have better rationalized upholding various transfers against fraudulent conveyance challenges by finding that sufficient consideration passed to the transferor because an opportunity had been given to it to escape bankruptcy through the strengthening of an affiliated corporation that received the benefit of the transfer.²³ Such an approach seems indisputably proper when a weak but still solvent entity is rendered insolvent only because of the inclusion of the guaranty on the liability side of the balance sheet.²⁴ This permits the analysis to focus upon economic reality in the appropriate factual context without rewarding legal laxity or inflexibly ignoring real benefits merely because they have no place on the company's balance sheet.²⁵

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the very top level of the structure. All entities operate under the direct control of common management, which retains responsibility for all decisionmaking and even, perhaps, for day-to-day operations. Financial institutions, understandably, are inclined to look at the group as a whole with different divisions, inextricably linked together.

²³ In *Williams v. Twin City Company*, 251 F.2d 678 (9th Cir. 1958), the bankrupt purchased a supply of lumber from the defendant on credit and, to secure its obligation, transferred certain warehouse receipts to defendant. Eventually, the bankrupt defaulted and a refinancing agreement involving a third party was reached. The bankrupt transferred all of his inventory and accounts receivable to a trustee for the benefit of the third party who guaranteed a promissory note of the bankrupt payable to the defendant. The defendant transferred the warehouse receipts to the third-party guarantor but retained a security interest in them to secure the guaranty of the bankrupt's note. Ultimately, the trustee sought to set aside, as a fraudulent conveyance, the transfer of assets to the trust. The Ninth Circuit denied the trustee's claim:

Consideration for the execution of the note by Elliff [the bankrupt] was the release to Mrs. Lannin [the third party] by the defendants of the warehouse receipts. The direct consideration did not run from the creditors to Elliff, but it is not essential that it do so. Consideration can run to a third party, so long as it is given in exchange for the promise sought to be enforced. This was done here. There was indirect benefit to Elliff by giving him a further chance to avoid bankruptcy—further time. 11 U.S.C.A. § 107, sub. d(1)(e), in defining fair consideration, merely requires a transfer, not a transfer to the debtor. We agree with the trial court that there was consideration.

Id. at 681. *Williams* is even more noteworthy because the court held that an indirect benefit may constitute fair consideration; note, however, that the transferor-bankrupt was the original debtor. In *McNellis v. Raymond*, 287 F. Supp. 232 (N.D.N.Y. 1968), *modified*, 420 F.2d 51 (2d Cir. 1969), the postponement of bankruptcy, an indirect benefit arising out of the transfer sought to be set aside, was held to constitute fair consideration. *But see Zellerbach Paper Co. v. Valley Nat'l Bank*, 13 Ariz. App. 431, 477 P.2d 550 (1970), *discussed in* note 6 *supra*.

²⁴ For a discussion of the balance sheet effects of a guaranty, see text accompanying note 50 *infra*.

²⁵ The same analysis presumably would apply to the conveyance of a security in-

Such an approach would lead to a finding of fair consideration for a guaranty in a variety of other appropriate contexts. If an alter ego situation presents sufficient consideration, then so should the guaranty of a loan to a third party that is not the alter ego of the guarantor but whose continued health and existence is vitally important to the guarantor—a vital supplier or customer, for example. Under this approach, fair consideration to the guarantor could be found without much difficulty when the loan to the affiliated corporation strengthens its operation sufficiently so that the health of the guarantor is maintained or improved, even though bankruptcy was not imminent. Unfortunately, however, no reported cases have gone so far, and the line of cases²⁶ interpreting the definition in a harshly literal way cannot be ignored.

2. Consideration for the Security Interest

Can fair consideration be found for giving a guaranty itself but not for granting a security interest on the property of the guarantor collateralizing the obligations? The test is that the loan guaranties must not be “disproportionately small” as compared to the property transferred.²⁷ Thus, if the guaranty is given for what is found to be fair consideration, and the guaranty represents a contingent obligation to pay, for example, \$10,000, then granting a security interest in machinery worth \$10,000 is necessarily for “fair consideration” within the meaning of the statute.

Suppose, however, that the lender takes a blanket lien on all of the assets of the guarantor that are found to have a value in excess of \$100,000. Because a sale of those assets for \$10,000 would clearly not be for fair consideration, the question presented is whether granting a security interest²⁸ in such property has the same effect as a sale. Because the secured party (the

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terest to secure an “upstream” guaranty or to a hypothecation of assets for the benefit of the borrowing entity.

²⁶ Cases cited note 19 *supra*.

²⁷ UFCA, *supra* note 8, at § 3; Bankruptcy Act § 67d, 11 U.S.C. § 107(d) (1970).

²⁸ For the purpose of continuity, throughout this discussion all security devices are referred to as “security interests.” This will help to relate all such security devices to Article 9 of the Uniform Commercial Code by using the terminology adopted by the Code. Generally speaking, however, the words “mortgage” or “lien” could be substituted wherever “security interest” appears. Thus, the use of Code terminology is not intended to ignore the fact that the Code applies only to personal property. UNIFORM COMMERCIAL CODE § 9-102. The principles discussed herein apply equally to real property mortgages.

lender) would only be entitled, even upon repossession and sale of all the assets, to an amount equal to the debt owed to it by the debtor, it would seem logical that all that was transferred by way of the mortgage was a \$10,000 interest in the assets. Unfortunately, this simple logic has not been adopted by the courts. Some cases indicate that, in determining fair consideration when a security interest is involved, the test of "disproportionately small" is made by comparing the amount of the loan with the full value of the property that is subject to the security interest.²⁹ This result seems illogical but appears to be the law nevertheless.³⁰ The possibility exists that the result might be avoided if the security interest were limited specifically to the amount of the debt, but no direct authority supports such a conclusion.

Accordingly, despite the illogic of the result, the lender, in taking a security interest from a guarantor, must limit that interest to collateral not "disproportionately" in excess of the debt that it is securing. Because satisfaction of an antecedent debt may constitute valid consideration under these provisions,³¹ a subsequent adjustment of the relationship of collateral to indebtedness can be made if the value of the collateral declines and the guarantor is either willing or contractually bound to do so. Although this exercise would appear to be void of substance,

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²⁹ See *Commonwealth Trust Co. v. Reconstruction Fin. Corp.*, 120 F.2d 254 (3d Cir. 1941); *In re Decker*, 295 F. Supp. 501 (W.D. Va. 1969), *aff'd per curiam sub. nom.* *Woodson v. Gilmer*, 420 F.2d 378 (4th Cir.), *cert. denied*, 399 U.S. 928 (1970). But see *Shay v. Gagne*, 275 Mass. 386, 176 N.E. 200 (1931); *Stark v. Flemington Nat'l Bank & Trust Co.*, 38 N.J. Super. 58, 118 A.2d 114 (1955).

