

VALUATION ISSUES IN APPLYING FRAUDULENT TRANSFER LAW TO LEVERAGED BUYOUTS†

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INTRODUCTION

A leveraged buyout¹ ("LBO") is a purchase transaction in which an acquiring entity purchases a business ("Target") largely through

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¹ In the typical leveraged buyout ("LBO"), the acquiring entity, a group of investors and managers, forms a wholly owned shell corporation. It then borrows the necessary funds required for the acquisition from a lending institution, giving the lender an unsecured note. It uses the funds to acquire Target's stock from the selling shareholders. Once it assumes control, it causes Target to guarantee its note to lender and to secure that obligation by granting a lien on Target's assets.

LBOs have attracted extensive criticism on various public policy grounds. Some critics find such transactions troubling because they benefit the new owners of Target at the expense of the federal treasury. LBOs offer tax benefits in the form of increased depreciation deductions as well as the deductions of interest payments on debt. See generally Canellos, *The Over-leveraged Acquisition*, 39 Tax Law. 91 (1985); Lowenstein, *Management Buyouts*, 85 COLUM. L. REV. 730, 759-64 (1985). See Marcis, *Leveraged Buyouts: Federal Income Tax Considerations*, in LEVERAGED MANAGEMENT BUYOUTS 175 (Y. Amihud ed. 1989) for a discussion of additional tax advantages. See also Cieri, Heiman, Henze II, Jenks, Kirschner, Riley & Sullivan, *An Introduction to Legal and Practical Considerations in the Restructuring of Leveraged Buyouts*, 45 BUS. LAW 333, 368-76 (1989) [hereinafter Cieri, *Leveraged Buyouts*] for a discussion of additional tax consequences.

Another criticism focuses on the unfairness of the price paid to selling shareholders. See Lowenstein, *supra* at 740; see also Comment, *Regulation of Leveraged Buyouts to Protect the Public Shareholder and Enhance the Corporate Image*, 35 CATH. U.L. REV. 489, 492-93 (1986). But see Booth, *Management Buyouts, Shareholder Welfare, and the Limits of Fiduciary Duty*, 60 N.Y.U. L. REV. 630, 634-38 (1985) (contending that the acquisition price is determined by an efficient market). Although LBOs have generated substantial values for shareholders, averaging a premium of between 30% to 40% over market price, critics are not satisfied that shareholders are fairly compensated. See Markey, *Legislative Views on Management Buyouts*, in LEVERAGED MANAGEMENT BUYOUTS, *supra* at 211.

A related fairness issue concerns the effect of an LBO on the rights of bondholders. Some have indicated that the relatively high premiums paid to shareholders comes at the

borrowed funds.² There are several ways to structure an LBO.³ However structured, all LBO transactions share two common characteristics. First, most if not all the borrowed funds are used to pay the selling shareholders. Consequently, when the dust settles and the buyout is complete, Target will have received little to none of those funds. Second, Target's assets indirectly finance the acquisition because they secure the loan extended to acquire Target. Thus, an LBO's effect is to substitute a significant amount of secured debt in the place of equity in Target's capital structure.

Although for investors an LBO may prove to be the "kiss which turns a frog into a handsome prince,"⁴ it pits the lender's⁵ interests

expense of existing bondholders. See, e.g., McDaniel, *Bondholders and Corporate Governance*, 41 BUS. LAW. 413, 414 (1986).

A final concern relates to the overleveraging of corporate America and its consequences. In 1984, John Shad, then Chairman of the Securities and Exchange Commission, warned more and more leverage would lead to more and more bankruptcies. John S.R. Shad, *The Leveraging of America*, statement before the New York Financial Writers Association (June 7, 1984), quoted in CONGRESSIONAL RESEARCH SERVICE, SUBCOMM. ON TELECOMMUNICATIONS, CONSUMER PROTECTION AND FIN. OF THE HOUSE COMM. ON ENERGY AND COMMERCE, 98TH CONG., 2D SESS., *MERGER ACTIVITY AND LEVERAGED BUYOUTS: SOUND CORPORATE RESTRUCTURING OR WALL STREET ALCHEMY?* 5 (Comm. Print 1984).

² "Acquiring entity" refers to one or more individuals or to specialized financial organizations that sponsor LBO transactions. See Anderson, *Defining the Game Board* in *LEVERAGED BUYOUTS* 11, 14-15 (S.C. Diamond ed. 1985). The best known of the latter is Kohlberg, Kravis, Roberts & Co. which, in 1988, won the largest ever LBO bid (\$25 billion) for RJR Nabisco Inc. See Wall St. J., Dec. 2, 1988, at A1, col. 6.

³ For a discussion of the six most common LBO structures, see Carlson, *Leveraged Buyouts in Bankruptcy*, 20 GA. L. REV. 73, 80-83 (1985). See also Bernstein, *Leveraged Buyouts: Legal Problems and Practical Suggestions*, in *LEVERAGED BUYOUTS*, supra note 2, at 120-24.

⁴ Balser, *Leveraged Buyout Financing*, in *HANDBOOK OF MERGERS, ACQUISITIONS AND BUYOUTS* 503, 503 (S.J. Lee & R.D. Colman ed. 1981). For example, investors in RJR Nabisco Inc. were expected to enjoy annual returns of 50% or more. See *How LBOs are Shaping Up*, *ECONOMIST*, Nov. 26, 1988, at 75.

⁵ Lenders fall into two categories depending on the party financing the transaction. The first category involves LBOs in which the selling shareholders provide leverage by taking the buyer's note for a significant portion of the purchase price. See, e.g., *Cate v. Nicely (In re Knox Kreations, Inc.)*, 474 F. Supp. 567, 569 (E.D. Tenn. 1979), *aff'd in part, rev'd in part*, 656 F.2d 230, 231 (6th Cir. 1981); *Steph v. Branch*, 255 F. Supp. 526, 528 (E.D. Okla. 1966), *aff'd*, 389 F.2d 233, 234 (10th Cir. 1968); *Sharrer v. Sandlas*, 103 A.D.2d 873, 873, 477 N.Y.S.2d 897, 898 (1984).

In the second category of LBOs, the lender financing the transaction is an independent institution. See, e.g., *Wieboldt Store, Inc. v. Schottenstein*, 94 Bankr. 488, 494-95 (Bankr. N.D. Ill. 1988); *Ohio Corrugating Co. v. DPAC, Inc. (In re Ohio Corrugating Co.)*, 91 Bankr. 430, 432 (Bankr. N.D. Ohio 1988); *Kupetz v. Continental Ill. Nat'l Bank and Trust Co.*, 77 Bankr. 754, 755-56 (Bankr. C.D. Cal. 1987), *aff'd sub nom. Kupetz v. Wolf*, 845 F.2d 842, 851 (9th Cir. 1988); *Credit Managers Ass'n v. Federal Co.*, 629 F. Supp. 175, 178 (C.D. Cal. 1985); *United States v. Gleneagles Inv. Co.*, 565 F. Supp. 556, 566 (M.D. Pa. 1983), *aff'd sub nom. United States v. Tabor Court Realty Corp.*, 803 F.2d 1288, 1307 (3d Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987); *Armstrong Co. v. Limperis (In re Process-Manz Press)*, 236 F.

against those of Target's unsecured creditors in the event of Target's business failure. By taking security interests in Target's assets, the lender reduces the assets to which Target's creditors look for repayment. Several legal theories are available to creditors to challenge the validity of lender's security interests or to seek other relief from LBO participants.⁶

The law of fraudulent transfers is the most creditor protective.⁷ This body of law originated several centuries ago at a time when

Supp. 333, 337 (N.D. Ill. 1964), *rev'd on other grounds*, 369 F.2d 513, 518-19 (7th Cir. 1966), *cert. denied*, 386 U.S. 957 (1967).

⁶ These theories and their potential usefulness for challenging an LBO are discussed in Queenan, *The Collapsed Leveraged Buyout and the Trustee in Bankruptcy*, 11 CARDOZO L. REV. 1, 28-47 (1989) and Sherwin, *Creditors' Rights Against Participants in a Leveraged Buyout*, 72 MINN. L. REV. 449, 453-64 (1988). These theories include lack of corporate power (*ultra vires*), equitable subordination, breach of fiduciary duty by corporate directors and shareholders, and unlawful distribution to shareholders, or unlawful redemption of shares, under state corporate statutes. See Sherwin, *supra*, at 453-62.

Although each of these legal theories is potentially applicable, its application to an LBO is not without problems. For example, directors normally owe no fiduciary duty to creditors because directors are selected by shareholders and represent the corporation. See Queenan, *supra* note 6, at 32. But see *Gleneagles*, 565 F. Supp. at 584 (holding controlling shareholder liable for breach of duty to creditors); New York Credit Men's Adjustment Bureau, Inc. v. Weiss, 305 N.Y. 1, 9-11, 110 N.E.2d 397, 399-400 (1953) (complaint stated cause of action for breach of fiduciary duty to creditors). The *ultra vires* doctrine is overinclusive because it may hinder transactions in which creditors' rights are not in danger of being harmed. Sherwin, *supra*, at 463. Moreover, in light of the expansion of business purposes and corporate powers, the doctrine has lost much of its potency. See, e.g., *Emerald Hills Country Club, Inc. v. Hollywood, Inc. (In re Emerald Hills Country Clubs, Inc.)*, 32 Bankr. 408, 419 (Bankr. S.D. Fla. 1983) (casting doubt on continued validity of doctrine).

On the other hand, the remedy of equitable subordination may be helpful in LBO cases. This common law remedy is codified at 11 U.S.C. § 510(b)(1988) of the Bankruptcy Code. Although the doctrine was traditionally applied to subordinate the claims of insiders, it may also be applied to subordinate an independent lender's claim if its conduct is sufficiently egregious. *Anaconda-Erickson, Inc. v. Hessen (In re Teltronics Servs., Inc.)*, 29 Bankr. 139, 169 (Bankr. E.D.N.Y. 1983), *aff'd*, 762 F.2d 185, 187 (2d Cir. 1985); see also *In re Process-Manz Press*, 296 F. Supp. at 348. The lender's interest, however, will be subordinated only to the extent necessary to offset the harm suffered. *Benjamin v. Diamond (In re Mobile Steel Co.)*, 563 F.2d 692, 701 (5th Cir. 1977).

Professor Clark has noted that the doctrine of equitable subordination may, in many cases, be the "functional" equivalent of fraudulent transfer law. Clark, *The Duties of the Corporate Debtor to its Creditors*, 90 HARV. L. REV. 505, 518-36 (1977).

⁷ See Sherwin, *supra* note 6, at 453-64; Queenan, *supra* note 6, at 28-47. The law of fraudulent transfers is contained in three separate statutes: the Uniform Fraudulent Conveyance Act ("UFCA"), 7A U.L.A. 430, Supp. 107 (1985 & Supp. 1990), currently in force in 12 states; the Uniform Fraudulent Transfer Act ("UFTA"), 7A U.L.A. 643, Supp. 130 (1985 & Supp. 1990), in force in 24 states; and the Bankruptcy Code, 11 U.S.C. § 548 (1988). Under each of these statutes, the law of fraudulent transfers applies equally to transfers of property and incurrences of obligations. 11 U.S.C. § 548(a); UFCA § 3, 7A U.L.A. 448; UFTA § 4, 7A U.L.A. 652. Thus, for example, where the form of the LBO transaction has Target giving a secured guaranty to the lender, the guaranty may be a fraudulent transfer.

the practice of leveraged buyouts was non-existent.⁸ The application of such ancient law to determine the validity of a modern commercial transaction may thus seem incongruous.⁹ From a policy stand-

See Carlson, *supra* note 3, at 81. By giving the guaranty, Target clearly "incurs" an obligation, and by granting a security interest, it unquestionably makes a "conveyance" or "transfer." See Rosenberg, *Intercompany Guaranties and the Law of Fraudulent Conveyances: Lender Beware*, 125 U. PA. L. REV. 235, 241 (1976). "Transfer" and "conveyance" have virtually the same meaning. The substitution of "transfer" for "conveyance" in the UFTA was designed to emphasize that the new Act applies to transfers of real property as well as personal property. UFTA, Prefatory Note, 7A U.L.A. 640.

Although the three statutes are very similar in fundamental respects, there are some important differences. The principal difference between section 548 of the Bankruptcy Code and both the UFCA and the UFTA concerns the applicable statute of limitations. Section 548 applies to transfers made within one year prior to bankruptcy. 11 U.S.C. § 548(a). The UFTA has a four-year statute of limitations. UFTA § 9(a), 7A U.L.A. 665. The UFCA incorporates the statute of limitations of the particular state. See UFTA § 9 comment 2, 7A U.L.A. 666. Some states have a six-year statute of limitations. See, e.g., MASS. GEN. L. ch. 260, § 2 (1988). The trustee in bankruptcy may take advantage of the longer statute of limitations. See 11 U.S.C. 544(b) (1988). For other substantive differences among the statutes, see generally Acles & Dorr, *A Critical Analysis of the New Uniform Fraudulent Transfer Act*, 1985 U. ILL. L. REV. 527 (1985); Cook & Mendales, *Uniform Fraudulent Transfer Act: An Introductory Critique*, 62 AM. BANKR. L. J. 87 (1988).

⁸ The present law of fraudulent transfers has its roots in the statute passed by the Parliament in 1571, 13 Eliz., ch. 5 (1571). In those days, the statute was intended to curb the practice by which debtors sold their property to friends or relatives for a nominal sum to defeat the efforts of creditors to satisfy their claims. Once a creditor had given up or compromised its claim in frustration, the debtor would reclaim the property. See Baird & Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829, 829 (1985); 1 G. GLENN, *FRAUDULENT CONVEYANCES AND PREFERENCES* § 61, at 83-84 (rev. ed. 1940).

⁹ Thus, for example, Professors Baird and Jackson have argued that fraudulent transfer law should not affect an LBO because "[a] firm that incurs obligations in the course of a buyout does not seem at all like the Elizabethan deadbeat who sells his sheep to his brother for a pittance." Baird & Jackson, *supra* note 8, at 852. Although Baird and Jackson concede that fraudulent transfer law should make gifts by an insolvent debtor actionable, without regard to fraudulent intent, they contend that an LBO should be exempt because of its business context. *Id.* at 831-34. They argue that creditors may not object to the LBO, and those that do may prohibit it contractually. See *id.* at 834-35. For the most part, these arguments have failed to persuade courts. See *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288, 1297 (3d Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987); *Vadnais Lumber Supply, Inc. v. Byrne (In re Vadnais Lumber Supply, Inc.)*, 100 Bankr. 127, 134-35 (Bankr. D. Mass. 1989); *Wieboldt Stores, Inc. v. Schottenstein*, 94 Bankr. 488, 499 (N.D. Ill. 1988); *Ohio Corrugating Co. v. DPAC, Inc. (In re Ohio Corrugating Co.)*, 91 Bankr. 430, 433 (Bankr. N.D. Ohio 1988); *Anderson Indus. v. Anderson (In re Anderson Indus.)*, 55 Bankr. 922, 926 (Bankr. W.D. Mich. 1985). Some courts, however, have been influenced by Baird's and Jackson's article. See *Kupetz v. Wolf*, 845 F.2d 842, 847 (9th Cir. 1988) (declining to use the law of fraudulent transfers to invalidate transfers made to selling shareholders in an LBO); *Kupetz v. Continental Ill. Nat'l Bank & Trust Co.*, 77 Bankr. 754, 759-60 (Bankr. C.D. Cal. 1987); *Credit Managers Ass'n v. Federal Co.*, 629 F. Supp. 175, 179 (C.D. Cal. 1985).

Several articles have criticized Baird's and Jackson's views of the scope of fraudulent

point, however, a modern LBO is no different from an eighteenth century transaction that unfairly deprived a debtor's creditors of the ability to be repaid.¹⁰ As a result, courts have generally evaluated such transactions under fraudulent transfer law, although some courts have limited its scope in various ways.¹¹

Fraudulent transfer law protects creditors from their debtors' abusive conduct. It defines two categories of abusive conduct. The first category encompasses transfers "with actual intent to hinder, delay, or defraud" creditors.¹² Fraudulent intent is often difficult to prove, however, because it involves inquiry into subjective intention.¹³ Therefore, a second category relies on objective criteria to establish fraudulent intent.¹⁴ Accordingly, even if a transferor does not have actual, fraudulent intent, a transfer will be conclusively presumed fraudulent if its effect is to cause injury to creditors. Creditors generally rely on the second category of fraudulent transfer law, "constructive" fraud, to challenge an LBO.¹⁵

transfer law. See generally Smyser, *Going Private and Going Under: Leveraged Buyouts and the Fraudulent Conveyance Problem*, 63 IND. L.J. 781 (1988); see also Queenan, *supra* note 6, at 24-25; Note, *Fraudulent Conveyance Law and Leveraged Buyouts*, 87 COLUM. L. REV. 1491, 1503-04 (1987).

¹⁰ The argument is considered in great detail in Smyser, *supra* note 9, at 793-802.

¹¹ See *infra* text accompanying notes 203-25.