In *Shay v. Gagne*, *supra*, the court said:

Here the mortgage was received by the mortgagee as security against loss from future contingent liabilities resulting from indorsements previously made . . . . [S]uch liabilities were antecedent debts. They were not "disproportionately small" in amount . . . . The mortgage, when given, was for an amount not in excess of the mortgagee's future contingent liabilities on his indorsements and, consequently, *was not greater in amount than was necessary to secure fully the mortgagee against such liabilities.*

275 Mass. at 390-91, 176 N.E. at 201-02 (emphasis supplied). Note that the comparison is between the obligation secured and the amount of the mortgage, rather than between the obligation secured and the value of the mortgaged property. It would seem that the comparison made in *Shay* is the proper one.

³⁰ The only apparent logical reason would seem to be that the assets pledged to secure the obligation are no longer freely marketable and, for example, cannot be used as security should the debtor need additional financing. While this is certainly true of some assets, such as accounts receivable, it is not necessarily the case with all. In the case of real estate and other fixed assets, for example, second mortgage financing can usually be found, albeit at higher interest rates.

³¹ Bankruptcy Act § 67d(1)(e), 11 U.S.C. § 107(d)(1)(e) (1970).

because a secured creditor is never entitled to more of the proceeds from the sale of a security than the obligation secured plus interest and costs, it may be necessary, nonetheless, in light of the existing case law.

3. Good Faith

To this point, only half of the statutory requirements for fair consideration have been dealt with. In addition to the requirement that adequate value pass, the transfer must also be made "in good faith."³² This requirement is somewhat peculiar because it adds a subjective element to what is otherwise an objective determination; it thus raises the question whether the draftsmen of the UFCA were true to their announced goals. In separating out certain of the "badges of fraud"³³ that had developed under the Statute of 13 Elizabeth and were capable of objective proof, and in making them irrebuttable presumptions of fraud, the draftsmen intended to require, in all other cases, proof, without the benefit of presumptions, of a subjective actual intent to defraud. Here, however, a hybrid remains: proof of the subjective lack of good faith, which is clearly something less than intent to defraud, plus proof of the objective fact of insolvency, equals voidability. What, then, does "good faith" mean?

The first question is whose good faith is relevant, the lender's or the guarantor's? The definition of fair consideration

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³² *Id.*; *Cohen v. Sutherland*, 257 F.2d 737 (2d Cir. 1958); *Inland Security Co. v. Estate of Kirshner*, 382 F. Supp. 338 (W.D. Mo. 1974).

³³ The Statute of 13 Elizabeth imposed criminal penalties upon transfers of property that "are devised and contrived of malice, fraud, covin, collusion, or guile, to the end purpose and intent, to delay, hinder or defraud creditors and offers of their just and lawful actions . . ." 13 Eliz. c. 5 (1570) (emphasis supplied). Predictably, intent was inordinately difficult to prove, and, beginning with *Twyne's Case*, 3 Co. Rep. 806, 76 Eng. Rep. 809 (Star Chamber 1607), the courts began to enunciate "badges of fraud"—fact patterns that would give rise to presumptions of intent to defraud. Literally dozens of "badges" were developed over the centuries. The draftsmen of the UFCA, in their prefatory note, cited as one of three conditions primarily responsible for the confusions and inconsistencies of the existing law the "attempt to make the Statute of Elizabeth cover all conveyances which wrong creditors, even though the actual intent to defraud does not exist." 7 UNIFORM LAWS ANN. 424 (master ed. 1970).

From that premise, the draftsmen attempted to sanction a few of the badges and eliminate the rest:

In the Act as drafted all possibility of a presumption of law as to intent is avoided. 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 (see Section 7) are declared fraudulent, it is expressly stated that the intent must be "actual intent, as distinguished from intent presumed as a matter of law."

Id.

is drafted in terms of what is given by the transferee (the lender) in exchange for the property of the transferor, and, accordingly, it would seem that it is the good faith of the transferee that is relevant. The conclusion is well supported by the available judicial construction.³⁴

One test frequently employed to determine what constitutes "good faith" on the part of the lender is whether the transaction "carries the earmarks of an arm's length bargain."³⁵ The phrasing of this test in terms of the arm's length quality of the bargain indicates a primary concern with "insider" conduct. Thus, as would be expected, the cases that enunciate this standard tend to involve insiders of the transferee.³⁶ Courts seem to strain to find a lack of good faith in this context.³⁷ The implications of these

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³⁴ See, e.g., *Cohen v. Sutherland*, 257 F.2d 737 (2d Cir. 1958); *Inland Security Co. v. Estate of Kirshner*, 382 F. Supp. 338 (W.D. Mo. 1974); *De Aragon v. Chase Manhattan Bank*, 322 F. Supp. 1006 (D.P.R. 1971), *aff'd*, 457 F.2d 263 (1st Cir. 1972). The leading treatise on bankruptcy is in accord:

"Grammatically considered, at least, the definition seems to indicate that the good faith of the transferee is all that matters." 4 COLLIER ON BANKRUPTCY ¶ 67.33, at 506 n.5 (14th ed. 1975).

³⁵ *Holahan v. Henderson*, 277 F. Supp. 890, 898-99 (W.D. La. 1967), *aff'd per curiam*, 394 F.2d 177 (5th Cir.), *cert. denied*, 393 U.S. 848 (1968); *accord*, *Bullard v. Aluminum Co. of America*, 468 F.2d 11, 13 (7th Cir. 1972); *Inland Security Co. v. Estate of Kirshner*, 382 F. Supp. 338, 350 (W.D. Mo. 1974); *cf.* *Pepper v. Litton*, 308 U.S. 295, 305-07 (1939) ("arm's length" test applied in an equitable subordination context).

³⁶ E.g., *Bullard v. Aluminum Co. of America*, 468 F.2d 11 (7th Cir. 1972); *Inland Security Co. v. Estate of Kirshner*, 382 F. Supp. 338 (W.D. Mo. 1974).

³⁷ In *Inland Security Co. v. Estate of Kirshner*, 382 F. Supp. 338 (W.D. Mo. 1974), Kirshner filled the respective roles of president, director, controlling shareholder and a "client" of the bankrupt. In return for a service fee, the bankrupt serviced its clients by collecting monies due on securities owned by the clients and disbursing the funds to the clients periodically. Funds collected for Kirshner's account were put into the bankrupt's general operating account and were consumed in the business of the bankrupt, not paid out to him. About eight months prior to filing a petition in bankruptcy, Kirshner transferred to himself, as a partial payment of the amount owed him, a secured promissory note issued by a local church.

Observing that the bankrupt was in precarious financial condition at the time of the transfer—a fact of which Kirshner was well aware—the court found a lack of good faith in the transaction:

A review of the record shows that Mr. Kirshner was the President, Director, managing officer and controlling stockholder of the bankrupt. Although he was formally referred to as a "client," it is apparent that Mr. Kirshner was the alter-ego of the bankrupt. The affairs and management of the bankrupt were dominated by Mr. Kirshner. The unsecured open account which was credited periodically by the bankrupt in favor of Mr. Kirshner was essentially a "... corporate pocket of the dominant stockholder, who, with disregard of the substance or form of corporate management, has treated its affairs as his own." *Pepper v. Litton*, 308 U.S. 295, 309, 60 S.Ct. 238, 246, 84 L.Ed. 281, 291 (1939); *Duberstein v. Werner*, 256 F. Supp. 515, 521 (E.D.N.Y. 1966). Mr. Kirshner was the alter-ego of the bankrupt. See, *Holahan v. Henderson*, 277

cases should not be troublesome in the context of the establishment of new lending relationships, but may become important in the context of continuing relationships, and particularly in

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F.2d 890, 898 (W.D. La. 1967), affirmed, 394 F.2d 177 (5th Cir. 1968).

Under these circumstances, the transaction of February 28, 1971, and Mr. Kirshner's dealings with the bankrupt must be subjected to "rigorous scrutiny." With respect to the challenged transaction "... the burden is on the director or stockholder not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein." *Pepper v. Litton*, 308 U.S. 295, 306, 60 S.Ct. 238, 245, 84 L.Ed. 281, 289 (1939); *Geddes v. Anaconda Copper Mining Co.*, 254 U.S. 590, 599, 41 S.Ct. 209, 65 L.Ed. 425, 432 (1921). "The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain." *Pepper v. Litton*, *supra*; *accord*, *Bullard v. Aluminum Company of America*, *supra*; *Holahan v. Henderson*, *supra*.

....

Furthermore, because of his position as President, Director, managing officer and controlling stockholder of the bankrupt, Mr. Kirshner's actions with respect to the transaction of February 28, 1971, must be viewed in light of his fiduciary relationship to the bankrupt. ... [T]he fiduciary relationship between Mr. Kirshner and the bankrupt, stockholders and creditors of the bankrupt had to be one of trust and confidence. This relationship imposed upon Mr. Kirshner the burden and duty of acting with utmost good faith in the best interests of the bankrupt, stockholders and creditors of the bankrupt, and required him to refrain from exploiting his position while in a strategic position of the highest trust, for his own personal profit and to the detriment of the bankrupt, stockholders, or creditors of the bankrupt.

Id. at 348-49.

In *Bullard v. Aluminum Co. of America*, 468 F.2d 11 (7th Cir. 1972), the transferor validly owed to the transferee a debt that was guarantied by the holder of 15% of the stock of the transferor. Thereafter, the transferor paid the defendant approximately one-half of the antecedent debt in full and final satisfaction thereof, and the defendant released the guarantor from its judgment. On the date of the settlement agreement, the transferor was insolvent. The court, emphasizing the relationship of the parties involved, found the transaction fraudulent:

Considering all the facts that attended this transaction we agree with the district court that the transfer was fraudulent within the meaning of § 67d(2)(a) of the Bankruptcy Act. We find most significant the relationship of the parties to the settlement agreement and the respective allocation of its benefits. Henry Kritzer, the President of the bankrupt as well as a director and stockholder of Bastian Morely, was released entirely and without any consideration on his part from a legally enforceable state court judgment against him. Moreover, Bastian Morely, the principal stockholder of the bankrupt, was permitted to retain its supplier and, for a consideration, extinguished its own antecedent debt to Alcoa. Finally, Alcoa acquired an advantage over the other creditors of the bankrupt at a time when Alcoa was certainly aware of the precarious financial position of Kritzer Radiant.

Id. at 13-14. The court in this analysis completely ignored that the bankrupt was equally liable upon the obligation as the guarantor and that, had the guarantor satisfied the obligation, he would have had a cause of action against the bankrupt corporation. If this result were to be taken literally, the holder of an antecedent debt could never be certain that he would be acting appropriately in accepting payment thereon, particularly if a third-party guarantor exists. Such a result, it is submitted, is contrary to commercial sense and is clearly erroneous.

work-out situations.³⁸ When a borrower is free to reject a lender's terms and to seek credit elsewhere, no problem of good faith in this context is involved. When, however, the lender is represented on the borrower's board of directors and thereby has a substantial influence on corporate policy, and, more importantly, when the lender is in a position to call a default if, for example, a guaranty and collateral for that guaranty are not forthcoming from the borrower's subsidiary, the "arm's length" standard may be applicable, and the lender is well advised to proceed with due caution.³⁹

Another standard of good faith that has been applied by some courts is whether the transferee knew or strongly suspected that the transferor was insolvent.⁴⁰ It may be questioned whether this standard comports with the draftsmen's intent in isolating this badge of fraud for objective treatment. The cause of action seems to require proof of two separate elements—lack of fair consideration, and insolvency—neither one of which is alone sufficient to establish a fraudulent conveyance without proof of actual intent to delay, hinder, or defraud creditors. Under the statute, absent such proof, a transfer by an insolvent company for fair consideration is valid, and a transfer without fair consideration by a solvent company is unchallengeable. When fair consideration is defined in terms of insolvency, however, the two elements become inseparable, with the result that a transfer by an insolvent corporation for objectively good consideration is voidable if the transferee knew or had reason to know of the insolvency. That, it is submitted, was not the intended meaning of the provision, and it harms the statutory scheme.⁴¹

The implications of these cases in the current context, how-

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³⁸ See, e.g., *In re Process-Manz Press, Inc.*, 236 F. Supp. 333 (N.D. Ill. 1964), *rev'd on other grounds*, 369 F.2d 513 (7th Cir. 1966), *cert. denied*, 386 U.S. 957 (1967).

³⁹ See generally Douglas-Hamilton, *Creditor Liabilities Resulting from Improper Interference with the Management of a Financially Troubled Debtor*, 31 Bus. Law. 343 (1975).