¹² The UFCA's intentional fraud section provides: "Every conveyance made and every obligation incurred with actual intent, as distinguished from intent presumed in law, to hinder, delay, or defraud either present or future creditors, is fraudulent as to both present and future creditors." UFCA § 7, 7A U.L.A. 509 (1985). The UFTA contains a similar provision. UFTA § 4(a)(1), 7A U.L.A. 652 (1985). The UFTA adds, however, a list of eleven factors to be considered in determining fraudulent intent. *Id.* § 4(b), 7A U.L.A. 653. The Bankruptcy Code's provision is substantially identical except with respect to the applicable statute of limitations. See 11 U.S.C. § 548(a)(1) (1988).

¹³ Thus, traditionally courts have resolved claims based on intentional fraud by relying on "badges of fraud" rather than on proof of subjective intention. Alces & Dorr, *supra* note 7, at 535. See *Tabor Court Realty Corp.*, 803 F.2d at 1304 ("[U]nder Pennsylvania law, an intent to hinder, delay, or defraud creditors may be inferred from transfers in which consideration is lacking and where the transferor and transferee have knowledge of the claims of creditors and know that the creditors cannot be paid."); *Consove v. Cohen (In re Roco Corp.)*, 701 F.2d 978, 984 (1st Cir. 1983) (circumstantial evidence relevant to issue of actual intent).

¹⁴ Jackson, *Avoiding Powers in Bankruptcy*, 36 STAN. L. REV. 725, 778 (1984). Thus, under all the fraudulent transfer laws, a transfer is deemed fraudulent, regardless of intention, if it is made without "fair consideration" or "reasonably equivalent value" and at the time of the transfer, the debtor either is insolvent or rendered insolvent, is in business and is left with "unreasonably small capital," or anticipates incurring debts beyond its ability to pay. See 11 U.S.C. § 548 (1988); UFCA, §§ 5, 6, 7A U.L.A. 504, 507 (1985); UFTA §§ 2, 4, 5, 7A U.L.A. 648, 652-53, 657 (1985). The distinction between constructive fraud and actual intent is sometimes difficult to maintain. See P. ALCES, *THE LAW OF FRAUDULENT TRANSACTIONS* ¶ 5.0.3 [3] at p. 5-111 (1989).

¹⁵ Cieri, *Leveraged Buyouts*, *supra* note 1, at 353; Note, *supra* note 9, at 1496.

A debtor is likely to cause injury to creditors in one of two ways. One is by making a gift.¹⁶ The other¹⁷ is by making a transfer for which it does not receive "fair consideration"¹⁸ or "reasonably equivalent value."¹⁹ Both types of transfer can potentially harm creditors because they diminish the debtor's estate to which creditors look for satisfaction of their claims. Therefore, under fraudulent transfer law, any transfer that is not supported by "fair consideration" or "reasonably equivalent value" is presumed constructively fraudulent.

In an LBO, it is difficult, if not impossible, to establish that Target received "fair consideration" or "reasonably equivalent value" in exchange for its transfer.²⁰ The lender gives value in

¹⁶ Professor Clark justified the fraudulent transfer laws' condemnation of gifts by debtors in precarious financial circumstances by the "normative ideal of [r]espect" which he argued underlies these laws and "can be captured by a cliché: be just before you are generous." Clark, *supra* note 6, at 510, 511. The cliché also appears in 1 G. GLENN, *supra* note 8, § 264, at 451. According to Clark, fraudulent transfer law has other normative ideals: "truth," "evenhandedness" and "nonhinderance." Thus, a debtor's transfer of a "false" mortgage to a friend in order to avoid paying creditors offends the ideal of "truth." Clark, *supra* note 6, at 509. A debtor who satisfies the claims of one creditor in preference to others offends the ideal of "evenhandedness." *Id.* at 511-12. Finally, a debtor who converts liquid assets into illiquid ones in order to hinder creditors offends the ideal of "nonhinderance." *Id.* at 512-13.

¹⁷ The reference here is to transfers for inadequate consideration, as opposed to gifts for which no consideration can exist by definition. The fraudulent transfer laws as currently in force do not draw this distinction. McCoid, *Constructively Fraudulent Conveyances: Transfers for Inadequate Consideration*, 62 TEX. L. REV. 639, 647-48 (1983).

¹⁸ The UFTA defines fair consideration as being given for property or an obligation when (a) in "good faith," as a fair equivalent, and in exchange therefore, property is conveyed or an antecedent debt is satisfied, or (b) the 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." UFTA § 3, 7A U.L.A. 448-49 (1985). The definition of fair consideration is very different from the consideration necessary to support a simple contract. Queenan, *supra* note 6, at 8. First, under the law of fraudulent transfers, courts inquire into the adequacy of the consideration given for property or an obligation. *See id.* But cf. RESTATEMENT (SECOND) OF CONTRACTS § 79 (1981) (ordinarily courts do not inquire into the adequacy of consideration). Second, under fraudulent transfer law, antecedent debt qualifies as consideration. Contract law provides otherwise. Queenan, *supra* note 6, at 8. Finally, fraudulent transfer law, but not contract law, requires that the debtor, not a third party, receive the consideration. 1 G. GLENN, *supra* note 8, § 276, at 473; Queenan, *supra* note 6, at 8.

¹⁹ The Bankruptcy Code and the UFTA require that the debtor receive "reasonably equivalent value" for property transferred or an obligation incurred but omit the subjective element of "good faith" that the UFTA contains. *See* 11 U.S.C. § 548(a)(2) (1988); UFTA §§ 4(a)(2), 5, 7A U.L.A. 653, 657 (1985). Neither the Code nor the UFTA defines "reasonably equivalent value." Both, however, define "value" as "property, or satisfaction, or securing of a present or antecedent debt," with some limitations that are not germane here. *See* 11 U.S.C. § 548 (d)(2)(A) (1988); UFTA § 3, 7A U.L.A. 650 (1985).

²⁰ *See, e.g., Credit Managers Ass'n v. Federal Co.*, 629 F. Supp. 175, 182 (C.D. Cal. 1986)

return for the transfer. That value, however, goes to pay off the selling shareholders rather than to Target. Consequently, Target does not receive any direct benefit from the LBO.²¹

Target's failure to receive "fair consideration" does not establish that the LBO is *ipso facto* constructively fraudulent. Were the rule not so limited, it would chill a debtor's freedom to dispose of its property and enter into advantageous relationships. Consequently, fraudulent transfer law only restricts a debtor's freedom when that freedom is at the expense of its creditors. Fraudulent transfer law only invalidates those transfers lacking "fair consideration" or "reasonably equivalent value" if a debtor's financial condition is precarious at the time of the transfer, or is made precarious as a result of the transfer.²²

This article is concerned with the manner in which financial precariousness is determined in the LBO context. Although financial precariousness is evaluated under three alternative tests, only two of these tests are of practical significance in an LBO; namely, the "insolvency" test and the "unreasonably small capital" test.²³

("[t]his is probably the case in every leveraged buyout"); *United States v. Gleneagles Inv. Co.*, 565 F. Supp. 556, 574 (M.D. Pa. 1983), *aff'd sub nom. United States v. Tabor Realty Corp.*, 803 F.2d 1288, 1307 (3d Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987). *But see* Kupetz v. Continental Ill. Nat'l Bank & Trust Co., 77 Bankr. 754, 761 (Bankr. C.D. Cal. 1987). In *Kupetz*, the court held that, even though Target may not have received fair consideration, from the selling shareholders' perspective, the sale of Target was for fair consideration. *Id.* In order to distinguish the case from *Credit Managers*, which involved a "classic" leveraged buyout scenario in which there possibly can never be fair consideration, the court seized on the fact that the selling shareholders were unaware that they were being paid from the proceeds of loans. *Id.*

²¹ Target may receive a number of substantial indirect benefits from an LBO. They may include new or more motivated management, tax benefits resulting from the substitution of deductible interest payments for nondeductible dividends, and, if Target was previously a public corporation, savings from avoiding the expense of complying with securities laws. *See* Kirby, McGuinness & Kandel, *Fraudulent Conveyance Concerns in Leveraged Buyout Lending*, 43 Bus. Law. 27, 35 (1987); Queenan, *supra* note 6, at 10-13. These benefits, however, do not constitute consideration. *See, e.g., Gleneagles*, 565 F. Supp. at 576 (new management not fair consideration within the meaning of Pennsylvania's UFCAL); *see also* Rosenberg, *supra* note 7, at 243 ("a literal reading [of fair consideration] requires receipt of a balance sheet asset or cancellation of a balance sheet liability to qualify as fair consideration").

²² The critical date for determining financial precariousness is the date on which the challenged transfer occurred or immediately thereafter. *See* Hyde Properties v. McCoy, 507 F.2d 301, 306 (6th Cir. 1974); Vadnais Lumber Supply, Inc. v. Byrne (*In re* Vadnais Lumber Supply, Inc.), 100 Bankr. 127, 137 (Bankr. D. Mass. 1989); *Gleneagles*, 565 F. Supp. at 577; Cate v. Nicely (*In re* Knox Kreations, Inc.), 474 F. Supp. 567, 571 (E.D. Tenn. 1979); Angier v. Worrel, 346 Pa. 450, 453, 31 A.2d 87, 89 (1943). *But see* Barrett v. Continental Ill. Nat'l Bank & Trust Co., 882 F.2d 1, 4-5 (1st Cir. 1989) (period extending in both directions from critical date).

²³ Under the third test, a transfer lacking consideration is fraudulent if the debtor

Part I discusses the "insolvency" test²⁴ and Part II discusses the "unreasonably small capital" test.²⁵ These discussions suggest that an LBO's compliance with fraudulent transfer law is dependent on the valuation standard a court chooses in construing these tests. The cases reveal that two basic valuation standards exist. The first assumes Target to be in liquidation, whether such liquidation is immediate or orderly. The other standard determines Target's value on a going-concern basis. The standards that guide a court's assessment of Target's financial condition are inherently vague and can produce inconsistent and unpredictable results.

Part III explores why a court might choose one approach over another.²⁶ It suggests that judicial assessment of Target's financial condition is subject to the court's view regarding the acceptable reach of fraudulent transfer law as well as its conclusion whether unsecured creditors or LBO participants, particularly lenders, should more fairly assume the loss from a failed LBO. Courts more sympathetic to the claims of creditors, particularly creditors who held claims at the time of an LBO, are more likely to employ a liquidation approach. Conversely, courts that entertain serious res-

"intends" or "believes" that it will incur debts beyond its ability to pay. UFCA § 6, 7A U.L.A. 507 (1985). The Bankruptcy Code and the UFTA have similar provisions but add that a transfer would also be fraudulent if the debtor "reasonably should have believed" that it would incur such debts. See 11 U.S.C. § 548 (a)(2)(B)(iii) (1988); UFTA § 4 (a)(2)(ii), 7A U.L.A. 652-53. Even under the UFCA, however, courts sometimes evaluate the debtor's state of mind under a reasonableness standard. See, e.g., *Waukesha County Dep't of Social Serv. v. Loper*, 53 Wis. 2d 713, 717, 193 N.W.2d 679, 681 (1972) (whether individual debtor "knew or should have known" of inability to pay debts).

It seems inappropriate to avoid an LBO lender's interests under this test. The relevant "intent" or "belief" under the statute is that of Target, or its principals. If the lender is unaware of Target's intent or belief, it would be manifestly unfair to penalize the lender for someone else's inequitable conduct. See *Sherwin*, *supra* note 6, at 501-02. Moreover, such a result would be inconsistent with cases decided under the intentional fraud branch of fraudulent transfer law. For example, in *Gleneagles*, the court stated that the LBO lender's security interests would not be set aside for intentional fraud if the lender was unaware of the fraud. See *Gleneagles*, 565 F. Supp. at 580; see also *Interstate Acceptance Corp. v. Lovins*, 380 S.W.2d 805 (Ky. 1964) (transferee's good faith precludes transferor's creditors from attaching the transfer). If the lender is aware of Target's fraudulent intent, however, liability under the present test would be redundant. Similarly, in the LBO context, the function of the test is easily accomplished by the "unreasonably small capital" test. Under the developing case law, adequacy of capital requires an analysis of Target's ability to generate cash flow to operate as a going concern. See *infra* text accompanying notes 175-78 for a discussion of this developing case law. Thus, if Target expects to generate adequate cash flow to cover its expected debts, it is unlikely that it would anticipate incurring debts beyond its ability to pay.

²⁴ See *infra* notes 28-136 and accompanying text.

²⁵ See *infra* notes 137-78 and accompanying text.

²⁶ See *infra* notes 179-232 and accompanying text.

ervations about applying constructive fraud to LBOs are more likely to approach issues of valuation from a going-concern perspective.

Part IV offers rationales why Target's valuation as a going-concern as determined by its cash flow accommodates the need to protect creditors while also protecting the reasonable commercial expectations of participants in an LBO.²⁷ Part IV also suggests that cash flow should sufficiently measure an LBO's compliance with fraudulent transfer law. If the court finds Target's future cash flow to be positive, Target should be deemed solvent as well as reasonably capitalized. The article concludes by suggesting that, in evaluating Target's financial condition based on cash flow, courts should consider the claims of subsequent creditors.

I. THE INSOLVENCY TEST AND STANDARDS OF VALUATION USED IN DETERMINING INSOLVENCY

A. *Statutory Definitions of Insolvency*

One test of the validity of an LBO is whether Target was either "insolvent" at the time of the LBO or made insolvent as a result of it.²⁸ With some differences in language and occasionally in result, all three statutory definitions of fraudulent transfer law measure "insolvency" by a balance-sheet test that compares assets against liabilities.²⁹ The Bankruptcy Code provides the most straightforward formulation of the balance-sheet test: Target is insolvent when its debts are "greater than [its] property at a fair valuation."³⁰ The Uniform Fraudulent Transfer Act ("UFTA") tracks the Bankruptcy Code.³¹ It provides for a rebuttable presumption of insolvency, however, when Target is "generally not paying [its] debts as they become due."³²

²⁷ See *infra* notes 233-77 and accompanying text.

²⁸ See *supra* note 22 for the relevant authorities.

²⁹ See, e.g., *Consove v. Cohen (In re Roco Corp.)*, 701 F.2d 978, 983 (1st Cir. 1983) (balance sheet); *Constructora Maza, Inc. v. Banco de Ponce*, 616 F.2d 573, 577 (1st Cir. 1980); *Pinto v. Philadelphia Fresh Food Terminal Corp. (In re Pinto)*, 98 Bankr. 200, 209 (Bankr. E.D. Pa. 1989); *Northern Va. Bank v. Vecco Constr. Indus. (In re Vecco Constr. Indus.)*, 9 Bankr. 866, 871 (Bankr. E.D. Va. 1981); *Transamerica Ins. Co. v. Trout*, 145 Ariz. 355, 360, 701 P.2d 851, 856 (Ariz. 1985); *Furniture Mfrs. Sales, Inc. v. Deamer*, 680 P.2d 398, 400 (Utah 1984).

³⁰ 11 U.S.C. § 101 (29)(A) (1988).

³¹ UFTA § 2(a), 7A U.L.A. 648 (1985).

³² *Id.* § 2(b). The drafters added the presumption in order to help a creditor overcome the difficulties typically involved in proving insolvency in the balance sheet sense. *Id.* § 2(b) comment 1, 7A U.L.A. 648-49. The presumption sets forth a test of insolvency in the equity

"Insolvency" under the Uniform Fraudulent Conveyance Act ("UFCA") is equivocal: Target is insolvent when the "present fair salable value" of its assets is less than the amount required to pay its "probable liability on [its] existing debts as they become absolute and matured."³³ It is unclear whether the UFCA states a balance-sheet test or whether it also incorporates an equity or cash-flow test.³⁴

B. *Alternative Standards of Valuation*

Although the basic concept of balance-sheet insolvency is clear, its application is anything but certain. This uncertainty largely arises because of the various standards that are available to value Target's assets and liabilities. Thus, a court can value Target's assets, assuming they were to be liquidated immediately. On the other hand, a court could value those same assets in terms of their value to Target as a going concern.

1. Valuation on the Basis of Liquidation

The most extreme liquidation standard to value appears in a line of cases decided under the UFCA. This case law often emphasizes the words "present" and "salable" in the UFCA's "present fair

sense. This test is easier to meet because it may be met by a company temporarily experiencing cash flow problems although the value of its assets may exceed its liabilities. See *Kreps v. Comm'r of Internal Revenue*, 351 F.2d 1, 9 (2d Cir. 1965); *South Cent. Enters., Inc. v. Farrington (In re Progressive Farmers Ass'n)*, 50 Bankr. 525, 543-44 (Bankr. W.D. Mo. 1985). The equity test of solvency, or common law test as it is also known, appears in the Uniform Commercial Code along with the balance sheet test. See U.C.C. § 1-201(23) (1989).

³³ UFCA § 2, 7A U.L.A. 442 (1985).