⁴⁰ *Cohen v. Sutherland*, 257 F.2d 737 (2d Cir. 1958), *In re Southern Land Title Corp.*, 316 F. Supp. 1059 (E.D. La. 1970), *aff'd*, 474 F.2d 1033 (5th Cir. 1973). *But see* *Nicklaus v. Peoples Bank & Trust Co.*, 258 F. Supp. 482, 486 (E.D. Ark. 1955), *aff'd per curiam*, 369 F.2d 683 (8th Cir. 1966).

Other courts have required, as a prerequisite to a finding of bad faith, that the transferee have knowledge that the transferor's purpose in effecting the transaction was to defeat the claims of the transferor's other creditors. *Gilmer v. Woodson*, 332 F.2d 541, 546-47 (4th Cir. 1964) (good faith in valuing the property exchanged was also required); *In re Messenger*, 32 F. Supp. 490, 494 (E.D. Pa. 1940). This test obviously requires much more than a suspicion of insolvency and, when applied, should provide little threat to the transaction.

⁴¹ See note 33 *supra*.

ever, are clear: a lending institution may be held to a standard that will not permit it to ignore the financial condition of the other contracting parties. Therefore, a guaranty and a lien on the assets securing the guaranty of a subsidiary or affiliate of a borrower may be voidable if the guarantor was insolvent on the date of the transaction or is rendered insolvent thereby, and if, should bankruptcy intervene, a present creditor of the guarantor remained unpaid on the date of bankruptcy. This conclusion could not possibly be drawn from reading the statute itself and could lead to manifestly unfair results where a lender is using its best efforts to attempt to rehabilitate a failing business and protect itself at the same time. Nevertheless, the implication cannot be ignored, and the lender would be well advised to proceed with the utmost caution in a situation approaching insolvency, even when everyone's ostensible purpose is to perform a rescue operation.

B. *Insolvency*

It must be concluded that, in the framework of institutional lending, the financial condition of the guarantor may become the central consideration. It enters into both elements of proof for the avoidance of a guaranty and/or security interest in the context of the provision being examined. The relevant inquiry, then, is how, and as of what date, the financial condition of the guarantor is determined.

1. The Date on Which Insolvency Is Determined

The relevant date for the determination of insolvency is undoubtedly the date of transfer—the date on which the obligation is incurred or the date on which the lien is granted in the assets. The Bankruptcy Act refines this concept slightly by defining when the transfer takes place:

For the purposes of this subdivision (d), a transfer shall be deemed to have been made at the time when it became so far perfected that no bona fide purchaser from the debtor could thereafter have acquired any rights in the property so transferred superior to the rights of the transferee therein, but, if such transfer is not so perfected prior to the filing of the petition initiating a proceeding under this Act, it shall be deemed to have been made immediately before the filing of such petition.⁴²

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⁴² Bankruptcy Act § 67d(5), 11 U.S.C. § 107(d)(5) (1970).

Thus, under the Bankruptcy Act version of the UFCA, a transfer represented by an unperfected security interest in personal property or unrecorded mortgage on real property will be deemed to have taken place on the date of bankruptcy⁴³—when the transferor most probably was clearly insolvent⁴⁴—rather than on the date upon which the security interest was granted—the date probably relevant under state law where the concept of transfer has not been refined. Accordingly, the date for testing insolvency under the Bankruptcy Act may be months, or even years, later than the relevant date under state law.⁴⁵ This discussion, however, will assume a sophisticated and diligent lender which immediately perfects its rights under state law and thereby cuts off any intervening rights of a potential bona fide purchaser. On this basis, then, under either state law or federal law pursuant to the Bankruptcy Act, the date on which the financial condition of the guarantying entity must be reconstructed is the date on which the obligation is incurred or the lien is granted.

2. Insolvency Defined

The UFCA defines insolvency as follows: "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."⁴⁶ The fraudulent conveyance provisions of the Bankruptcy Act contain their own definition of insolvency that supersedes the general definition for the rest of that statute: "A person is 'insolvent' when the present fair salable value of his property is less than the amount required to pay his debts."⁴⁷ Insolvency is easier to prove under this definition than under the general bankruptcy definition,⁴⁸ for the other definitions in the section and under

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⁴³ See *Jackson Sound Studios, Inc. v. Travis*, 473 F.2d 503 (5th Cir. 1973); *Phillips v. Wier*, 328 F.2d 368 (5th Cir. 1968). See also *Kindom Uranium Corp. v. Vance*, 269 F.2d 104 (10th Cir. 1959).

⁴⁴ The reason for the qualification "most probably" is that there is no jurisdictional requirement in the Bankruptcy Act that a voluntary bankrupt be insolvent before filing a petition.

⁴⁵ Some practitioners purport to avoid the uncertainties surrounding the relevant date of transfer in the guaranty-plus-security-interest context by casting the transaction in the mold of a hypothecation of property rather than a security interest. With a hypothecation, property is unequivocally transferred (by granting permission to pledge it) on a particular date to another party who pledges it to the lender, and no dispute as to the relevant date of transfer can arise.

⁴⁶ UFCA, *supra* note 8, at § 2(1).

⁴⁷ Bankruptcy Act § 67d(1)(d), 11 U.S.C. § 107(d)(1)(d) (1970).

⁴⁸ A person shall be deemed insolvent within the provisions of this Act

the UFCA make it clear that exempt assets are excluded but liabilities that are not provable in bankruptcy are included.⁴⁹ Thus, fewer assets and more liabilities are included than under the general bankruptcy definition of insolvency.

What assets and liabilities are considered? With respect to assets, only those nonexempt assets with a "present fair salable value" are to be considered, and only to the extent of that value.⁵⁰ Before an asset is counted, it must have a market value,

whenever the aggregate of his property, exclusive of any property which he may have conveyed, transferred, concealed, removed, or permitted to be concealed or removed, with intent to defraud, hinder, or delay his creditors, shall not at a fair valuation be sufficient in amount to pay his debts . . .

Bankruptcy Act § 1(19), 11 U.S.C. § 1(19) (1970).

⁴⁹ For example, intentional tort claims or causes of action in negligence with respect to which an action has not been commenced yet are not provable in bankruptcy and therefore are not included as liabilities under the general definition of insolvency but are included as liabilities in determining insolvency for fraudulent conveyance purposes. See Bankruptcy Act §§ 1(14), 63a(7), 11 U.S.C. §§ 1(14), 103(a)(7) (1970).

⁵⁰ Bankruptcy Act § 67d(1)(d), 11 U.S.C. § 107(d)(1)(d) (1970). Although Collier states that the term "present fair salable value," found in § 67d(1)(d), and "fair valuation," found in § 1(19), are probably equivalent, 4 COLLIER ON BANKRUPTCY ¶ 67.32, at 498 (14th ed. 1975), there is authority that they are not synonymous. In *In re Crystal Ice & Fuel Co.*, 283 F. 1007 (D. Mont. 1922), all of the corporation's property was subject to a trust deed securing a bond issue subject to foreclosure because of failure to pay interest. On this evidence, the court found that the fair valuation exceeded debts while the salable value did not exceed debts. The court said:

The record alone indicates that, though the debts exceeded the "salable value" of the property, this was due to the character of the property and as a going concern, to the trust deed, liens, seizure, neglect and the aggregation of their embarrassing circumstances disabling the company from operation and payment, rather than due to debts exceeding the fair valuation of the property. Salable value and fair valuation are not synonymous, and the conclusion "wholly insolvent" because of the fact that the "salable value" of the company's property was less than its debts may be and is proven to be not at all the insolvency of the Bankruptcy Act, viz. insufficiency of its property at fair valuation to pay its debts.

"At times a debtor's property, though amply sufficient in value to discharge all his obligations, may not be convertible without sacrifice into that form by which payments may be made. This law regards that possibility. In this there is indulgence to the debtor." *Pierie v. Trust Co.*, *supra*; *In re Butte Duluth Mining Co.*, *supra*.

That is, although his property be not presently salable for enough to pay his debts, its fair valuation may be more than enough; and if so, he is not insolvent nor subject to bankruptcy for insolvency.

Id. at 1009-10.

Although other cases do not clearly draw this distinction, it appears that while "fair valuation" anticipates the possibility of liquidation within a reasonable time, "present fair salable value" anticipates a more immediate liquidation. This has been suggested in an article by Professor McLaughlin. McLaughlin, *Application of the Uniform Fraudulent Conveyance Act*, 46 HARV. L. REV. 404, 420 (1933). Professor McLaughlin's discussion of insolvency is brief, but he notes that statements with respect to the concept of insolvency have been too loose to indicate any deliberation by the courts.

One Pennsylvania case arising under the UFCA held it to be error to find only

measured by a willing seller and willing buyer, and it must be subject to liquidation within a reasonably immediate period of time.⁵¹ Thus, if an asset can be converted to cash only in the future, it will not be included on the asset side. For an asset to be salable, it must be of a nature to be transferable in a market place for which a market can be deemed to exist. Thus, assets that commonly appear on balance sheets, such as leasehold improvements, accrued expenses, and good will, must usually be eliminated from the consideration of insolvency, and all tangible salable assets must be valued at current market value rather than at cost. For example, in the prevalent mid-1970's real estate market, it is highly questionable whether a large and expensive piece of commercial real estate could be included in the computation at a value approaching its "real" value, inasmuch as it is most unlikely that a willing buyer could be found within a time period approaching immediacy. On the other hand, certain non-balance-sheet assets, such as patents, might qualify under this test and should be included.⁵²

"fair salable value" instead of "present fair salable value." *Fidelity Trust Co. v. Union Nat'l Bank of Pittsburgh*, 313 Pa. 467, 169 A. 209, *cert. denied*, 291 U.S. 680 (1933). *Fidelity Trust* involved shares of stock and did not allow for a period of time to market the shares in order to get the best price. The court stated that valuation of the stock should be based on a single immediate sale.

⁵¹ The requirement that the asset be available to pay debts within a reasonable time has arisen in controversy most often with regard to pending claims as assets. In *In re Cooper*, 12 F.2d 485 (D. Mass. 1926), evidence as to the value of a suit for a breach of contract instituted after the commencement of the bankruptcy proceedings was excluded. The basis for this ruling was that, because of the protracted nature of judicial proceedings, funds from an eventual settlement would not be available within a reasonable time. This does not mean, however, that a claim could never be an asset used for determining insolvency. The court said, "The test seems to be whether the claim is one which can be rendered available for the payment of debts within a reasonable time." *Id.* at 486; see *In re Bichel Optical Laboratories, Inc.*, 299 F. Supp. 545 (D. Minn. 1969) (antitrust claim held not to be an asset for purposes of determining solvency).

Another reason for not including a legal claim probably has been its uncertainty in character and amount, and thus its lack of appreciable value. See *Penn v. Grant*, 244 F.2d 309 (9th Cir.), *cert. denied*, 355 U.S. 837 (1957) (usury claim against finance company).

On the other hand, a court may include amounts that would have become available to the company within a reasonable time. In *Tumarkin v. Gallay*, 127 F. Supp. 94 (S.D.N.Y. 1954), receipts received in advance on a contract were said to have value as an asset because the contract upon which they were contingent was almost completed.

Under this requirement, it is clear that the property valuation need not be made at once but may be deferred for a reasonable time. In *Duncan v. Landis*, 106 F. 839 (3d Cir. 1901), one of the oldest cases in this area, the court, overruling an instruction to the jury that required instant disposition and liquidation of the stock in question, stated: "A man's property, at a fair valuation, may amount to sufficient to pay his debts, [sic] although he might not be able to realize at once the amount of that valuation." *Id.* at 859.

⁵² *Cf. Newsome Value Co. v. Crown Tire & Rubber Co.*, 279 F. 569 (8th Cir. 1922);

With respect to liabilities, the definition clearly anticipates inclusion of all debts, matured or unmatured, liquidated or unliquidated, fixed or contingent. Certainly, it would seem that on the face of the statute no exception should be made to allow exclusion of a guaranty on the liability side of the ledger. Contrary authority does exist, however. One court took the following approach:

[T]he liability of a person as surety or indorser, if the principal is solvent and abundantly able to pay, is not such a liability as could be counted against him on the question of his solvency or insolvency, because, if called on to pay such debt, he would immediately have an asset which would be equal to the amount he would be required to pay.⁵³

Of course, this problem is relevant only in the situation in which, prior to incurring the guaranty, the guarantor is solvent within the definition cited above. The question, then, is whether the guarantor is "rendered insolvent" by contracting the guaranty. The implication of the above quotation is that if, at the time that the obligation is incurred, the principal obligor is solvent and therefore is able to pay debts as they mature, then the obligation is not included on the liability side of the guarantor's balance sheet. To state the proposition in a different fashion, the contingent liability represented by the guaranty would be included, but it would be offset by a contingent asset represented by the guarantor's right of subrogation against the primary obligor if called upon to perform under the guaranty. Some conceptual problems are presented in this approach. The notion that the guaranty of a solvent obligor is offset by a contingent asset based on the right of subrogation is simply not realistic; when and if the guarantor is called upon to perform, the value of that contingent asset in all likelihood would be discounted severely because it probably would be no longer collectible. Otherwise, the guarantor would not have been called upon to perform. Thus, on the critical date for the determination of solvency—the date on which the guaranty is given—it is nearly impossible to justify a more than token value for the contingent asset. An alternative approach would be first to evaluate all un-

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Chicago Motor Vehicle Co. v. American Oak Leather Co., 141 F. 518, 522 (7th Cir. 1905).