³⁴ See *United States v. Tabor Realty Corp.*, 803 F.2d 1288, 1304 (3d Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987) (cash flow); *United States v. Gleneagles Inv. Co.*, 565 F. Supp. 556, 579 (M.D. Pa. 1983) ("a company with highly illiquid assets would not be insolvent if the operation of its business produced sufficient cash for the payment of its debts as they matured"), *aff'd sub nom. United States v. Tabor Realty Corp.*, 803 F.2d at 1307; *Fleet v. Rhode (In re Fleet)*, 89 Bankr. 420, 425 (Bankr. E.D. Pa. 1988) (referring to the UFCA as stating the "common-law insolvency test" but also adding, somewhat equivocally, that UFCA "embraces not only insolvency in the bankruptcy sense, but also 'a condition wherein a debtor has insufficient present salable assets to pay existing debts as they mature'") (quoting *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288, 1303 (3d Cir. 1986) (quoting *Larrimer v. Feeney*, 411 Pa. 604, 608, 192 A.2d 351, 353 (1963)). *But see Meyer v. General Am. Corp.*, 569 P.2d 1094, 1096 (Utah 1977) (UFCA's test "is not insolvency in the bankruptcy sense but merely a showing that the party's assets are not sufficient to meet liabilities as they become due"); *Pinto v. Philadelphia Fresh Food Terminal Corp. (In re Pinto)*, 98 Bankr. 200, 209 (Bankr. E.D. Pa. 1989) (noting that UFCA states a common-law test); *Vener, Transfers in Fraud of Creditors under the Uniform Acts and the Bankruptcy Code*, 92 Com. L.J. 218, 224 (1987) (noting the ambivalence of the UFCA test).

salable value" test.³⁵ This judicial emphasis suggests valuation based on an assumption that assets will be immediately liquidated.³⁶ Measuring value in terms of immediate liquidation renders illiquid assets valueless. Consequently, under this line of cases, assets that are not "liquid" or cannot be fairly quickly sold do not become part of the "assets" column in Target's balance sheet.

In *United States v. Gleneagles Investment Co.*,³⁷ the court seemed to apply this standard to determine Target's solvency. The *Gleneagles* court held the LBO voidable under both the constructive and intentional fraud provisions of the Pennsylvania UFCA.³⁸ In *Gleneagles*, Target was the parent company of a group of subsidiaries engaged in coal production and the sale of coal lands.³⁹ The United States sued over certain delinquent taxes and sought, under the UFCA, to invalidate certain mortgages and liens given to the lender to secure the loans made to finance the acquisition.⁴⁰

Gleneagles illustrates the profound impact that choice of a valuation standard can have on a court's determination of whether an LBO complies with fraudulent transfer law. The *Gleneagles* court greatly aided the government's claim of constructive fraud by broadly construing the phrase "present fair salable value" in making its insolvency determination. As noted, an insolvency determination requires a court to engage in "facts-and-figures" analysis to determine if Target's assets exceed its liabilities.⁴¹ Obviously, the specific

³⁵ See, e.g., *Gleneagles*, 565 F. Supp. at 578 ("present may not be disregarded") (quoting *Fidelity Trust Co. v. Union Nat'l Bank*, 313 Pa. 467, 475, 169 A. 209, 213 (1933), cert. denied, 291 U.S. 680 (1934)); *In re Fleet*, 89 Bankr. at 425 (emphasizing liquidity and salability); *Fidelity Trust Co.*, 313 Pa. at 475, 169 A. at 209 (explicitly emphasizing the immediacy of the sale by noting that it was error to find "fair salable value" instead of "present" fair salable value); *Corbin v. Franklin Nat'l Bank (In re Franklin Nat'l Bank Sec. Litig.)*, 2 Bankr. 687, 711 (Bankr. E.D.N.Y. 1979), aff'd, 633 F.2d 203 (2d Cir. 1980) (stating "'present fair salable value' means just that; the fair value of presently salable assets.").

³⁶ See *supra* note 35 for the cited authorities. One commentator has noted that "[t]he word 'present' in the UFCA definition would seem to suggest that the debtor's assets should be evaluated at liquidation value rather than fair market value." Heiman, *Fraudulent Conveyances*, in 2 *ASSET-BASED FINANCING: A TRANSACTIONAL GUIDE* § 21.03[2][a], at 21-15 (1987). Rosenberg also notes that although the balance sheet test anticipates the possibility of liquidation within a reasonable time, the UFCA test anticipates a more immediate liquidation. Rosenberg, *supra* note 7, at 254 n.50; see also McLaughlin, *Application of the Uniform Fraudulent Conveyance Act*, 46 HARV. L. REV. 404, 420 (1933) (noting the intermediacy of the UFCA test between the bankruptcy and the equity standard).

³⁷ 565 F. Supp. 556 (M.D. Pa. 1983). *Gleneagles* is the first and, so far only, case to void an LBO financed by a third party as a fraudulent transfer.

³⁸ *Id.* at 564.

³⁹ *Id.*

⁴⁰ *Id.* at 560, 572.

⁴¹ See *supra* text accompanying note 29.

assets and liabilities considered by the court will critically influence the court's ultimate insolvency or solvency conclusion.⁴² The court's choice of valuation standard may thus determine the conclusion by excluding certain assets from consideration.

The *Gleneagles* court appeared to avoid a forced-sale standard by interpreting "present fair salable value" to mean "that value which can be obtained if the assets are liquidated with reasonable promptness in an arms-length transaction in an existing and not [a] theoretical market."⁴³ The court's reference to an "arms-length transaction" suggests an exchange between a "willing seller and buyer."⁴⁴ It negates the compulsion and consequent sacrifice in price usually associated with a forced-sale standard.⁴⁵ Moreover, despite the court's assumption of liquidating assets with "promptness," it

⁴² See, e.g., *Kepler v. Atkinson* (*In re Atkinson*), 63 Bankr. 266, 269 (Bankr. W.D. Wis. 1986) (debtor's claim against her son not an asset because it could not be sold); *Kepler v. Schmalbach* (*In re Lamanski*), 56 Bankr. 981, 989 (Bankr. W.D. Wis. 1986) (worthless counterclaim not an asset); *Chase Nat'l Bank v. United States Trust Co.*, 236 A. D. 500, 503, 260 N.Y.S. 40, 44 (1932) (unsecured indebtedness due to debtor from a realty company and 35% of its stock were not assets because unsalable).

The foregoing cases underscore an important fact: to qualify as an asset, property must be leviable, i.e., available to satisfy the claims of creditors. See UFCA § 1, 7A U.L.A. 430 (1985) (defining "asset" to mean property available for the payment of debts); see also 1 G. GLENN, *supra* note 8, § 139, at 258 (noting that "transferability" and ability to be converted into cash are the essence of an asset).

⁴³ 565 F. Supp. at 578.

⁴⁴ *American Nat'l Bank & Trust v. Bone*, 333 F.2d 984, 987 (8th Cir. 1964); *Syracuse Eng'g Co. v. Haight*, 110 F.2d 468, 471-72 (2d Cir. 1940); *Northern Va. Bank v. Vecco Constr. Indus.*, 9 Bankr. 866, 871 (Bankr. E.D. Va. 1981); *First Nat'l Bank v. Perdue Hous. Indus., Inc.* (*In re Perdue Hous. Indus., Inc.*), 437 F. Supp. 36, 38 (W.D. Okla. 1977); *In re Bichel Optical Laboratories, Inc.*, 299 F. Supp. 545, 547 (D. Minn. 1969).

The judicial concept of fair market value as determined by a "willing seller and a willing buyer" has a long pedigree. See Bonright & Pickett, *Valuation to Determine Solvency under the Bankruptcy Act*, 29 COLUM. L. REV. 582, 600 (1929) (citing *Duncan v. Landis*, 106 F. 839 (3d Cir. 1901), as the leading authority that rejected immediate liquidation value and established the willing-seller, willing-buyer test as the appropriate valuation standard in bankruptcy litigation). The concept, however, is often misused or little understood. For example, the credibility gap on the part of the appraisal profession has spawned intense debate concerning the meaning of "fair market value." See Montalva, *Appraising For Lenders—Part One, THE SECURED LENDER*, Mar.-Apr. 1988, at 55 (cataloguing nine different concepts of value); see also Queenan, *Standards for Valuation of Security Interests in Chapter 11*, 92 COM. L.J. 18, 19 (1987) (cataloguing six different valuation standards for valuing security interests).

⁴⁵ The value obtained under such a standard presupposes a prompt sale where it is assumed the buyer's price reflects the seller's "necessities and embarrassments." See, e.g., *Duncan v. Landis*, 106 F. 839, 858 (3d Cir. 1901). The value obtained under a forced-sale standard may also reflect the lack of advertising and sales efforts that normally accompany other types of sales. Queenan, *supra* note 44, at 19. The American Society of Appraisers' Machinery and Equipment Committee, however, defines "liquidation value" as the value obtained at a "properly advertised and conducted public auction," though under a forced sale condition. Montalva, *supra* note 44, at 56.

qualifies the term "promptness" with "reasonable,"⁴⁶ again seeming to avoid the undue sacrifice in price that immediate liquidation would cause.

Nevertheless, it is difficult to avoid the conclusion that *Gleneagles* used a fairly broad, i.e., harsh, standard of liquidation. Indeed, the court relied on the Pennsylvania Supreme Court's opinion, *Larrimer v. Feeney*⁴⁷ in which the court stated:

A debtor may have . . . assets which have a small salable value, but which if held to a subsequent date could have a much higher salable value. Nevertheless, if the *present* salable value of assets [is] less than the amount required to pay existing debts as they mature, the debtor is insolvent.⁴⁸ (Emphasis in original.)

Some commentators have noted that a valuation standard based on "present fair salable value" is inherently uncertain because it requires a further determination of the amount of time and the conditions under which it might be "fair" to allow Target to dispose of its assets.⁴⁹

Nevertheless, *Gleneagles* and *Larrimer* suggest that, at a minimum, there are two periods of time within which the sale of Target's assets is assumed to occur, one shorter than the other. These courts concluded that the UFCA contemplated "present" liquidation whereas the Bankruptcy Code envisioned "subsequent" liquidation.⁵⁰ This distinction is based on the view that the bankruptcy test

⁴⁶ 565 F. Supp. 556, 578 (M.D. Pa. 1983), *aff'd sub nom.* United States v. Tabor Realty Corp., 803 F.2d 1288, 1307 (3d Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987).

⁴⁷ *Id.* (citing *Larrimer v. Feeney*, 411 Pa. 604, 192 A.2d 351 (1963)).

⁴⁸ *Feeney*, 411 Pa. at 608, 192 A.2d at 353.

⁴⁹ See Bonright & Pickett, *supra* note 44, at 594; see also *id.* at 598 (noting a similar indeterminacy in respect to the fair valuation standard applicable in bankruptcy). In bankruptcy, however, it is "admitted that a 'distressed' sale is not the proper test." *Darky v. Shawnee Southwest, Inc.*, 399 F. Supp. 587, 591 (W.D. Okla. 1975); see *Syracuse Eng'g Co.*, 110 F.2d at 471; *Ohio Corrugating Co. v. DPAC, Inc. (In re Ohio Corrugating Co.)*, 91 Bankr. 430, 438 n.10 (Bankr. N.D. Ohio 1988); *Bergquist v. Anderson-Greenwood Aviation Corp. (In re Bellanca Aircraft Corp.)*, 56 Bankr. 339, 385 (Bankr. D. Minn. 1985).

⁵⁰ See *infra* text accompanying notes 56-59 for an illustration of the difference between the UFCA test and bankruptcy test. See also *Gleneagles*, 565 F. Supp. at 579; *Larrimer*, 411 Pa. at 608, 192 A.2d at 353. These courts distinguished between an asset's "small present salable value" and its "higher value if held to a subsequent date." The distinction implies that the "small" amount obtained when an asset is sold quickly results from the seller's lack of power to decline the price offered as well as the brevity of the time allowed for negotiating and completing the sale. See Bonright & Pickett, *supra* note 44, at 600. In contrast, the "higher" value obtained when an asset is sold at a "subsequent date" implies a sale between a "willing" seller and a "willing" buyer, under normal market conditions. See *id.*; see also *American Nat'l*

of solvency evolved from a desire to protect debtors from involuntary bankruptcy if they had more assets than liabilities.⁵¹

On the other hand, some commentators have viewed the UFCA standard as embodying an amalgam of two approaches.⁵² This standard encompasses insolvency in the sense of both bankruptcy and equity.⁵³ Under this view, if a debtor's net worth on paper is negative, the "present fair salable value" of its assets must be less than its liabilities.⁵⁴ The converse, however, is not true. A debtor's net worth on paper may be substantial: that is, more than sufficient to pass muster under the bankruptcy test of insolvency. If the debtor's net worth cannot be liquidated for an amount sufficient to pay its obligations as they become due, the debtor would be insolvent under the UFCA.⁵⁵

The 1922 Montana case of *In re Crystal Ice & Fuel Co.*⁵⁶ is an early illustration of the difference between the UFCA test and the bankruptcy test. A corporation had issued a trust deed to secure a bond issue. The corporation later defaulted on interest payments and the trust deed became subject to foreclosure.⁵⁷ The evidence indicated that the debtor's assets exceeded its debts under the bankruptcy test of "fair valuation," even though under the "present fair salable value standard," they did not.⁵⁸ The court expressly distinguished between the two tests, observing that "although [a debtor's]

Bank & Trust Co., 333 F.2d at 987 (price obtained at a "prompt" sale does not represent fair market value); *Syracuse Eng'g Co.*, 110 F.2d at 471.

⁵¹ *Fleet v. Rhode (In re Fleet)*, 89 Bankr. 420, 425 (Bankr. E.D. Pa. 1988) ("the bankruptcy solvency test has traditionally been stringent, due to the vestige from the day of commonplace involuntary proceedings that 'a man ought not to be forced into bankruptcy if, at a fair valuation of his possessions, he has more than he owes'") (quoting *McGill v. Commercial Credit Co.*, 243 F. 637, 646-49 (D. Md. 1917)). Professor Glenn notes the same difference between the tests and raises an interesting question. See 1 G. GLENN, *supra* note 8, § 272, at 465-66. He states that a transfer could pass muster under the lenient bankruptcy test but fail the "present fair salable value" test. *Id.* In such a case, according to Professor Glenn, the trustee in bankruptcy would be well advised to bring his or her suit under state law. *Id.* at 466. Such a suit was permitted under the Bankruptcy Act of 1938. 11 U.S.C. § 110(e) (1970). The trustee's right to proceed in this manner has been preserved. See *id.* § 544(b) (1988). This seems to be what the trustee in *Gleneagles* did. See 565 F. Supp. at 583.

⁵² See L.P. KING & M.L. COOK, CREDITORS' RIGHTS, DEBTORS' PROTECTION AND BANKRUPTCY 348 (1985) ("The UFCA sets forth a hybrid test for involvency. . . . The Bankruptcy Code, by contrast, provides a simple 'balance' sheet test for insolvency."); Verner, *supra* note 34, at 224.

⁵³ See *supra* note 35 for the cited authorities.

⁵⁴ *Larrimer*, 411 Pa. at 608, 192 A.2d at 353.

⁵⁵ *Id.*

⁵⁶ 283 F. Supp. 1007 (D. Mont. 1922).

⁵⁷ *Id.* at 1008.

⁵⁸ *Id.* at 1009-10.

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."⁵⁹ The distinction between these standards is significant not only in terms of different estimates of value but also, and more importantly, in terms of the assets that may be included to determine solvency.

Gleneagles dramatically illustrates the effect that the distinction between these two standards has on solvency determinations in the LBO context. The defendants, seeking to establish Target's solvency at the time of the LBO, showed that Target owned "vast lands, culm banks, and coal reserves."⁶⁰ The court acknowledged that these assets had "tremendous value."⁶¹ Nevertheless, the court declined to include these assets in its solvency determination because they were "highly illiquid," requiring "an extended period of time" to liquidate.⁶² In addition, the defendants established that Target had mining equipment with a "fair market value" of between six and twenty-two million dollars.⁶³ The court also disregarded this evidence because the equipment was not "rapidly salable."⁶⁴ It noted

⁵⁹ *Id.* at 1010. The court noted that "[a]t 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." *Id.* Based on this reasoning, several commentators have noted that "saleable value and fair value are not synonymous." 2 COLLIER ON BANKRUPTCY ¶ 101.26 at p. 101-55 (15th ed. 1985); see also Rosenberg, *supra* note 7, at 255. Rosenberg noted the distinction and stated that:

if an asset can be converted to cash only in the future, it will not be included on the asset side. . . . 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.

Id. See also McLaughlin, *supra* note 36, at 420 ("present fair salable value" anticipates immediate liquidation whereas "fair valuation" anticipates the possibility of liquidation within a reasonable time). But see Ragusin, *Brother-Sister Corporate Guaranties: Increased Legal Acknowledgment of Business World Realities*, 11 J. CORP. L. 391, 403 (1986) (referring to the distinction as an "extravagant theory concocted in some circles" and wondering if the distinction is "still valid").

⁶⁰ *United States v. Gleneagles Inv. Co.*, 565 F. Supp. 556, 579 (M.D. Pa. 1983), *aff'd sub nom.* *United States v. Tabor Realty Corp.*, 803 F.2d 1288, 1307 (3d Cir. 1986), *cert. denied* 483 U.S. 1005 (1987).

⁶¹ *Id.*

⁶² *Id.*

⁶³ *Id.*

⁶⁴ *Id.* The court considered several factors in determining whether Target's assets were "rapidly salable." First, it considered whether a "fairly liquid" market existed for a particular asset. *Id.* For example, the court found that Target's Huber Breaker could not be operated efficiently at 1973 coal prices. *Id.* at 580. Therefore, it determined that the market for this type of equipment was illiquid. *Id.* at 579. Second, the court seemed to think that an asset's

a debtor was not solvent "merely because [it] . . . has assets with a fair market value which would permit [it] to pay [its] debts at some future time upon a liquidation of [its] business."⁶⁵ Harking back to the *Larrimer* test, the court emphasized that solvency requires the "present" ability to pay one's debts as they mature.⁶⁶ Thus, the *Gleneagles* approach means that fewer assets are likely to appear on the balance sheet.⁶⁷

Gleneagles ensures a "less-cluttered" balance sheet of assets in LBOs involving capital-intensive companies.⁶⁸ The assets of such companies are unlikely to count as assets for purposes of solvency because they cannot be sold with the requisite *Gleneagles* degree of promptness. Wholesale adoption of this standard would not only inhibit LBO transactions generally, it would also deprive owners of the capitalized value of their businesses.

The Third Circuit Court's approval in *United States v. Tabor Court Realty Corp.* of the *Gleneagles* lower court's reasoning makes it difficult to argue that *Gleneagles* only applies the conventional, bankruptcy "fair valuation" test. On appeal, the defendants urged the Third Circuit to apply a different valuation test. The defendants correctly pointed out to the court the narrow approach taken by other states.⁶⁹ The defendants argued that the district court had erroneously applied a standard of "immediate liquidation" rather than the standard of liquidation within a "reasonable time" followed by the overwhelming majority of courts.⁷⁰ The Third Circuit was unimpressed. It dismissed the argument, curtly observing that the trial court had "applied the *Larrimer* criteria of Pennsylvania, not those of Montana and New York."⁷¹ The Third Circuit's remark is puzzling because Montana and New York, as well as Pennsylvania, purport to measure insolvency using a uniform test of "present fair salable value."⁷²

rapid salability would be affected by encumbrances on the asset. *Id.* Finally, the court considered that even if an asset could be sold fairly rapidly, it might be important to the operations of Target's business. Consequently, it would not be regarded as an asset available for payment of debts. *Id.* at 579-80.

⁶⁵ *Id.* at 578.

⁶⁶ *Id.*

⁶⁷ Rosenberg reached a similar conclusion based on an analysis of the UFCA's "present fair salable value" standard. See Rosenberg, *supra* note 7, at 255; see also *supra* note 59.

⁶⁸ See Brief of Amicus Curiae, National Commercial Finance Ass'n, Inc. at 16, *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288 (3d Cir. 1986) (No. 85-5636).

⁶⁹ *Tabor Court Realty Corp.*, 803 F.2d at 1303.

⁷⁰ *Id.*

⁷¹ *Id.* at 1304.

⁷² See UFCA table of jurisdictions wherein Act has been adopted, 7A U.L.A. 427 (1990 Supp.).

Unlike *Larrimer* and its progeny, most courts do not draw a distinction between the UFCA and Bankruptcy Code's tests of valuation.⁷³ In applying the UFCA, most courts have not emphasized the words "present" and "salable" and therefore have not recognized the sharp discount in value reflecting lack of liquidity that the words might suggest.⁷⁴ Thus, most courts employ a valuation standard similar to that employed under the Bankruptcy Code.

Despite its endurance for nearly a century,⁷⁵ the bankruptcy test provides no precise standards for valuation other than that the valuation be "fair."⁷⁶ The task of articulating a more precise standard has fallen on the courts. Not surprisingly, the courts have not formulated a clear and consistent standard of insolvency.⁷⁷ The task is beset with inherent difficulties.

First, valuating a person's assets "at a specific time is at best an inexact science and may often be impossible."⁷⁸ Consider, for example, the discrepancies in valuation that can arise in appraising a single-family home. Second, valuation is usually decided on the basis of expert testimony. Although an expert is supposedly objective, reality suggests otherwise. The appraiser is often an advocate.⁷⁹

⁷³ See, e.g., *Wieboldt Stores, Inc. v. Schottenstein*, 94 Bankr. 488, 505 (N.D. Ill. 1988) ("[f]air valuation is near enough in meaning to 'fair value of salable assets' to defeat defendants' motion to dismiss"); *Seligson v. New York Produce Exch.*, 394 F. Supp. 125, 129 (S.D.N.Y. 1975) (the definitions in the UFCA and in the Bankruptcy Code are substantially equivalent); *United States v. 58th St. Plaza Theatre, Inc.*, 287 F. Supp. 475, 497 (S.D.N.Y. 1968) ("The standard to be applied under the [UFC] is insolvency in the 'bankruptcy' sense."); see also *Cieri, Leveraged Buyouts*, *supra* note 1, at 361.

⁷⁴ See, e.g., *Hyde Properties v. McCoy*, 507 F.2d 301, 307 (6th Cir. 1974); *Tri-Continental Leasing v. Zimmerman*, 485 F. Supp. 495, 500-01 (N.D. Cal. 1980); *Cate v. Nicely (In re Knox Kreations)*, 474 F. Supp. 567, 571 (E.D. Tenn. 1979), *aff'd in part, rev'd in part*, 656 F.2d 230, 231 (6th Cir. 1981); *United States v. Kerr*, 470 F. Supp. 278, 283 (E.D. Tenn. 1978).

⁷⁵ The "fair valuation" standard has been the test of insolvency for bankruptcy purposes since 1898. See National Bankruptcy Act of 1898, ch. 541, § 1(15), 30 Stat. 544 (repealed 1978); see also 1 G. GLENN, *supra* note 8, § 272, at 465. This standard replaced the "equity" of "inability to pay debts as they mature" approach that was favored prior to that time.

⁷⁶ See 11 U.S.C. § 101(31)(A) (1988); see also *American Nat'l Bank & Trust Co. v. Bone*, 333 F.2d 984 (8th Cir. 1964) ("[t]he statute describes the controlling standard of valuation with on brief phrase: 'fair'").

⁷⁷ Compare the standard formulation of the test in *Syracuse Engineering Co. v. Haight*, 110 F.2d 468, 471 (2d Cir. 1940) ("[a] proper regard for the interests of the bankrupt, as well as the interests of his creditors, compels the conclusion that fair market price is the most equitable standard") with *Wieboldt Stores*, 94 Bankr. 485, 505 (Bankr. N.D. Ill. 1988) ("[i]n determining 'fair valuation,' a court must consider the property's intrinsic value, selling value, and the earning power of the property").

⁷⁸ *Constructora Maza, Inc. v. Banco de Ponce*, 616 F.2d 573, 577 (1st Cir. 1980); *Emerald Hills Country Club v. Hollywood, Inc. (In re Emerald Hills Country Club, Inc.)*, 32 Bankr. 408, 420 (Bankr. S.D. Fla. 1983).

⁷⁹ *Solk & Grant, Valuation Techniques for Closely-Held Enterprise*, 92 Com. L.J. 254, 256 (1987).

Furthermore, the appraisal profession itself lacks internal consensus regarding the use of crucial valuation terminology.⁸⁰ Courts often decide the valuation question by splitting the difference between the values asserted by the experts.⁸¹

In addition to the uncertainty that these factors contribute to valuation results, a fundamental legal question exists regarding "fair valuation." Most courts seem to agree that despite its fuzziness, the mandate of fair valuation is satisfied by estimating the amount for which an asset will exchange within a "reasonable time."⁸² This estimate is assumed to approximate an asset's "fair market value."

The critical factor affecting valuation is the period of time assumed to be a "reasonable time."⁸³ Thus, whether a debtor's assets received "fair valuation" depends on the court's determination of the time within which a debtor can fairly be expected to liquidate its assets. In theory, arguably all courts agree that fair valuation is not synonymous with the valuation that would prevail at a sheriff's sale or forced sale.⁸⁴ In practice, however, despite disclaimers to the contrary, the results in *Larrimer* and *Gleneagles* appear to approach a forced-sale valuation of assets.

Thus, one problem with fair valuation is that its "governing" standard of valuation is elastic and indeterminate. The shorter the time period within which a debtor is expected to liquidate assets, the more it approaches "liquidation" value; conversely, the longer the time period, the closer the valuation standard approximates the mandate of fair valuation. Because "reasonable time" can never be formulated precisely, it shrouds the determination of insolvency with uncertainty.⁸⁵

⁸⁰ See *id.* The lack of educational requirements and governmental certification procedures governing entry into the appraisal profession has contributed to the "proliferation" of inconsistent valuation results. *Id.*

⁸¹ *Id.* at 257 (citing Haynsworth, *Valuation of Business Interests*, 33 MERCER L. REV. 457, 486 n.82 (1982), and authorities cited therein).

⁸² See *Briden v. Foley*, 776 F.2d 379, 382 (1st Cir. 1985) (reasonable time); *Syracuse Eng'g Co. v. Haight*, 110 F.2d 468, 471 (2d Cir. 1940) (same); *Ohio Corrugating Co. v. DPAC, Inc.* (*In re Ohio Corrugating Co.*), 91 Bankr. 430, 436 (Bankr. N.D. Ohio 1988); *Flynn v. Midamerican Bank & Trust Co.* (*In re Joe Flynn Rare Coins, Inc.*), 81 Bankr. 1009, 1017 (Bankr. D. Kan. 1988); *Jahn v. Reading Body Works*, (*In re Fassnacht & Sons*), 45 Bankr. 209, 217 (Bankr. E.D. Tenn. 1984); *First Nat'l Bank of Stiegler v. Perdue Hous. Indus., Inc.* (*In re Perdue Hous. Indus., Inc.*), 437 F. Supp. 36, 38 (W.D. Okla. 1977).

⁸³ See *supra* note 82 and accompanying text for a discussion of fair valuation. See also Fortgang & Mayer, *Valuation in Bankruptcy*, 32 U.C.L.A. L. REV. 1061, 1062 (1985) ("Valuation in bankruptcy is a function of time."); 5 T. EISENBERG, *DEBTOR-CREDITOR LAW*, ¶ 22.03[E], at 22-34 (1989) ("A longer period of time for sale may permit a diligent search for the best buyer and other promotional and marketing efforts . . .").

⁸⁴ See *supra* note 82 and accompanying text.

⁸⁵ See, e.g., *In re Joe Flynn Rare Coins, Inc.*, 81 Bankr. at 1017 (noting the ambiguity of

2. Insolvency on a Going-Concern Value Basis

A more fundamental uncertainty causing courts difficulty is whether the mandate of "fair valuation" incorporates the concept of "going-concern value" and, if so, the relationship between "going-concern value" and fair market value.⁸⁶ In other words, does insolvency refer to an excess of liabilities over assets in the event of a liquidation of a debtor's assets or does it refer to the debtor's inability to pay its debts within a reasonable period of time while continuing its business?⁸⁷

The distinction is crucial. In the first case, the court assumes no future for an asset's relationship to the debtor's business, and it therefore values the asset based on that perspective.⁸⁸ Consequently, only assets that may be converted into cash within a reasonable time are included under the balance-sheet test. Asset values recorded on a debtor's balance sheet, although proper as accounting entries, are not determinative of fair market value.⁸⁹

The assumption of liquidation is important in another respect. Liquidation usually implies that assets are to be sold piecemeal, with specific values assigned to specific assets.⁹⁰ As a result, assets that have no independent value are disregarded. Intangibles such as customer lists, supply lines, distribution networks, and unpatented process technology are examples. Such assets, though valuable to a business, are inseparable from it. They are unlike tangible assets

"fair valuation" with respect to the standard by which assets should be valued); *Virginia Nat'l Bank v. Jones*, 5 Bankr. 736, 738 (Bankr. E.D. Va. 1980) ("True value is an elusive pimpernel."); see also Baird & Jackson, *supra* note 8, at 840-41, in which the authors argue for excluding LBOs from coverage under fraudulent transfer law because of the uncertainty inherent in value determinations.

⁸⁶ *Bergquist v. Anderson-Greenwood Aviation Corp. (In re Bellanca Aircraft Corp.)*, 56 Bankr. 339, 385 (Bankr. D. Minn. 1985).

⁸⁷ Bonright & Pickett, *supra* note 44, at 591; see Fortgang & Mayer, *supra* note 83 at 1063, stating the "[t]he choice between 'liquidation values' and 'going concerns values' lies at the heart of most disputes over asset valuation in bankruptcy."

⁸⁸ Fortgang & Mayer, *supra* note 83, at 1064 (defining "liquidation value" as the value an asset will bring at a sale less the cost of selling it). Although most courts use "liquidation value" interchangeably with "forced-sale value," others use it in the sense of fair market value. Compare *In re Bellanca Aircraft Corp.*, 56 Bankr. at 385 (liquidation value equals distressed sale price) with *Constructora Maza, Inc. v. Banco de Ponce*, 616 F.2d 573, 577 (1st Cir. 1980) (balance sheet test "focuses . . . on the liquidation value of the debtor's assets compared to his liabilities").

⁸⁹ See, e.g., *F.S. Bowen Electric Co. v. United States Fidelity and Guaranty Co.*, 256 F.2d 46, 49 (4th Cir. 1958).

⁹⁰ See, e.g., *United States v. Gleneagles Inv. Co.*, 565 F. Supp. 556, 579-80 (M.D. Pa. 1983), *aff'd sub nom. United States v. Tabor Realty Corp.*, 803 F.2d 1288, 1307 (3d Cir. 1986), *Cert. denied*, 483 U.S. 1005 (1987).

because they possess no residual value after the business ceases to exist.⁹¹

On the other hand, if valuation assumes a debtor will continue in business as a going concern, an asset's value is better reflected by its indirect contribution to the earnings of a business rather than by its ability to be sold and the proceeds to be used to pay debts. The American Accounting Association explains the assumptions underlying the "going concern" concept:

The "going concern" concept assumes the continuance of the general enterprise situation. In the absence of evidence to the contrary, the entity is viewed as remaining in operation indefinitely. Although it is recognized that business activities and economic conditions are changing constantly, the concept assumes that controlling environmental circumstances will persist sufficiently far into the future to permit existing plans and programs to be carried to completion. Thus the assets of the enterprise are expected to have continuing usefulness for the general purpose for which they are required ⁹²

"Going-concern" valuation requires determining the market value of an ongoing business as a whole.⁹³ It measures the business's plans, programs and assets, tangible as well as intangible, all of which contribute to its earnings. This valuation approach assumes that an ongoing business includes an additional element of value because the assets, viewed as a whole and as part of a business, significantly contribute to the enterprise's income-producing activities. This approach reflects the assumption that the whole is greater than the sum of its parts. Therefore, although the case law evinces confusion regarding the relationship between going-concern value

⁹¹ Cross, *Intangible Assets: Extra Comfort for the LBO Lender*, Mergers & Acquisitions, Nov.-Dec. 1988, at 47. Patents and copyrights, however, are a different matter because they can be separated from the business and retain value even after the business ceases to exist. *Id.* Cross suggests that the most important factor that accounts for the difference between target's net book value and its purchase price is the existence of nonseparable intangible assets. *Id.*

⁹² See G. NEWTON, BANKRUPTCY ACCOUNTING AND INSOLVENCY ACCOUNTING: PRACTICE AND PROCEDURES 500-01 (2d ed. 1981) (quoting AAA COMMITTEE ON ACCOUNTING CONCEPTS AND STANDARDS, ACCOUNTING AND REPORTING STANDARDS FOR CORPORATE FINANCIAL STATEMENTS AND PRECEDING STATEMENTS AND SUPPLEMENTS at 2).

⁹³ *In re Bellanca Aircraft Corp.*, 56 Bankr. 339, 386 (Bankr. D. Minn. 1985) (citing *Atlanta Knitting Mills v. Nathason Bros. Co.* (*In re Nathason Bros. Co.*), 64 F.2d 912, 913 (6th Cir. 1933)).

and market value, "going-concern" value seems to represent simply one measure of fair market value.⁹⁴

Application of the "going-concern" standard can sometimes be misleading, however. A court's acceptance of this standard as the appropriate one in a given case does not preclude the court from declining to use it to value specific assets. For example, in determining Target's solvency, the court in *Ohio Corrugating Co.* approved "going-concern" valuation for inventory, but rejected its use for machinery and equipment.⁹⁵ The court adopted a "nuts and bolts" appraisal for the machinery and equipment because it found that this latter approach more nearly reflected a proportional amount of the eventual sale price of all assets of the company.⁹⁶

If consistently understood and applied, "going-concern" values generally exceed liquidation values. Another recent LBO case illustrates the difference in results produced by these two competing approaches. In *Kupetz v. Continental Illinois National Bank & Trust Co.*,⁹⁷ the court disapproved the valuation results that flowed from the assumption that Target was being liquidated. Under this assumption, the appraiser had valued Target's receivables at seventy-five percent of their face value.⁹⁸ In *Kupetz*, the court found that Target collected most of its receivables within forty-five days because of the financial strength of its customers.⁹⁹ Therefore, the court indicated that if Target had been viewed from the perspective of a going concern, the receivables would have been valued at face value or at a much lower discount rate.¹⁰⁰

⁹⁴ See *id.*

⁹⁵ 91 Bankr. 430, 437-38 (Bankr. N.D. Ohio 1988).