⁵³ *In re Bowers*, 215 F. 617, 618 (N.D. Ga. 1914).

matured liabilities to determine the likelihood of their coming due and then to discount them accordingly. This method, besides doing violence to the statutory language, adds another element of uncertainty to the determination of insolvency.

Thus, three methods of treating the guaranties for balance sheet purposes remain: they may be included in full, under all circumstances, as liabilities without offset; they may be left off the balance sheet under all circumstances or included with offsetting assets; or their inclusion and the extent thereof may be made dependent on the likelihood that the liability will be incurred.

None of these results is particularly pleasing. Even more disturbing, however, is the absence of any recent precedent in the area and any precedent at all specifically relating to fraudulent conveyances. Given this situation, the safest course is to add the contingent liability represented by the guaranty to the liability side of the balance sheet in all cases, and not to include any contingent asset, represented by the rights of subrogation, on the asset side. Unfortunately, this overcautious approach is likely to result in an overly broad conception of insolvency that is out of touch with economic reality. A more flexible approach based on probabilities would be preferable.

In summary, the attorney for the lender whose positive credit judgment requires a collateralized or noncollateralized "cross-stream" or "upstream" corporate guaranty of the lending transaction faces a morass of problems in determining the validity of the obligation under the statutory provisions: sparse, confusing, and poorly written statutes; poorly rationalized and articulated case law; a dearth of recent interpretive case law on some central concepts; and a dearth of any case law at all on others. Although some suggestions of limited usefulness are offered at the conclusion of this Article, this section must end with the pessimistic observation that, unless the guarantor is solvent even after including the contingent liability represented by the guaranty, the lender should be advised that it should not rely upon the enforceability of such a guaranty or security interest in the guarantor's assets for repayment of the obligation.

III. ACTUAL INTENT TO HINDER, DELAY, OR DEFRAUD CREDITORS

The foregoing discussion involves a statutory provision under which lack of fair consideration combined with insolvency

gives rise to an irrebuttable presumption of an intent to defraud creditors. The UFCA and the Federal Bankruptcy Act version of the UFCA, in slightly different language, continue to render voidable "every conveyance made and every obligation incurred with actual intent, as distinguished from intent presumed in law, to hinder, delay, or defraud either present or future creditors."⁵⁴ Because actual intent must be proved without the benefit of presumptions, it is generally very difficult to obtain relief under this provision. There are certain advantages, however, to pursuing such a cause of action. Because a transaction voidable under this section is fraudulent as against both present and future creditors,⁵⁵ the trustee in bankruptcy can avoid the transfer as long as a single general unsecured creditor exists at the time of the bankruptcy, whether the credit transaction occurred prior or subsequent to the voidable transfer. The previously discussed section is for the benefit only of present creditors.⁵⁶ A pretransfer creditor with a provable claim therefore must remain unpaid, or a trustee will not be able to set aside such a transaction for the benefit of the estate.

As noted,⁵⁷ one of the draftsmen's principal purposes in drafting the UFCA was to abolish the "badges of fraud" that had developed in the common law process as irrebuttable presumptions of actual intent to defraud. Under the UFCA, no such irrebuttable presumptions should exist, other than those that have been specifically legislated into the Act. Accordingly, proving a cause of action under the "actual intent to defraud" section should receive the benefit of no presumption. Inasmuch as it is impossible to look into the minds of the parties, however, inferences must be permitted with respect to various facts and circumstances from which the requisite intent can be deduced.⁵⁸ The question, then, becomes whether, in addition to the presumptively fraudulent situation discussed in the prior portion of this Article, actual intent to defraud creditors can be found properly in the legitimate collateralized lending transaction under examination.

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⁵⁴ UFCA, *supra* note 8, at § 7; Bankruptcy Act § 67d(2)(d), 11 U.S.C. § 107(d)(2)(d) (1970).

⁵⁵ UFCA, *supra* note 8, at § 7.

⁵⁶ See note 13 *supra*.

⁵⁷ See note 33 *supra* & accompanying text.

⁵⁸ See, e.g., *Battjes v. United States*, 172 F.2d 1, 5 (6th Cir. 1949).

The leading treatise on bankruptcy law summarizes the case law as follows:

Circumstances from which courts have been willing to infer fraud include concealment of facts and false pretenses by the transferor, reservation by him of rights in the transferred property, his absconding with or secreting the proceeds of the transfer immediately after their receipt, *the existence of an unconscionable discrepancy between the value of property transferred and the consideration received therefor*, the fact that the transfer was made to satisfy or secure a debt long since forgiven, the fact that the transferee was an officer or was an agent or creditor of an officer of an embarrassed corporate transferor, the creation by an opposed debtor of a closely-held corporation to receive the transfer of his property.⁵⁹

Similarly, the United States District Court for the Southern District of New York has stated:

“Actual intent . . . to hinder, delay or defraud either present or future creditors . . .” is sufficient to render conveyances fraudulent, and even “fair consideration” cannot save conveyances made under the circumstances proscribed by [UFCA section on actual intent]. The requisite intent under this section need not be proven by direct evidence but may be inferred (a) where the transferor has knowledge of the creditor’s claim and knows that he is unable to pay it; (b) where the conveyance is made without fair consideration; or (c) where the transfer is made to a related party (i.e., husband to wife, corporation to stockholder).⁶⁰

If these statements are accepted at face value, it seems that not only would the same facts that result in a fraudulent conveyance under section 67d(2)(a) also give rise to a fraudulent conveyance under the actual-intent-to-defraud provision, but even less would suffice under certain circumstances. For example, if fair consideration is not present in granting a guaranty and/or security interest collateralizing that guaranty, the forego-

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⁵⁹ 4 COLLIER ON BANKRUPTCY ¶ 67.37, at 539-43 (14th ed. 1975) (footnotes omitted) (emphasis supplied).