⁹⁶ *Id.* at 438.

⁹⁷ 77 Bankr. 754, 762-63 (C.D. Cal. 1987), *aff'd sub nom.* *Kupetz v. Wolf*, 845 F.2d 842 (9th Cir. 1988).

⁹⁸ *Id.* at 762-63. Accounts receivable may be discounted from their face value if their collectibility is in doubt. *Constructora Maza, Inc. v. Banco de Ponce*, 616 F.2d 573, 577 (1st Cir. 1980). Collectibility is assessed in light of the account debtors' track record of payment, their current solvency, and whether the account debt is in dispute. *Id.*

⁹⁹ *Kupetz*, 77 Bankr. at 762-63.

¹⁰⁰ See *id.* Other cases involving the appropriate discount rate for valuing receivables have reached similar results viewing the debtor as a going concern. See, e.g., *Roelmeyer v. Walter E. Heller & Co. (In re Lackow Bros.)*, 752 F.2d 1529, 1531 (11th Cir. 1985). In this case, the trustee in bankruptcy sought to avoid as preferential, payments made to the creditor during the preferential period. Whether the payments were preferential critically depended on the standard of valuation the court applied: going-concern value or liquidation value. *Id.* at 1531. In deciding to use going-concern value, the court found significant that, in making additional loans, the creditor relied on the values of inventory and accounts indicated in debtor's "computer printouts." *Id.*

The impact of valuation on a "going-concern" basis can be even more dramatic. *Kupetz* again demonstrates that effect. A "going-concern" perspective not only increases the value of specific assets but also serves to determine if something qualifies for inclusion on Target's balance sheet. In *Kupetz*, for example, Target operated a showroom in which it displayed mannequins and other garment display forms it manufactured. The appraiser viewed Target's lease obligations as a liability.¹⁰¹ Similarly, the appraiser viewed certain of Target's third party consulting contracts as additional liabilities.¹⁰² The appraiser's view flowed from its assumption that Target was to be liquidated. The court suggested that viewed from the "going-concern" assumption, the lease might have been sold or otherwise been of value to Target; the consulting contracts similarly would have had value to Target.¹⁰³ To that extent, such value would be property to be considered as an asset in determining Target's solvency.

Another LBO case indicates a radically different approach to determining "going-concern" value. In *In re Vadnais Lumber Supply, Inc. v. Byrne*, the court stated that a business's "going-concern" value is the appropriate standard to measure Target's solvency.¹⁰⁴ The traditional method for determining enterprise value under this standard requires the capitalization of income or earnings.¹⁰⁵ It assumes that the value of a business lies in its ability to provide a future stream of income. Under this approach, as under the "asset appraisal" approach, solvency remains a function of whether Target's assets exceed its liabilities. Under this method, however, it is the capitalized value of the business that constitutes the asset column on Target's balance sheet.¹⁰⁶

Determining a company's capitalized value is not an easy matter. It involves two basic steps. The appraiser first must select an appropriate net profit figure that represents the enterprise's annual earning capacity.¹⁰⁷ To arrive at this figure, the appraiser must

¹⁰¹ *Kupetz*, 77 Bankr. at 763.

¹⁰² *Id.*

¹⁰³ *Id.*

¹⁰⁴ 100 Bankr. 127, 131 (Bankr. D. Mass. 1989).

¹⁰⁵ *Id.* at 132.

¹⁰⁶ *Muskegon Motor Stockholders Protective Comm. v. Davis (In re Muskegon Motor Specialties)*, 366 F.2d 522, 526 (6th Cir. 1966) ("In bankruptcy, a finding of insolvency is arrived at by a comparison of the assets (here being the capitalized value of future earnings) with liabilities.").

¹⁰⁷ *Vadnais Lumber Supply, Inc. v. Byrne (In re Vadnais Lumber Supply, Inc.)*, 100 Bankr. 127, 132 (Bankr. D. Mass. 1989); Queenan, *supra* note 82, at 39-40.

calculate projections of future sales and estimates of profit margins on sales.¹⁰⁸ The appraiser reaches its estimate of sales and profit margins based on a detailed analysis of the company's operating history in light of current trends or factors.¹⁰⁹ The appraiser then multiplies this net figure by an appropriate capitalization rate or "multiplier."¹¹⁰

The most difficult part of determining business value involves selecting the appropriate capitalization rate. No criteria exist to guide this decision.¹¹¹ The absence of criteria reflects a lack of consensus regarding the various factors that contribute to the risks associated within an enterprise and the industry to which it belongs. Despite the inherent difficulties in selecting a risk figure, which is what the capitalization rate represents, the capitalization rate reflects the product of two variables: the going or market interest rate for a riskless loan at the time, and the appraiser's judgment of the degree of risk regarding the particular business.¹¹²

Although courts frequently use the capitalization of income method to determine a debtor's solvency in bankruptcy reorganization,¹¹³ no court has used it to determine liability in a fraudulent transfer context. Thus, *Vadnais's* inclination to use the capitalization of income method in the context of an LBO represents a significant development. There is no reason why it should not be applied in the LBO context.

¹⁰⁸ *In re Muskegon Motor Specialties*, 366 F.2d at 526.

¹⁰⁹ G. NEWTON, *supra* note 92, at 375.

¹¹⁰ *In re Muskegon Motor Specialties*, 366 F.2d at 526, 527.

¹¹¹ See Note, *Valuation of Dissenters' Stock Under Appraisal Statutes*, 79 HARV. L. REV. 1453, 1467 (1966) ("[t]he multiplier is likely to represent the point of greatest disparity between the contending parties because of the absence of objective criteria by which to measure it and because a very small variation will result in a significant difference in the final appraisal value").

¹¹² G. NEWTON, *supra* note 92, at 378. Assume, for example, a business's estimated future income is \$900,000 per year. This predicted future income must then be reduced to present value by use of a discount rate. The discount rate reflects "both the time period before the [predicted future income] will be realized and the uncertainty as to what the actual [income] will be." Schaefer, *The Fallacy of Weigh[ing] Asset Value and Earnings Value in the Appraisal of Corporate Stock*, 55 S. CAL. L. REV. 1031, 1037 (1982). Now if we assume that 10% is the appropriate discount rate, the capitalized value of the business is \$2,000,000 [1 divided by 10% x 100,000]. If the business was much riskier, calling for a discount rate of 20%, the value of the business would be half as much [1 divided by 20% x 200,000]. The higher the business risk, the higher the discount rate, the smaller the capitalization rate, and the lower the value of a business.

¹¹³ See *In re Muskegon Motor Specialties*, 366 F.2d at 526. See generally Queenan, *supra* note 44, at 43-49.

C. Valuation of Liabilities

The problems of valuation are not unique to assets; courts must also value liabilities. The UFCA, UFTA, and the Bankruptcy Code all similarly define liabilities.¹¹⁴ Each statute defines liabilities in the broadest possible manner to cover all debts whether liquidated, unliquidated, fixed, contingent, or absolute. Accordingly, courts have interpreted liabilities broadly to include debts barred by the statute of limitations, pending lawsuits (even if they later prove unfounded), pending claims (regardless of their merit), and contingent claims.¹¹⁵ Judicial inquiry is plenary regarding the includability of a particular liability in a debtor's balance sheet. Thus, a debtor's particular accounting method does not circumscribe or foreclose judicial inquiry.¹¹⁶ The underlying purpose of fraudulent transfer law to prevent a debtor from defrauding its creditors explains both the judicial reluctance to be bound by a debtor's own practice and the elasticity available to construe liabilities. Therefore, courts have regarded an expansive conception of liabilities and close judicial scrutiny as necessary to accomplish this salutary objective.¹¹⁷

1. Valuation of Unmatured Obligations

The definition of liabilities, however, leaves unanswered several valuation questions. For example, should the liability on an unmatured obligation be calculated by its face value or be discounted to reflect its present value?¹¹⁸ None of the fraudulent transfer statutes addresses this issue. For example, even though the Bankruptcy Code requires the estimation of an unliquidated claim for purposes of determining its allowed amount in bankruptcy, it does not contain any comparable provision regarding valuation of liabilities. As a

¹¹⁴ See 11 U.S.C. § 101(4)(A), (11) (1988); UFCA § 1, 7A U.L.A. 430 (1985); UFTA § 1(5), (3), 7A U.L.A. 644 (1985).

¹¹⁵ See *Tri-Continental Leasing Corp. v. Zimmerman*, 485 F. Supp. 495, 499-501 (N.D. Cal. 1980).

¹¹⁶ See, e.g., *F.S. Bowen Electric Co. v. United States Fidelity and Guaranty Co.*, 256 F.2d 46, 49 (4th Cir. 1958). But see *Joshua Slocum, Ltd. v. Boyle* (*In re Joshua Slocum, Ltd.*), 103 Bankr. 610, 623-24 (Bankr. E.D. Pa. 1989) (assigning weight to a debtor's treatment of liabilities according to GAAP).

¹¹⁷ See, e.g., *Tri-Continental Leasing Corp.*, 485 F. Supp. at 500.

¹¹⁸ See *Carlson*, *supra* note 3, at 90; *Fortgang & Mayer*, *supra* note 83, at 1094-95; *Bonright & Pickett*, *supra* note 44, at 593-94.

result, all unmatured liabilities are accelerated and allowed in their full face amount, without regard to interest rate or maturity date.¹¹⁹

Computing unmatured obligations in this manner is erroneous because it ignores the discount problem that can significantly affect the solvency calculation of Target. The present value of an unmatured debt is less than its face amount if the contract rate of interest is less than the market rate of interest. Although an LBO lender will rarely offer more favorable interest terms than the market rate, the contract rate may well be lower than the market rate in certain cases because the financing lender enjoys institutional and transaction cost advantages.¹²⁰ For example, in *Credit Managers Association v. Federal Co.*¹²¹ a parent company sold its subsidiary to the subsidiary's management.¹²² Management gave the parent a promissory note for the purchase price at an interest rate much lower than the prevailing market rate.¹²³ The court discounted the face amount of the LBO debt from \$1.2 million to its present value of \$900,000.¹²⁴

Although *Credit Managers* did not involve the issue of Target's solvency, its holding has significant ramifications in that regard. It indicates that it would be erroneous in calculating solvency to accord liabilities their face values. If the question of solvency were a question of Target's ability to pay all its debts at once, regardless of their maturity dates, counting liabilities at their face values would no doubt be accurate.¹²⁵ But that result assumes Target's business has very limited or no future. If one assumes Target is a going concern, however, not all of its debts would be due and payable in their face amount.¹²⁶ Therefore, if a "going-concern" perspective more ap-

¹¹⁹ Fortgang & Mayer, *supra* note 83, at 1094-95 (citing H.R. REP. No. 595, 95th Cong., 1st Sess. 353 (1977) and S. REP. No. 989, 95th Cong., 2d Sess. 63 (1978)).

¹²⁰ See Carlson, *supra* note 3, at 90.

¹²¹ 629 F. Supp. 175 (C.D. Cal. 1985).

¹²² *Id.* at 177.

¹²³ See *id.* at 177-78.

¹²⁴ *Id.* at 179.

¹²⁵ Kupetz v. Continental Ill. Nat. Bank & Trust Co., 77 Bankr. 754, 762 (Bankr. C.D. Cal. 1987) ("[The Appraiser] used questionable methods in appraising the solvency of [Target] after the sale. He maintained liabilities at their full value, but discounted assets . . ."); Bonright & Pickett, *supra* note 44, at 594 (stating that it is unjustifiable to count liabilities at full value if the business is a going concern).

¹²⁶ See Fortgang & Mayer, *supra* note 83, at 1066 (pointing out the distinction between GAAP and insolvency or liquidation accounting and noting that it is only in the latter case that liabilities must be treated as due and payable in their face amount); Verner, *supra* note 34, at 226 (indicating that such an approach would "declare insolvent a substantial proportion of the business and professional entities of the nation").

appropriately captures Target's situation, Target's liabilities for purposes of the solvency calculation should be properly discounted.

2. Contingent Liabilities

A related valuation problem concerns the status and treatment of contingent liabilities. For example, often an LBO involves an upstream guarantee in which a shell parent corporation causes Target to guarantee repayment of the funds parent borrowed to purchase Target's stock. Should Target's guarantee liability be valued at its face amount or should it be discounted to reflect the probability that the guarantee obligation will materialize? None of the fraudulent transfer statutes addresses this valuation problem, other than to provide that contingent liabilities be included in calculating solvency.¹²⁷ As a general proposition, valuing contingent liabilities at their face amount would be erroneous.¹²⁸ Every entity against whom a lawsuit has been commenced faces "contingent" liability. Every bank that has issued a letter of credit does so as well. By definition, such liabilities are not certain and even may be unlikely to occur. Thus, they should be discounted by the probability that the contingency will materialize.¹²⁹ For example, if the probability of occurrence of a contingency is ten percent, the face amount of the liability should be reduced by ninety percent.

In the case of an LBO structured as an upstream guarantee, does it make sense to discount the face amount of the guarantee liability? In *In re Knox Kreations*, the United States District Court of the Eastern District of Tennessee reversed the bankruptcy judge's decision to include the face amount of Target's guarantee obligation.¹³⁰ In so doing, the court relied on the UFCA's "probable liability" language.¹³¹ Despite the holding in *Knox Kreations* that "a contingent liability should be discounted," discounting an LBO obligation when it is structured as an upstream guarantee may not

¹²⁷ See *supra* note 114 for the cited statutes.

¹²⁸ See *In re Xonics Photochemical, Inc.*, 841 F.2d 198, 199 (7th Cir. 1988). *But see* Chase Manhattan Bank (N.A.) v. Oppenheim, 109 Misc. 2d 649, 651, 652, 440 N.Y.S.2d 829, 831 (N.Y. Sup. Ct. 1981); *Marine Midland Bank v. Stein*, 105 Misc. 2d 768, 770, 433 N.Y.S.2d 325, 327 (N.Y. Sup. Ct. 1980); see also *supra* text accompanying notes 115-17 for a discussion of the expansive manner in which courts have construed "liabilities."

¹²⁹ *In re Xonics Photochemical, Inc.* 841 F.2d at 200.

¹³⁰ *Cate v. Nicely (In re Knox Kreations, Inc.)*, 474 F.Supp. 567, 571-72 (E.D. Tenn. 1979).

¹³¹ See *id.*; see also UFCA; § 2, 7A U.L.A. 442 (defining insolvency as debtor's "probable liability" on existing debts exceeding assets).

make sense. After all, is it meaningful in such circumstances to describe Target's liability as "contingent?" In such LBOs, the repayment obligation really falls on Target (the guarantor) rather than on the primary obligors (the buyers). The latter are only conduits through whom repayments are made. Unless they have assets or income of their own, the buyers inevitably and invariably rely on Target to discharge the obligation they incurred.¹³² The LBO's structure as a guarantee obligation should not hide the economic reality of the transaction. In reality, the obligation is contingent in name only, not in fact.

The court's contrary suggestion in *In re Knox Kreations* is unconvincing.¹³³ The *Knox* court suggested that the LBO participants anticipated that Target would generate enough revenue to enable the buyers themselves to pay the debt load; that is, if the buyer—primary obligor—earned positive income from Target's operations, the likelihood that Target would pay the obligation's full face amount was less than one hundred percent. But because a lender's decision to call the upstream guarantee depends on Target's success in producing positive income, it defies common sense to characterize Target's obligation as "secondary."

Moreover, the theory the *Knox* court applied to discount Target's guarantee obligation raises a further problem. If an LBO debt structured as an upstream guarantee is discounted to reflect its contingency, the same rationale should apply to discount similar debt incurred in LBOs structured differently. Suppose a shell corporation assumes the obligation to repay the LBO loan at the outset. The shell corporation then merges with Target, which is the surviving entity. In such a case, by definition, there is no "contingent" obligation. Yet, the economic reality of the transaction is the same in each case: the LBO participants expect the loan to be repaid with income generated by Target's operations. Target bears the entire burden of the obligation. Thus, a discount should be made only if the primary obligor has assets or income of its own wholly separate from those of Target, or if other guarantors also exist. Otherwise,

¹³² See *United States v. Gleneagles Inv. Co.*, 565 F. Supp. 556, 578 (M.D. Pa. 1983), *aff'd sub nom. United States v. Tabor Court Realty Corp.*, 803 F.2d 1288, 1307 (3d Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987) ("[The LBO buyer] had no source of income and intended to use the assets of [Target] to pay the interest and principal on the [LBO] loans. These debts therefore constitute an obligation of [Target].").

¹³³ *But see* Carlson, *supra* note 3, at 91 (arguing that a contingent guarantee in an LBO should be discounted by the probability that the guarantee will never be called if the LBO buyer earns positive income from Target's operations).

the law will encourage LBO participants to structure the LBO as a guarantee because such structure will advantageously affect any later solvency calculation. This advantage will arise even though the structure adopted has nothing to do with the substance of the transaction from the point of view of fraudulent transfer law.

Another issue in valuing liabilities involves convertible debt securities.¹³⁴ Such instruments have debt and equity features. Therefore, the debt portion clearly represents liability to Target. Because of ambiguities in the case law,¹³⁵ however, the entire face value of these instruments may be considered in computing Target's balance sheet.¹³⁶

II. STANDARDS USED TO DETERMINE UNREASONABLY SMALL CAPITAL

The second test of the validity of an LBO is whether it left Target with an "unreasonably small capital" with which it may carry on its business or later transactions.¹³⁷ The insolvency test of fraudulent transfer law condemns Target's transfer to protect creditors who hold claims against it at the time of the LBO. Target's failure to maintain a reasonable amount of capital injures and thus is voidable by existing creditors as well as subsequent ones.

¹³⁴ Mavredakis & Greene, *How a Deal Can Come Back to Haunt a Seller*, MERGERS & ACQUISITIONS, Nov.-Dec. 1987, at 70.

¹³⁵ See *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 696 (3d Cir. 1968). Courts use a number of criteria to determine whether an investment represents debt or equity:

- (1) the intent of the parties; (2) the identity between creditors and shareholders;
- (3) the extent of participation in management by the holder of the instrument;
- (4) the ability of the corporation to obtain funds from outside sources; (5) the 'thinness' of the capital structure in relation to debt; (6) the risk involved; (7) the formal indicia of the arrangement; (8) the relative position of the obligees as to other creditors regarding the payment of interest and principal; (9) the voting power of the holder of the instrument; (10) the provision of a fixed rate of interest; (11) a contingency on the obligation to repay; (12) the source of the interest payments; (13) the presence or absence of a fixed maturity date; (14) a provision for redemption by the corporation; (15) a provision for redemption at the option of the holder; and (16) the timing of the advance with reference to the organization of the corporation.

Id. at 696.

¹³⁶ See, e.g., *Joshua Slocum, LTD v. Boyle* (*In re Joshua Slocum, LTD*), 103 Bankr. 610, 622-23 (Bankr. E.D. Pa. 1989) (trustee arguing that redemption price for mandatorily redeemable stock should be counted as debt in determining whether transfers made to corporation president under an employment termination agreement were fraudulent).

¹³⁷ 11 U.S.C. § 548 (a)(2)(B)(ii) (1988); UFCA § 5, 7A U.L.A. 427, 504 (1985); UFTA § 4(a)(2)(i), 7A U.L.A. 639, 653 (1985).

Unlike "insolvency," however, "unreasonably small capital" is not statutorily defined. Given its importance in fraudulent transfer law, some courts have expressed surprise at this lack of definition.¹³⁸ Yet even the UFTA, the latest effort in modernizing fraudulent transfer law, fails to state a statutory definition. The UFTA did break new ground, however, by substituting "unreasonably small assets" for "unreasonably small capital," to clarify that the special meaning of capital in corporate law has no relevance to fraudulent transfer law.¹³⁹ Beyond this modification, little agreement exists among courts regarding the meaning of either "capital" or "unreasonable amounts" of it. Cases reveal two broad approaches.

A. *Approaches to the Determination of Unreasonably Small Capital*

1. Pledging All of Debtor's Assets/Insolvency

The first approach equates "unreasonably small capital" with the pledging of all or substantially all of a debtor's assets. In the seminal case of *Diller v. Irving Trust Co. (In re College Chemists, Inc.)*,¹⁴⁰ Diller sold all the shares of her company, College Chemists Inc., to Weiner.¹⁴¹ Weiner promised to pay the purchase price and secured that promise by granting a purchase money security interest in all of the company's assets. The district court affirmed the referee's decision that the security interest was void because it left the company with "unreasonably small capital."¹⁴² In affirming the avoidance, the Second Circuit found it significant that the company's liabilities exceeded the value of its assets. As a result, the court easily concluded that the company was left with not just "unreasonably

¹³⁸ See, e.g., *Spanier v. United States Fidelity & Guaranty Co.*, 623 P.2d 19, 24 (Ariz. App. 1980). The absence of a statutory definition, however, may not be too surprising. The amount of capital a business requires for its operations is so bound up with the particular nature of each business that articulating an abstract definition applicable across the board may prove difficult or even unhelpful. Cases construing the "unreasonably small capital" provision have clearly recognized that corporate undercapitalization is a question of fact to be determined on a case by case basis. See *Barrett v. Continental Ill. Nat. Bank & Trust Co.*, 882 F.2d 1, 5 (1st Cir. 1989) (discussing the relativity inherent in the term and the need for inquiry to focus on the nature of each individual enterprise and its need for capital); *Wells Fargo Bank v. Desert View Bldg. Supplies, Inc.*, 475 F. Supp. 693, 697 (D. Nev. 1978), *aff'd*, 633 F.2d 225 (9th Cir. 1980) (case by case determination required); *Jenney v. Vining*, 415 A.2d 681, 683 (N.H. 1980) (same).

¹³⁹ UFTA § 4 comment 4, 7A U.L.A. 654.

¹⁴⁰ 62 F.2d 1058 (2d Cir. 1933) (*per curiam*).

¹⁴¹ *Id.* at 1058.

¹⁴² *Id.*

small capital" but with no "capital at all."¹⁴³ Whether the vice condemned in *In re College Chemists, Inc.* is insolvency, or the pledge of all of a company's assets, which resulted in insolvency, is unclear.

In *Sharrer v. Sandlas*,¹⁴⁴ a New York appellate decision, the shareholders of a closely-held corporation sold their stock and took a security interest in all the corporation's assets to secure the deferred portion of the purchase price.¹⁴⁵ Unlike *In re College Chemists, Inc.*, Target's debt did not exceed the value of its assets so that Target was not rendered insolvent. Nevertheless, the court relied on *In re College Chemists, Inc.* to conclude that Target was "effectively" left with no capital because all of its assets were encumbered.¹⁴⁶

Similarly, in *Teitlebaum v. Voss (In re Tuller's, Inc.)*,¹⁴⁷ the Court of Appeals for the Second Circuit found it unnecessary to decide whether the debtor was rendered insolvent in a similar transaction.¹⁴⁸ The court held that the transaction was invalid because all the corporate assets had been mortgaged.¹⁴⁹ Under this reasoning, virtually all corporate buyouts will be *per se* fraudulent when the selling shareholders finance the acquisition because the effect of the transaction is to leave little or no unencumbered assets.

*Pirrone v. Toboroff (In re Vaniman International, Inc.)*¹⁵⁰ suggests that what is offensive is not so much the all-encompassing pledge as it is the lack of remaining equity in the assets encumbered. *Vaniman* involved a seller-financed corporate buyout in which the fair market value of the corporate assets exceeded its liabilities by a narrow margin just before the corporation placed a second mortgage on its assets to secure the purchase price of its own stock.¹⁵¹ The effect of the second mortgage was to convert the corporation's existing thin surplus into a relatively large deficit. The court found this "minus capitalization" a sufficient basis for concluding that the corporation was left with "unreasonably small capital."¹⁵² It reasoned that the effect of the corporation's "minus capitalization" was

¹⁴³ *Id.*

¹⁴⁴ 103 A.D.2d 873, 477 N.Y.S.2d 897 (1984).

¹⁴⁵ *Id.* at 873, 477 N.Y.S.2d at 898.

¹⁴⁶ *Id.* at 873-74, 477 N.Y.S.2d at 899.

¹⁴⁷ 480 F.2d 49 (2d Cir. 1973).

¹⁴⁸ *See id.* at 51.

¹⁴⁹ *Id.* at 52.

¹⁵⁰ 22 Bankr. 166 (Bankr. E.D.N.Y. 1982).

¹⁵¹ *Id.* at 177.

¹⁵² *Id.* at 186.

to close off its only source of additional financing.¹⁵³ The court implicitly assumed that a company without unencumbered assets or sufficient equity in encumbered assets would be unlikely to obtain credit.

A related line of cases is more explicit in this regard. These cases hold that a finding of insolvency also supports a finding of "unreasonably small capital."¹⁵⁴ Although this branch of caselaw does not refer to *In re College Chemists* and its adherents, the courts' reasoning is the same. Whether a debtor's insolvency results from pledging all of its assets or otherwise, the debtor will be left with "no capital" with which to operate its business. Therefore, these courts view insolvency by definition as establishing "unreasonably small capital."

2. "Working Capital"/Cash Flow

A second major line of cases has construed "unreasonably small capital" to mean "working capital" adequate for the business in which a debtor is engaged.¹⁵⁵ Although the cases do not clearly articulate a definition of "working capital," the opinions seem to refer to a debtor's ability to raise sufficient cash resources to operate its business.¹⁵⁶

For example, in *Wells Fargo Bank v. Desert View Building Supplies, Inc.*,¹⁵⁷ the parent corporation caused its subsidiary to borrow funds and to secure the loan with its assets.¹⁵⁸ The subsidiary used the loan proceeds to pay off the parent's debt. The court found that the subsidiary was marginally profitable before its secured borrowing. It also found that the debt service had taken a company that had a retained earnings of \$280,000 and placed it in a situation where it had little cash resources to operate its business.¹⁵⁹ Although

¹⁵³ *Id.*

¹⁵⁴ See *United States v. Gleneagles Inv. Co.*, 565 F. Supp. 556, 580 (M.D. Pa. 1983), *aff'd sub nom. United States v. Tabor Realty Corp.*, 803 F.2d 1288, 1307 (3d Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987); *White v. Coon (In re Purco, Inc.)*, 76 Bankr. 523, 529 (Bankr. W.D. Pa. 1987); *New York Credit Men's Adjustment Bureau, Inc. v. Adler*, 2 Bankr. 752, 756 (S.D.N.Y. 1980); *Spanier v. United States Fidelity & Guaranty Co.*, 623 P.2d 19, 24 (Ariz. App. 1980). A recent case suggests that proof of solvency will likewise establish reasonable capitalization. *Pinto v. Philadelphia Fresh Food Terminal Corp. (In re Pinto)*, 89 Bankr. 486, 501 (Bankr. E.D. Pa. 1988).

¹⁵⁵ See *infra* notes 157-63 and accompanying text for a discussion of these cases.

¹⁵⁶ *Id.*

¹⁵⁷ 475 F. Supp. 693 (D. Nev. 1978), *aff'd mem.*, 633 F.2d 225 (9th Cir. 1980).

¹⁵⁸ *Id.* at 695.

¹⁵⁹ *Id.* at 695, 697.

the company contended that it was able to continue its operations at the same yearly gross and obtain trade credit without difficulty, the court focused on the fact that the company's cash on hand was "extremely low."¹⁶⁰

In *Zuk v. Zale*,¹⁶¹ a special master found the debtor had \$5,000 in "working capital" at the time of the challenged transfer.¹⁶² The evidence showed the debtor's general contracting business normally required \$7,000 to \$13,000 of working capital. The court found \$5,000 sufficient working capital if "payments for work completed [by the debtor] came in each month."¹⁶³ The court found it significant that current payments by customers allowed the debtor to finance its operations from current receipts. The court seemed to think the adequacy of a debtor's capital should be evaluated by its expected cash flow, i.e., whether his cash receipts would be sufficient to cover debts.

In both *Wells Fargo Bank* and *Zuk*, the debtors were "balance-sheet solvent" at the time of the challenged transfer.¹⁶⁴ Thus, the question of whether positive cash flow would negate balance sheet insolvency was never before these courts. Some cases suggest, however, that the amount of capital sufficient to preclude invalidation under the "unreasonably small capital" standard cannot be determined merely by valuing a debtor's equity in property at one point in time.¹⁶⁵

In *Widett v. George*,¹⁶⁶ for example, the Massachusetts Supreme Judicial Court indicated that the market value of the debtor's equity was less significant than the "good prospects" of debtor's business.¹⁶⁷ The debtor in *Widett* operated a restaurant whose relevant characteristics, according to the court, were a prompt turnover of inventories and cash payments by customers.¹⁶⁸ The court believed the restaurant might reasonably expect to finance its operations primarily from current receipts.¹⁶⁹

¹⁶⁰ *Id.* at 697.

¹⁶¹ 114 N.H. 813, 330 A.2d 448 (1974).

¹⁶² *Id.* at 816, 330 A.2d at 450.

¹⁶³ *Id.* at 816, 330 A.2d at 451.

¹⁶⁴ See *Wells Fargo Bank v. Desert View Bldg. Supplies, Inc.*, 475 F. Supp. 693, 695 (D. Nev. 1978); *Zuk*, 114 N.H. at 816, 330 A.2d at 451.

¹⁶⁵ See *Barrett v. Continental Ill. Nat. Bank & Trust Co.*, 882 F.2d 1, 5 (1st Cir. 1989).

¹⁶⁶ 336 Mass. 746, 148 N.E.2d 172 (1958).

¹⁶⁷ *Id.* at 750, 148 N.E.2d at 175.

¹⁶⁸ *Id.* at 751, 148 N.E.2d at 175.

¹⁶⁹ *Id.* Another court strongly suggests that insolvency may matter little "if a corporation is actively pursuing its regular business with a reasonable expectation that business conditions

In determining the reasonableness of a debtor's capital, recent cases have given decisive importance to the debtor's cash flow expectation. In *Credit Managers Association v. Federal Co.*,¹⁷⁰ the United States District Court for the Central District of California rejected the negative implications of unfavorable balance sheet ratios and instead focused on a detailed cash flow analysis.¹⁷¹ *Credit Managers* involved a management-led LBO of a subsidiary of the Federal Company.¹⁷² The management caused the subsidiary to execute a promissory note for \$1.2 million, which represented the deferred portion of the purchase price for the subsidiary's stock. As part of the transaction, the management also caused the subsidiary to pay off more than seven million dollars of intercompany debt to its parent.¹⁷³ It accomplished this transaction by borrowing that amount from General Electric Credit Corporation (GECC). As security for the loan and the deferred portion of the purchase price, the subsidiary pledged virtually all of its assets. Unable to raise sufficient cash to continue its operations, it failed a year and one half later. Nevertheless, the court held that the LBO did not leave the company with "unreasonably small capital" because its cash flow expectations were reasonable.¹⁷⁴

Credit Managers' detailed attention to and reliance on cash flow projections to measure adequate capitalization is significant. The court clearly rejected the assumptions implicit in the cases that find a business unreasonably capitalized merely because its assets are fully encumbered. Accordingly, under *Credit Managers*, a company's mortgaging of all its assets is not dispositive as long as the company entertains reasonable expectations of staying in business and raising enough cash from operations and other sources to service its debt. In *Credit Managers*, the plaintiffs sought to establish that the absence of unencumbered assets made additional borrowings impossible.¹⁷⁵ The court, however, found GECC had agreed to increase its line of credit by \$2.5 million even after the LBO.¹⁷⁶ GECC made the decision to provide additional credit after convincing itself of the

will improve and that it will be re-established on a sound financial condition." *Telefest, Inc. v. VU-TV, Inc.*, 591 F. Supp. 1368, 1376 (D.N.J. 1984).

¹⁷⁰ 629 F. Supp. 175 (C.D. Cal. 1985).

¹⁷¹ *Id.* at 187.

¹⁷² *Id.* at 177.

¹⁷³ *Id.* at 178.

¹⁷⁴ *Id.* at 187.

¹⁷⁵ *Id.* at 186.

¹⁷⁶ *Id.* at 184.

strength of the debtor's cash flow.¹⁷⁷ Consequently, the court concluded the debtor's cash flow was reasonable.

Credit Managers is significant in another respect. In determining whether Target's cash flow was adequate, the court did not focus on whether expectations were actually met, but rather on whether they were reasonable in light of the circumstances existing at the time of the LBO.¹⁷⁸ The court concluded that unexpected occurrences that frustrated the expectations would not be sufficient to disprove such occurrences if it was reasonable to assume the non-occurrence of the frustrating event. Thus, *Credit Managers* shifts the risk of such occurrences from Target and the LBO lender to the creditors of the company.

III. THE CHOICE OF APPROACH: WHAT LIES BEHIND IT?

The preceding two sections discussed the basic approaches that courts use to determine a debtor's financial condition in the context of an LBO. Clearly, the process of determining financial condition is far less objective than it might first appear. In the LBO context particularly, the court's view of the reach of fraudulent transfer law significantly influences its determination of financial condition. In other words, lurking behind the differences in approach is a difference in judicial opinion regarding whether creditors or LBO participants should more fairly assume the loss from a failed LBO. Courts more solicitous of creditors than LBO participants are more likely to employ an approach that gives effect to such solicitude. Conversely, courts that entertain serious reservations about applying the constructive fraud provisions to an LBO context are likely to apply these provisions in ways that allocate the risk of loss from such transactions to creditors of Target.

A. *Judicial Use of Broad Standards to Protect Creditors over Equity Owners*

A fundamental debtor duty under the fraudulent transfer law is to respect the rights of creditors.¹⁷⁹ Consistent with this duty, a debtor must give "primacy" to the interests of creditors before its own when it transfers property or incurs an obligation.¹⁸⁰ An LBO

¹⁷⁷ *Id.* at 183-84.

¹⁷⁸ *Id.* at 184, 187.

¹⁷⁹ See Clark, *supra* note 6, at 510.

¹⁸⁰ See *id.* at 510-11.

not only offers opportunities for purposive disregard of the duty, it can also leave creditors in the cold. In effect, no matter how an LBO is structured, it allows selling shareholders to liquidate their investments so that, unless Target is left with enough assets, the shareholders will have preferred themselves at the expense of creditors, contrary to the order of priorities established by *de jure* liquidation.¹⁸¹ Thus, a court that views the likely effects of an LBO as reversing the normal order of priorities may be equally likely to assess Target's financial condition under restrictive, stringent tests that will ensure that creditors' rights are not unfairly subordinated to those of the selling shareholders.