⁶⁰ United States v. 58th St. Plaza Theatre, Inc. 287 F. Supp. 475, 498 (S.D.N.Y. 1968).

ing quotation implies that actual intent to defraud may be found if the transferor is insolvent in the equity sense—that is, if the transferor is unable to pay liabilities as they mature⁶¹—even if it is not insolvent as defined by the statute. In fact, the court appears to say that there need not be *any* kind of insolvency present. Although section 67d(2)(a) would permit a security interest in the guarantor's assets, no matter how grossly in excess of the guaranteed amount, as long as insolvency as defined in the statute did not result, the foregoing quotations indicate that such gross disparity may constitute actual intent to defraud, or at least to delay, creditors, without regard to the solvency or insolvency of the transferor.

Notwithstanding the language of the textwriters and some courts, an examination of the case law decided under this provision, none of which is particularly analogous to the situation at hand, indicates that a finding of actual intent to defraud usually entails the existence of more than a single "badge of fraud." The usual process is to examine a series of misdeeds existing under particular circumstances and to conclude that the series is sufficient to establish the required intent to defraud.⁶² It is unlikely that the existence of a single "badge," particularly one that is an element necessary to establish presumptive fraud under the other provisions, is sufficient to establish such a presumption here. Nevertheless, both the statutory language and loose language in various opinions exist, and the possibility of crossing the line into actual intent should never be ignored. After getting a cross-corporate guaranty, security for the guaranty, plus a few "something elses"—or perhaps even a single "something else"—the lender may find itself deemed to be a participant in an actually fraudulent scheme.

IV. THE SAVING PROVISION

If a guaranty or lien is found to be fraudulent under any of the foregoing provisions, the remedy provided in both the

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⁶¹ See, e.g., *Finn v. Meighan*, 325 U.S. 300, 303 (1944).

⁶² See, e.g., *In re Allied Dev. Corp.*, 435 F.2d 372, 373 (7th Cir. 1970); *United States v. Leggett*, 292 F.2d 423, 427 (6th Cir.), *cert. denied*, 368 U.S. 914 (1961); *Chorost v. Grand Rapids Factory Show Rooms, Inc.*, 172 F.2d 327, 329 (3d Cir. 1949); *In re Peoria Braumeister Co.*, 138 F.2d 520, 524 (7th Cir. 1943); *Lackawanna Pants Mfg. Co. v. Wiseman*, 133 F.2d 482, 487 (6th Cir. 1943); *In re Process-Manz Press, Inc.* 236 F. Supp. 333, 348 (N.D. Ill. 1964), *rev'd*, 369 F.2d 513 (7th Cir. 1966), *cert. denied*, 386 U.S. 957 (1967); *Gafco, Inc. v. H.D.S. Mercantile Corp.*, 47 Misc. 2d 661, 263 N.Y.S.2d 109 (N.Y. Civ. Ct. 1965).

UFCA and the Bankruptcy Act is the avoidance of the transfer.⁶³ In other words, the lien simply will be invalidated and the guaranty rendered unenforceable. A saving provision can be found, however, under both the UFCA and the Bankruptcy Act. The UFCA provides: "A purchaser who without actual fraudulent intent has given less than a fair consideration for the conveyance or obligation, may retain the property or obligation as security for repayment."⁶⁴ This differs subtly from the Bankruptcy Act provision:

A transfer made or an obligation incurred by a debtor adjudged a bankrupt under this Act, which is fraudulent under this subdivision against creditors of such debtor having claims provable under this Act, shall be null and void against the trustee, except as to a *bona fide* purchaser, lienor, or obligee for a *present* fair equivalent value: . . . *And provided further*, That such purchaser, lienor, or obligee, who without actual fraudulent intent has given a consideration less than fair, as defined in this subdivision (d), for such transfer, lien, or obligation, may retain the property, lien, or obligation as security for repayment.⁶⁵

Some authority supports the proposition that "purchaser" in the UFCA is probably as broad in its coverage as "purchaser, lienor or obligee" in the Bankruptcy Act.⁶⁶ The Bankruptcy Act, however, unlike the UFCA, limits protection to purchasers, lienors, or obligees for a "*present* fair equivalent value." Thus, although an antecedent debt constitutes fair consideration for a transfer under both the UFCA and the Bankruptcy Act, if the transaction is otherwise fraudulent, the language of the Act indicates that protection is rendered only to the transferee for a present fair consideration. Even though, for example, a guaranty and lien on the assets of the subsidiary of a borrower, given subsequent to the loan in a work-out situation, may be fair consideration under the fair consideration and insolvency provision, nevertheless, if the transaction is voided because it is found

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⁶³ UFCA, *supra* note 8, at § 9(1); Bankruptcy Act § 67d(6), 11 U.S.C. § 107(d)(6) (1970).

⁶⁴ UFCA § 9(2).

⁶⁵ Bankruptcy Act § 67d(6), 11 U.S.C. § 107(d)(6) (1970) (emphasis on "*bona fide*" and "*present*" supplied).

⁶⁶ *See, e.g.,* City of New York v. Johnson, 137 F.2d 163 (2d Cir. 1943) (lien creditor deemed to be a purchaser within the meaning of the statute).

to have been made with actual intent to defraud, no protection will be afforded the lender under the Bankruptcy Act version to the extent that the consideration for the lien was monies previously advanced to the parent.

Collier, however, arguing that the language should not be read so literally, states, "If the antecedent debt amounts to a fair equivalent of the property transferred therefor, the transfer will presumably be upheld in full, although the transferee is technically not a 'bona-fide purchaser, lienor, or obligee for a *present* fair equivalent value.'"⁶⁷ Although this result is reasonable, it can be reached only by ignoring express statutory language. Reliance on this interpretation therefore cannot be advised safely.

The existence of actual fraudulent intent is a crucial issue here as it was in section 67d(2)(d),⁶⁸ and courts do not seem to have fashioned separate tests for actual intent under the two sections.⁶⁹ Clearly, actual fraudulent intent should not be equated with the lack of good faith that results in lack of fair consideration under the statute. Although the existence of good faith necessarily precludes actual fraudulent intent, the absence of good faith does not indicate actual fraudulent intent. A purchaser who lacks good faith, however, may not be a "bona fide" purchaser as required by the Bankruptcy Act's saving provision and therefore may be precluded from successfully invoking it.⁷⁰ The UFCA's saving provision does not, by its terms, require that the purchaser be "bona fide."