Gleneagles illustrates a court that viewed the LBO as having provided Target's selling shareholders with "cozy accommodations" at the expense of creditors.¹⁸² In *Gleneagles*, the court concluded that the transaction was both intentionally and constructively fraudulent. In reaching the conclusion that the LBO was constructively fraudulent, the court applied a valuation standard of "immediate liquidation."¹⁸³

Although one could argue that the court was simply following well-established precedent in assessing Target's solvency on a broad standard, one cannot avoid the conclusion that more than mere *stare decisis* was involved in the unflinching application of those criteria. It is not unreasonable to suppose that the court's finding of intentional fraud carried over to and colored its analysis of the solvency issue. It would have been extremely difficult and even disingenuous to keep the impact of the intentional fraud finding from spilling over in to the constructive fraud analysis. Furthermore, it is difficult to explain why the court lent its prestige to the use of a liquidation standard at odds with the overwhelming authority in the country.¹⁸⁴

¹⁸¹ See Smyser, *supra* note 9, at 807-08.

¹⁸² See *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288, 1293, 1297 (3d Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987); see also *United States v. Gleneagles Inv. Co.*, 565 F. Supp. 556, 584 (M.D. Pa. 1983) (holding the selling shareholders liable for breach of their duty of loyalty to creditors by undertaking the LBO when a prudent person would have discovered from the precarious nature of Target's financial condition that the LBO would injure creditors).

¹⁸³ See *supra* text accompanying notes 35-72 for a discussion of *Gleneagles*.

¹⁸⁴ See *supra* note 73 and accompanying text for a discussion of the substantive equivalence of meaning courts ascribe to the UFCA and Bankruptcy Code tests of fair valuation. Indeed, one court has dismissed as "hypertechnical" the apparent distinction between the Bankruptcy Code's "fair valuation" and the UFCA's "present fair salable value" standards. *Wieboldt Stores, Inc. v. Schottenstein*, 94 Bank. 488, 505 (N.D. Ill. 1988).

Equally significant in the use of such a standard is the cast of players standing on both sides of the LBO. On one side stood existing creditors who, prior to the LBO, were owed about eight million dollars in delinquent obligations, including federal taxes, property taxes, pension fund, and employee welfare fund obligations.¹⁸⁵ On the other side stood the existing shareholders and the secured lender who expected the loan to be repaid from the liquidation of assets, not the company's cash flow.¹⁸⁶ Not only had Target been in financial trouble prior to the LBO, its future was equally bleak. For example, its cash flow was insufficient to meet its obligations and much of it was earmarked for servicing the LBO debt load. In light of these factors, the court must have found it inequitable to allow LBO participants to benefit from the transaction at the clear expense of the existing creditors. The court also suggested that existing creditors were especially deserving of judicial protection because they were vulnerable. Unlike subsequent voluntary creditors who presumably could protect themselves from undesirable LBOs, the creditors in this case had no such opportunity.¹⁸⁷

Judicial reluctance to protect shareholders at the expense of creditors manifests itself in other ways as well. Two such manifestations are notable here, both of which involve the "unreasonably small capital" standard of fraudulent transfer liability. Some courts hold that a debtor's pledging of all its assets *per se* establishes a debtor's "unreasonably small capital."¹⁸⁸ This view assumes that a debtor's lack of unencumbered assets precludes the debtor from obtaining additional credit.¹⁸⁹ An all-encompassing pledge undoubt-

¹⁸⁵ *Gleneagles*, 565 F. Supp at 565, 572.

¹⁸⁶ *Id.* at 564-65. The court found that prior to the LBO, Target had an unflattering financial condition. Its coal production business was generally unprofitable. Indeed, in the five year period before the LBO, it operated at a loss and was frequently delinquent in the payment of real estate taxes and trade accounts. Most of its cash flow was generated by the sale of surplus lands. *Id.* at 564, 579. The LBO lender was aware of the poor state of Target's finances and made various arrangements for repayment of principal and interest.

¹⁸⁷ See *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288, 1297 n.2 (3d Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987). The major creditors in this case were "involuntary," in that they did not become creditors by virtue of a contract. Even if they had been contract creditors, however, they could not have protected themselves from the adverse consequences of the LBO because they became creditors before LBOs became a popular method of financing corporate acquisitions. *Id.*

¹⁸⁸ See *supra* text accompanying notes 140-54 for a discussion of cases holding that a debtor with insufficient unencumbered assets is unreasonably capitalized.

¹⁸⁹ See, e.g., *Pirrone v. Toboroff (In re Vaniman Int'l Inc.)*, 22 Bankr. 166, 186 (Bankr. E.D.N.Y. 1982).

edly makes additional financing difficult or even impossible if one assumes that secured financing is the only way a debtor can raise needed cash to operate a business. But secured financing is only one method to obtain credit. It by no means exhausts the universe of credit sources.

A business may raise equity capital from existing or new owners.¹⁹⁰ It may obtain additional financing from an existing secured lender or a new lender if the former is willing to subordinate its lien or debt.¹⁹¹ Most importantly, a fully encumbered business may be able to generate sufficient cash flow from its operations to continue in business.¹⁹² Thus, although unencumbered assets are important to a business's continued viability, they are not determinative.

Nevertheless, courts repeatedly condemn as fraudulent transfers the security interests that selling shareholders retain in the assets of the corporation they own.¹⁹³ In these bootstrap acquisitions, the selling shareholders finance the buyer's acquisition by accepting the buyer's note for a significant portion of the purchase price.¹⁹⁴ The buyer then uses the purchased corporation's assets to secure its note.

It is this type of transaction that *In re College Chemists* and its progeny condemns. These courts conclude that the transaction leaves the company's future ability to carry on business "on an expectancy of profit."¹⁹⁵ The creditors' ability to be repaid likewise

¹⁹⁰ See, e.g., *Allied Products Corp. v. Arrow Freightways, Inc.*, 104 N.M. 544, 545, 724 P.2d 752, 753 (1986). *Allied Products* involved an LBO financed by the selling shareholders in which the new owner invested additional equity capital, personally guaranteed some \$250,000 of Target's debts to third parties and renegotiated the terms of another major debt. *Id.* See Markell, *Toward True and Plain Dealing: A Theory of Fraudulent Transfers Involving Unreasonably Small Capital*, 21 IND. L. REV. 469, 490 (1988) (criticizing the view that equates total encumbrance of a company's assets with unreasonable capitalization).

¹⁹¹ Markell, *supra* note 190, at 490.

¹⁹² See *Credit Managers Ass'n v. Federal Co.*, 629 F. Supp. 175, 183-84 (C.D. Cal. 1985) (giving decisive importance to future cash flow from operations in determining whether Target is reasonably capitalized); *Telefest, Inc. v. VU-TV, Inc.*, 591 F. Supp. 1368, 1376 (D.N.J. 1984) (reasonable expectation of improvement in business conditions negates negative inference from the excess of liabilities over assets); see also Carlson, *supra* note 3, at 95 ("What is necessary is a cash flow that exceeds costs of operation, including the cost of servicing outstanding debt.") (citing Lopucki, *A General Theory of the Dynamics of the State Remedies! Bankruptcy Systems*, 1982 WIS. L. REV. 311, 327).

¹⁹³ See *Pirrone v. Toboroff (In re Vaniman Int'l, Inc.)*, 22 Bankr. 166, 181 (E.D.N.Y. 1982). These interests are known as "bootstrap acquisitions."

¹⁹⁴ Smyser, *supra* note 9, at 788.

¹⁹⁵ See *supra* notes 138-50 and accompanying text. Professor Glenn quotes a judge who described the thought process of someone carrying business "on the expectancy of a profit"

rests on the company's expectancy of profit. Although selling shareholders remain safe because they hold a security interest in all the assets of their former company, these courts apparently find it fundamentally unfair to allow shareholders to retain a position of safety while creditors are exposed to possible loss.¹⁹⁶ It is little wonder then that the analysis of Target's capital is either skimpy or non-existent in these opinions. All too often the court glibly concludes that the debtor's pledging of all of its assets is *ipso facto* "unreasonably small capital."¹⁹⁷ Under this logic, a bootstrap acquisition is inevitably invalid *per se* unless it succeeds or unless somehow adequate provisions exist for creditors by, for example, reducing the level of leverage.¹⁹⁸ Without such provisions, a selling shareholder of a failed bootstrap acquisition may find it difficult to persuade a court, after the fact, that a challenged transfer should not "shock its conscience."¹⁹⁹

as follows: "The grantor virtually says, If I succeed in business, I make a fortune for myself. If I fail, I leave my creditors unpaid." 1 G. GLENN, *supra* note 8, § 334, at 579; *see also In re Vaniman Int'l Inc.*, 22 Bankr. at 180 (E.D.N.Y. 1982) (finding significant the fact that the buyer of Target was "a penniless young man with nothing to lose").

¹⁹⁶ *See Wells Fargo Bank v. Desert View Bldg. Supplies, Inc. (In re Desert View Bldg. Supplies, Inc.)*, 475 F. Supp. 693, 696 (D. Nev. 1978). In *In re Atlas Foundry Co.*, 155 F. Supp. 615, 616 (D.N.J. 1957), the trustee in bankruptcy framed the question for the court in a manner suggesting the unfairness of preferring shareholders to creditors, as follows: "May stockholders of a corporation through use of a fictitious consideration, obtain a mortgage on the realty of the corporation as part consideration for the sale of their shares of stock in the corporation?" Although the corporation was cash rich and was not insolvent at the time of the buyout, the court declared the mortgage invalid.

¹⁹⁷ *See supra* notes 140-53 for a discussion of cases holding that a debtor with insufficient unencumbered assets is unreasonably capitalized. *But see Armstrong Co. v. Limperis (In re Process-Manz Press, Inc.)*, 236 F. Supp. 333, 346 (N.D. Ill. 1964), *rev'd on other grounds*, 369 F.2d 513, 518-19 (7th Cir. 1966), *cert. denied*, 386 U.S. 957 (1967) (finding unreasonably small capital from evidence of inability to pay debts, an increase of debt, and bank overdrafts, all after the challenged transaction); *Allied Products Corp. v. Arrow Freightways, Inc.*, 104 N.M. 544, 545, 724 P.2d 752, 753 (1986) (in finding reasonable capitalization, court considered that buyer had invested substantial additional equity, personally guaranteed Target's debts, renegotiated on other debt, and doubled its gross revenue, all after the transaction).

¹⁹⁸ *See Allied Products*, 104 N.M. at 545, 724 P.2d at 753 (indicating some of the ways in which adequate provisions for creditors may be made).

¹⁹⁹ *See id.* at 548, 724 P.2d at 756. *Allied Products* indicates the circumstances in which a court is unlikely to find that the LBO left Target with unreasonably small capital. The court acknowledged that the transaction "made future financing difficult, if not impossible." *Id.* Nevertheless, it rejected the creditors' claims that the transaction left Target with unreasonably small capital. It did suggest that "[i]t does seem unfair, in retrospect, that [shareholders] should be permitted to retain all the proceeds of [Target's] liquidation, while these [creditors] go unsatisfied." *Id.* The court, however, refused to find the transaction "unconscionable" or "grossly inequitable" to "the degree of 'shocking the conscience of the court.'" *Id.* In reaching that conclusion, the court considered the fact that Target had operated successfully for a year after the transaction, during which time the buyer "injected" into Target \$100,000 of

A similar perception of unfairness to creditors seemingly underlies the view of those courts that find "unreasonably small capital" if they find insolvency. Equating insolvency with "unreasonably small capital" has significant consequences. Fraudulent transfer law distinguishes between two groups of creditors: existing and subsequent. Only existing creditors may invalidate transfers made by a debtor who was insolvent or rendered insolvent as a result of the transfer.²⁰⁰ On the other hand, both existing and subsequent creditors may invalidate transfers that leave a debtor with "unreasonably small capital."²⁰¹ Thus, a court that equates insolvency with "unreasonably small capital" permits subsequent creditors to invalidate transfers based on a showing of financial condition that the statutory scheme suggests was only intended to protect existing creditors.

Several courts have blurred, if not ignored, these distinctions to permit subsequent creditors to invalidate transfers on the basis of insolvency.²⁰² For example, in *Spanier v. U.S. Fidelity & Guaranty Co.*,²⁰³ the company's stockholders acquired a security interest in the company's assets as part of a bootstrap acquisition. The court concluded that the transaction rendered the company insolvent²⁰⁴ and that the company was also unreasonably capitalized,²⁰⁵ thereby opening the door for subsequent creditors to invalidate the security interest.

If a showing of insolvency satisfies the standard of "unreasonably small capital," the distinction between existing and subsequent

his own money, personally guaranteed \$250,000 of Target's debts to third parties, renegotiated a \$75,000 debt, and substantially increased its revenue. *Id.* at 545, 548, 724 P.2d at 753, 756.

²⁰⁰ UFCA § 4, 7A U.L.A. 474 (1985); UFTA, § 5, 7A U.L.A. 657 (1985); see, e.g., *TWM Homes, Inc. v. Atherwood Realty & Inv. Co.*, 29 Cal. Rptr. 887, 896, 214 Cal. App. 2d 826, 843 (1963). The Bankruptcy Code, however, has eliminated the distinction between existing and future creditors. See 11 U.S.C. § 548(a)(2)(B)(i) (1988); S. RIESENFELD, CREDITORS' REMEDIES AND DEBTORS' PROTECTION 659-60 (4th ed. 1987).

²⁰¹ 11 U.S.C. § 548 (a)(2)(B)(ii) (1988); UFCA § 5, 7A U.L.A. 504; UFTA § 4, 7A U.L.A. 652-53.

²⁰² See, e.g., *United States v. Gleneagles Invest. Co.*, 565 F. Supp. 556, 580 (M.D. Pa. 1983), *aff'd sub. nom.* *United States v. Tabor Realty Corp.*, 803 F.2d 1288, 1307 (3d Cir. 1986), *cert. denied*, 483 U.S. 1005 (1980); *New York Credit Men's Adjustment Bureau, Inc. v. Adler*, 2 Bankr. 752, 756 (S.D.N.Y. 1980); *White v. Coon (In re Purco, Inc.)*, 76 Bankr. 523, 529 (Bankr. W.D. Pa. 1987); *Louisiana Indus. Coatings, Inc. v. Pertuit (In re Louisiana Indus. Coatings, Inc.)*, 31 Bankr. 688, 695, 698 (Bankr. E.D. La. 1983); *Spanier v. United States Fidelity & Guaranty Co.*, 127 Ariz. 589, 594, 623 P.2d 19, 24 (Ct. App. 1980).

²⁰³ 127 Ariz. 589, 623 P.2d 19 (1980).

²⁰⁴ *Id.* at 592, 623 P.2d at 22.

²⁰⁵ *Id.* at 594, 623 P.2d at 24.

creditors becomes irrelevant.²⁰⁶ According to one commentator, it also contradicts the rationale for the distinction. According to the latter, the insolvency branch of fraudulent transfer law only protects existing creditors because it assumes subsequent creditors can investigate their debtor's financial condition at the time of the transaction.²⁰⁷ Although the *Spanier* court did not explicitly engage in a balancing analysis weighing the equities between selling shareholders and creditors, the court's disregard of the statute's plain language indicates its discomfort with transactions that allow shareholders to liquidate their investments without making adequate provisions for creditors, even subsequent ones. As with transactions in which the debtor encumbers all of its assets for the benefit of shareholders, the court may view the insolvent debtor as carrying on its business on "an expectancy of profit," thereby unfairly shifting its risks to creditors.²⁰⁸

B. *Limiting the Impact of Fraudulent Transfer Law to Protect LBO Participants*

Other courts have not relied on a debtor's lack of unencumbered assets²⁰⁹ or net worth²¹⁰ as the essential predicate for a finding

²⁰⁶ This argument failed to persuade the *Spanier* court. In its view, the proper distinction is between business and personal creditors. See *id.* at 594-95, 623 P.2d at 24-25. According to the court, the insolvency standard protects existing personal creditors whereas the unreasonably small capital provision protects only business creditors, existing as well as future. *Id.* The court also held that the unreasonably small capital standard requires a lesser showing than insolvency, thereby allowing business creditors to avoid a transfer that did not render the debtor insolvent. See *id.* The court's interpretation clearly favors business creditors over personal ones. There is little however, in the statute to support it.

²⁰⁷ Markell, *supra* note 190, at 492 n.160 (citing *Crumbaugh v. Kugler*, 2 Ohio St. 374, 379 (1854)) (subsequent creditors "give credit to their debtor as he is—for what he has, not for what he once had"). Cf. P. Alces, *supra* note 14, ¶ 5.02[2][a], at 5-52 ("As a practical matter, financially speaking, the difference between insolvency and having unreasonably small capital is not of great consequence.").