V. PROPOSALS FOR STRUCTURING LENDING TRANSACTIONS

It is sometimes possible to structure loans to a group of corporations in such a way as to minimize the effect of the problems analyzed in this Article. In this endeavor, the guiding principle is to make certain that the loan is made and that the con-

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⁶⁷ 4 COLLIER ON BANKRUPTCY ¶ 67.41, at 598 (14th ed. 1975).

⁶⁸ See notes 56-60 *supra* & accompanying text.

⁶⁹ Cf. *In re Process-Manz Press, Inc.*, 236 F. Supp. 333 (N.D. Ill. 1964), *rev'd on other grounds*, 369 F.2d 513 (7th Cir. 1966), *cert. denied*, 386 U.S. 957 (1967) (finding of actual intent under § 67d(2)(d) precludes application of § 67d(6)).

The leading case on the interpretation of this proviso states, "Actual fraudulent intent requires a conscious realization by the lienor that taking the lien will work a fraud on the debtor's creditors." *In re Peoria Braumeister Co.*, 138 F.2d 520, 524 (7th Cir. 1943). Of course, this may be proven by circumstantial evidence. Also, the appropriate standard is inquiry notice, so a failure to ask the obvious question may jeopardize the transaction. See cases cited in 4 COLLIER ON BANKRUPTCY ¶ 67.41, at 596-97 (14th ed. 1975).

⁷⁰ See *In re Allied Dev. Corp.*, 435 F.2d 372, 376-77 (7th Cir. 1970).

sideration passes to those entities owning the assets upon which the lender relies in making the positive credit determination.

This result can be achieved in a variety of ways, depending on the facts and the goals to be met. Sometimes, the problems can be avoided entirely in the parent-subsidary context by lending to the subsidiary, rather than to the parent corporation, with a secured "downstream" guaranty running from the parent to the lender. As noted, fair consideration certainly should be found when there is a "downstream" guaranty.⁷¹ In addition, the parent can be required to waive its right of subrogation to the lender's claim against the subsidiary if the parent is called upon to honor its commitment, and the subsidiary can then pass the loan proceeds to the parent, in appropriate circumstances, by way of dividends and loans or repayment of intercompany indebtedness. The net effect of this procedure is precisely the same as if the loan were made to the parent and secured by the assets of the entire group of corporations.⁷²

A particular problem area is presented by loans to finance acquisitions or to pay off acquisition debt, for clearly, in such a situation, the guarantying subsidiaries of the acquiring parent receive no consideration. Again, the technique described in the preceding paragraph may be effective, as long as the entity to which the loan is actually made is solvent. An alternative route to avoid "upstream" guaranty problems in the acquisition debt context is the merger technique. If the acquired subsidiary is merged into the borrower simultaneously with the loan transaction, and the lender takes a lien on the assets of the borrower, the net result is a first lien on the assets of the formerly independent, acquired entity, which now belong to the borrower. At the same time, the other subsidiaries can be merged into the parent corporation. As long as the combined entity emerges solvent, the creditors of the formerly independent subsidiaries can-

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⁷¹ See text accompanying notes 3-5 *supra*.

⁷² Several recent lawsuits suggest that some problems associated with this approach may arise in the future. In connection with the Penn Central and the North American Acceptance Corporation bankruptcies, suits were commenced alleging that the parent corporation operated the subsidiary corporation exclusively for its own benefit, with the consent and cooperation of the lender. In the North American Acceptance Corporation case, the trustee alleged that that corporation's parent, Omega-Alpha, Inc., caused its subsidiary to borrow \$9,000,000 from Chase Manhattan Bank and First National City Bank and then to loan the money to Omega-Alpha for five years on an unsecured note, even though North American's note with the bank was fully secured. The complaint sought damages against the Chase Manhattan Bank for participating in an allegedly fraudulent scheme. The Penn Central litigation was settled, and the North American litigation is pending.

not complain; a collateralized guaranty by the same corporations as independent entities, however, would be subject to all of the problems discussed above. Of course, this merger technique may be employed outside the acquisition context as well.

For tax or other motives, the borrower may insist that the acquired assets remain in a subsidiary and that the merger approach cannot be used. In such a case, the acquisition may be structured as a purchase of assets, with the lender taking a security interest in all of the borrower's assets, including those just purchased. Thereafter, or simultaneously, the purchased assets may be transferred, with the lender's permission and subject to the lender's lien, to a newly formed subsidiary in exchange for the stock of that subsidiary. Subsequently, to assure complete protection by putting potential creditors of the new subsidiary on notice of the lender's lien, and not for credit purposes, the lender may want to obtain from the subsidiary a guaranty collateralized by a second lien on its assets, with appropriate notice of the lien filed or recorded. Thus, there would be no existing creditors of the subsidiary to complain of the lien, and subsequent creditors would be on notice thereof.

A different situation occurs when a parent and its subsidiaries constitute an integrated operation and the parent actually funds the operations of its subsidiaries. In such a case, when the purpose of a loan is to provide operating capital for a parent and all of its subsidiaries, the lender, for example, could enter into an accounts receivable financing arrangement with the parent and its subsidiaries, under which the subsidiaries would continually hypothecate their accounts receivable to the parent, which in turn would pledge them to the lender. If cash flow projections for each subsidiary indicate that any advances from the lender would be distributed to the subsidiaries substantially proportionate to the generation of receivables, each subsidiary most likely would receive fair consideration from the parent in exchange for the hypothecation of its receivables.

In appropriate circumstances, a lender, of course, may be able to rely on "upstream" or "cross-stream" guaranties. When, for example, the guaranty is in an amount that will not even approach rendering the entity insolvent, no fraudulent conveyance question is presented.

Notwithstanding the foregoing suggestions for loan structuring, no foolproof formulation can be set forth that would insulate the lender from any conceivable legal challenges to its

right to seek repayment from the guarantying entity. "Actual intent to delay, hinder, or defraud" present or future creditors always lingers on the horizon if a lender goes too far. Of course, it is impossible to predict with certainty when a court would find fraud in fact as opposed to fraud presumed by law. Furthermore, it is impossible to state exactly what assets, liabilities, and valuations a court would consider relevant to its determination of the solvency or insolvency of the entities in question on the date of the transaction. Nevertheless, recognizing the foregoing potential difficulties, the approaches outlined above are designed to avoid the significant possibility of invalidity associated with a typical "upstream" or "cross-stream" guaranty situation. Although the safest advice is that the lender should treat the availability of the assets of a subsidiary or affiliated corporation for repayment of the obligations of the borrower as a bonus rather than a necessity, the foregoing approaches at least represent some steps that can aid in the achievement of the desired result.