²⁰⁸ See *Pirrone v. Toboroff (In re Vaniman Int'l Inc.)*, 22 Bankr. 166, 186, 188 (Bankr. E.D.N.Y. 1982) (debtor's insolvency left it with no capital, casting the hazards of its business on creditors); *White v. Coon (In re Purco, Inc.)*, 76 Bankr. 523, 528 (Bankr. W.D. Pa. 1987) (suggesting that it is unfair for shareholders to retain security interests in their own corporation while creditors take the risk). But see *Cate v. Nicley (In re Knox Kreations, Inc.)*, 474 F. Supp. 567, 572 (E.D. Tenn. 1979) ("Although defendant, as president [and sole stockholder], did grant a security interest to himself, the new owner, [buyer], assented to the transfers as part of an arms-length transaction in which the buyer was under no compulsion to buy. There was no special relationship between [buyer] and defendant.").

²⁰⁹ See, e.g., *Credit Managers Ass'n v. Federal Co.*, 629 F. Supp. 175, 186 (C.D. Cal. 1985) (considering cash flow); *Allied Products Corp. v. Arrow Freightways, Inc.*, 104 N.M. 544, 548, 724 P.2d 752, 756 (1986) (considering ability to finance future operations).

²¹⁰ *Telefest, Inc. v. VU-TV, Inc.*, 591 F. Supp. 1368, 1376 (D.N.J. 1984); see also Barret

of "unreasonably small capital." Indeed, some of these courts seem to exhibit some basic discomfort with the application of fraudulent transfer law to LBOs.²¹¹ Two factors seem to explain this judicial quietude.

First, LBOs involve an outside and presumably independent third party who finances the LBO. Generally, the third party lender views its involvement in an LBO as a normal incident of its business. Unlike the selling shareholders in a bootstrap acquisition, the third party lender has no relationship to Target. Therefore, judicial suspicion of self-dealing and purposive disregard of creditor rights is presumptively unlikely, provided the lender has taken appropriate precautions to satisfy itself of Target's financial viability.²¹²

Second, the LBO lender parts with significant amounts of funds in exchange for the security interests it acquires in Target's assets. In contrast, selling shareholders in a bootstrap acquisition acquire security interests in exchange for shares of the corporation. Neither lender's funds nor the shares of the corporation are of any value to Target itself and, from Target's point of view then, there is no difference. Nevertheless, a difference exists in terms of the equities of the parties to the transaction. The lender, a creditor, in the LBO competes with other creditors. In the bootstrap scenario, shareholders (owners) compete with creditors. Upholding a bootstrap acquisition would prefer equity interests to creditor interests, a result that courts are reluctant to reach.²¹³

v. Continental Ill. Nat. Bank & Trust Co., 882 F.2d 1, 4 (1st Cir. 1989) (declining to rely on "technical" insolvency as proof of unreasonable capitalization because of "the risk of ascribing undue weight to the state of a company's balance sheet on a particular day"). The *Barret* court believed that the proper approach to "unreasonably small capital" requires a court to examine a company's capital "throughout a reasonable period of time surrounding the precise date of a challenged transfer." *Id.*

²¹¹ See, e.g., *Kupetz v. Continental Ill. Nat. Bank & Trust Co.*, 77 Bankr. 754, 760 (C.D. Cal. 1987); *Credit Managers Ass'n*, 629 F. Supp. at 179-81; *Ohio Corrugating Co. v. DPAC, Inc. (In re Ohio Corrugating Co.)*, 91 Bankr. 430, 435 (Bankr. N.D. Ohio 1988).

²¹² See *Credit Managers Ass'n*, 629 F. Supp. at 183, 184 (finding third party lender's cash flow analysis as proof of financial viability); *In re Ohio Corrugating Co.*, 91 Bankr. at 438 (giving "presumptive validity" to Target's balance sheet prepared according to GAAP because the court "felt that participants in an LBO must be protected from the perfect hindsight often evidenced in creditors' subsequent attack on the corporate buyout").

²¹³ *In re Vaniman Int'l Inc.*, 22 Bankr. 166, 181 (Bankr. E.D.N.Y. 1982) (placing corporate assets where insiders can reach them but where creditors cannot is precisely the type of conduct fraudulent transfer law is designed to prohibit). As Professor Clark notes, the basic ideal of fraudulent transfer law commands controlling insiders to refrain from acting in ways designed to prefer themselves at the expense of creditors. Clark, *supra* note 6, at 510 n.16.

Several courts assert that not every creditor evokes or deserves judicial sympathy. Some courts are distinctly uncomfortable if the creditors seeking to invalidate the LBO are subsequent creditors.²¹⁴ These courts, openly hostile to such creditors, have sought to exclude them from legal protection, even though the statutory provision regarding "unreasonably small capital" in so many words includes subsequent creditors. These courts believe equity and fairness do not permit a subsequent creditor to extend credit willingly to Target and then to invalidate an LBO if it later fails. Because such conduct does not seem to sit well with courts, they have resorted to various devices to contain the impact of fraudulent transfer law on LBOs that the parties enter into in the ordinary course of business.

1. Cash Flow Projections

Judicial reliance on the cash flow approach as a way to curb the impact of fraudulent transfer law on LBOs may not be apparent at first blush. The consequences of using such an approach are best appreciated if several factors are kept in mind. First, by using cash flow to determine Target's financial viability, a court recognizes Target's business value as a whole—not the value of its assets, assuming they were somehow liquidated. As noted, the liquidation approach that relies on the break-up value of Target's assets does not and cannot recognize the influences and effects of intangible interests that cannot be valued separately from a business. As a result, valuing Target's assets on a piecemeal basis, however accurate, cannot satisfactorily measure its ability to pay its debts.

Equally significant, under the cash flow approach, the court determines "unreasonably small capital" as a function of the LBO lender's *projections*. The cash flow method clearly represents a far cry from the idea of *leviable assets* that other approaches emphasize.²¹⁵ These other approaches give no value to assets that cannot be quickly sold, as *Gleneagles* well demonstrates.²¹⁶ Similarly, these

²¹⁴ See *supra* note 211 for cited authorities.

²¹⁵ The idea of leviable assets appears to be at the core of the reasoning of courts that find unreasonably small capital on finding insolvency or a debtor's pledging of all of its assets.

²¹⁶ *United States v. Gleneagles Inv. Co.*, 565 F. Supp. 556, 577-78 (M.D. Pa. 1983), *aff'd sub nom. United States v. Tabor Realty Corp.*, 803 F.2d 1288, 1307 (3d Cir. 1986), *cert. denied*, 107 S. Ct. 3229 (1987); see also *Chase Nat'l Bank v. United States Trust Co.*, 236 App. Div. 500, 503, 260 N.Y.S. 40, 44 (1932) ("not every asset, but only such as are salable enter the equation").

approaches disregard contingent assets.²¹⁷ As a result, a debtor easily could be found insolvent and, for that reason, unreasonably capitalized, even though its operations could generate sufficient cash flow to meet its expected debts. Even when a debtor is not insolvent under this standard, its pledging of all its assets may *ipso facto* establish "unreasonably small capital." This approach assumes that the wholesale pledge of the debtor's estate leaves no assets from which creditors may satisfy their claims. Under this approach, virtually every LBO will be fraudulent.²¹⁸ In contrast, under the cash flow method, LBO participants are protected from fraudulent transfer liability as long as the LBO lender makes a reasonable, even if ultimately incorrect, prediction of Target's financial viability.

2. Limiting the Scope of Liabilities

Judicial sensitivity to the interests of LBO participants, particularly the LBO lender, and judicial hostility to the equities of subsequent creditors, may express itself in other ways. For example, a court can limit the scope of Target's liabilities. *In re Ohio Corrugating Co.*²¹⁹ is an excellent example of this approach. Traditionally, courts have given and applied inclusive scope to the term "liabilities."²²⁰ In addition, in determining whether to include a particular liability in the balance sheet, courts have often been reluctant to be bound by a debtor's accounting method²²¹ in order to protect creditors from debtor fraud.²²²

In *Ohio Corrugating*, the court disregarded both Target's unfunded pension liabilities and its environmental clean-up obligations.²²³ Although the court acknowledged that Generally Accepted

²¹⁷ See *supra* note 42 for a discussion of the impact on a debtor's solvency of disregarding contingent assets.

²¹⁸ See Cook & Mendales, *The Uniform Fraudulent Transfer Act: An Introductory Critique*, 62 AM. BANKR. L.J. 87, 91 (1988) (stating that "a leveraged acquisition that left a corporation with little or no unencumbered property would be even more readily subject to attack [under the UFTA] than under present law"). The commentators' view is based on the UFTA's definition of "assets" as non-exempt property that is not subject to a valid lien. See UFTA § 1(2)(i), 7A U.L.A. 644 (1985).

²¹⁹ 91 Bankr. 430 (Bankr. N.D. Ohio 1988).

²²⁰ See, e.g., *Tri-Continental Leasing Corp. v. Zimmerman*, 485 F. Supp. 495, 499-500 (N.D. Cal. 1980); *Davis v. Nielson*, 9 Wash. App. 864, 515 P.2d 995 (1973) (debt barred by limitations).

²²¹ See, e.g., *F.S. Bowen Electric Co. v. United States Fidelity & Guaranty Co.*, 256 F.2d 46, 49 (4th Cir. 1958); *Bergquist v. Anderson-Greenwood Aviation Corp.* (*In re Bellanca Aircraft Corp.*), 56 Bankr. 339, 385 (Bankr. D. Minn. 1985).

²²² *Tri-Continental Leasing Corp.*, 485 F. Supp. at 500.

²²³ 91 Bankr. at 438, 439.

Accounting Principles ("GAAP") do not control what may be included as a debtor liability, it departed from the acknowledged prevailing view by "assign[ing] presumptive validity" to GAAP treatment of such liabilities.²²⁴ The court concluded that GAAP was a reasonable basis with which to measure includable liabilities on a debtor's balance sheet and therefore excluded unfunded pension liabilities.²²⁵ The court's reliance on GAAP was curious because it turns on its head the policy purpose behind a broad conception of liabilities. Far from being a means to protect creditors from constructive fraud, *Ohio Corrugating's* restrictive approach virtually exempts all LBOs from attack under the insolvency branch of fraudulent transfer law because no reasonable lender would ever finance an LBO in which the balance sheet did not meet GAAP standards. The court's use of GAAP as a standard is also curious in light of prevailing practices in the LBO industry. According to these practices, lenders seldom finance an LBO unless they first obtain expert opinions assuring them of Target's financial solvency.²²⁶ Such expert opinions specifically address the impact on a company's solvency of off-balance sheet liabilities, such as unfunded pension liabilities and environmental clean-up obligations.²²⁷ Based on industry practice, it would therefore be unreasonable for an LBO lender to rely on GAAP to measure the kinds of liabilities it should consider in assessing Target's financial viability.

Despite these incongruities, the *Ohio Corrugating* court's reliance on GAAP is not surprising. First, according to the court, it would be both unfair and punitive to undo an LBO at the behest of subsequent creditors because they willingly extend credit after a buyout relying on Target's performance.²²⁸ If fraudulent transfer law protects these creditors, the doctrine of constructive fraud would serve as a form of insurance.²²⁹ Second, unlike shareholder-financed acquisitions, the court might have viewed valuation results reached by or on behalf of an independent lender as posing little

²²⁴ *Id.* at 438.

²²⁵ *Id.*

²²⁶ See Maher & Stewart-Lewis, *The Accountant's Substitute for LBO Solvency Letters*, Mergers & Acquisitions, Sept.-Oct. 1988, at 42 (noting the accounting profession's ban on solvency letters and lenders' resort to valuation firms for such letters, all in reaction to liability under the law of fraudulent transfers).

²²⁷ See VALUATION RESEARCH, Summer 1988, at 3 ("An increasingly important area of inquiry [under the balance-sheet test] is that of liabilities that may arise from . . . pension plan funding . . . [and] obligations imposed by the 1980 'Superfund' law.").

²²⁸ *In re Ohio Corrugating Co.*, 91 Bankr. 430, 435 (Bankr. N.D. Ohio 1988).

²²⁹ See *id.*

threat of self-dealing. The presence of an independent lender might signal that the LBO was not intended to defraud creditors.²³⁰ In *Ohio Corrugating*, Target's reconstituted balance sheet showed a deficit of \$700,000, representing over twenty percent of Target's total liabilities.²³¹ This deficit is a relatively large shortfall and would have been even larger if the court had included off-balance sheet liabilities. Nevertheless, according to the court Target was solvent.²³²

IV. A SUGGESTED APPROACH TO DETERMINE FINANCIAL PRECARIOUSNESS: CASH FLOW

An LBO stands or falls on an assessment of Target's financial condition under two alternative tests—insolvency and unreasonably small capital. The standards to guide such assessment are inherently vague and unpredictable. As a result, the critical question under these tests is which standard of valuation a court will use to evaluate Target's financial condition. For example, a court could determine Target's value on the basis of how much its assets will bring if sold piecemeal immediately or within a reasonable time. A court could also value Target as a going concern, whereby assets would be on the basis of their use and contribution to revenue.²³³ In the LBO context, the court's choice of which standard to apply seems to depend on its view of the acceptable reach of fraudulent transfer law and its assessment of whether Target's creditors were unfairly disadvantaged by the LBO.

This section argues that if Target was a going concern at the time of its LBO, it is unreasonable to assess Target's financial condition on the basis of liquidation value, whether the liquidation is assumed to occur immediately or within a reasonable time.²³⁴ If

²³⁰ The LBO in *Ohio Corrugating Co.* was financed by Security Pacific Business Credit, Inc., an outside party. The court believed that the lender's and other LBO participants' reliance on GAAP was reasonable. *Id.* at 432, 438. The court also stated that the constructive fraud provisions of the Bankruptcy Code, 11 U.S.C. § 548 (1988), should be construed to require "a small degree of scienter or awareness of fraud." *Id.* at 439. The court, however, found nothing in the LBO participants' intent to "buttress a finding of insolvency." *Id.*

²³¹ *Id.*

²³² In concluding that Target was solvent, the court placed much importance on the fact that Target had paid its debts as they matured for a period of ten months after the LBO during which trade creditors were paid off six or seven times. *Id.* at 440.

²³³ Generally, going-concern values exceed liquidation values. Fortgang & Mayer, *supra* note 83, at 1064.

²³⁴ Liquidation value, however, should be the governing standard if at the time of the LBO, Target was "so close to shutting its doors that a going concern standard [would be] unrealistic." *Vadnais Lumber Supply, Inc. v. Byrne (In re Vadnais Lumber Supply, Inc.)*, 100

Target was a going concern at the time of its LBO, its solvency or capitalization should be determined on the basis of its value as a going concern. Under this standard, judicial inquiry should focus on whether Target's projected cash flow is sufficient to cover its expected debts and the costs of its operation. If the court finds that Target's cash flow is positive, then Target should be deemed solvent in the balance sheet sense as well as reasonably capitalized. Moreover, in conducting this inquiry, courts should consider, rather than dismiss, the claims of subsequent creditors.

A. *Going Concern Value as the Appropriate Standard*

Fraudulent transfer law exists to protect creditors from a debtor's fraudulent conduct. The function and standard of valuation should therefore relate to this underlying purpose and help determine creditors' chances of satisfying their claims.²³⁵ The foregoing criteria might suggest liquidation as the only valid valuation standard. After all, the most expedient way to use assets to satisfy a debt is to sell them and apply the proceeds to the debt. From this distinctively creditor-oriented perspective, it makes perfect sense to measure asset value by the proceeds of immediate liquidation or liquidation within a reasonable time. Valuation under these standards is bound to disregard, to a greater or lesser degree, certain kinds of illiquid and contingent assets,²³⁶ or assets that cannot be sold separately from a business.²³⁷ Even though such assets contribute greatly to the value of a debtor's business, they are disregarded because they are not available quickly or within a reasonable time for the payment of debts. Further, the fraudulent transfer statutes require determination of solvency by weighing the value of a debtor's assets against all of its liabilities, irrespective of their maturities or contingencies.

Nonetheless, such a standard is inappropriate. Its effect is to extend the reach of fraudulent transfer law in ways that go beyond

Bankr. 127, 131 (Bankr. D. Mass. 1989) (citing *Mitchell v. Investment Sec. Corp.*, 67 F.2d 669, 671-72 (5th Cir. 1933); *In re Windor Indus., Inc.*, 459 F. Supp. 270, 276-77 (N.D. Tex. 1978)).

²³⁵ *Vadnais Lumber Supply*, 100 Bankr. at 137. The court stated that because fraudulent transfer law is designed to protect creditors, the financial condition intended must be related in some way to ability to pay debts." *Id.*

²³⁶ See *supra* text accompanying notes 52-67 for a discussion of a broad (harsh) approach to solvency determination.

²³⁷ See *infra* text accompanying note 248 for a discussion of non-separable but important assets.

what is reasonably necessary to protect creditors. An approach of this nature assumes that Target's business has no future and that therefore its break-up value should determine its ability to pay its debts. Similarly, it assumes that Target's long-term debt or installment obligations are immediately due.²³⁸ Such an approach deprives Target of the capitalized value of its earnings. Very few businesses would be considered solvent under such a standard.²³⁹

A liquidation approach rests on unrealistic assumptions. In an honest LBO, neither seller nor buyer contemplates that liquidation will occur. If Target was a going concern at the time of its LBO, it is also unreasonable to assume that the parties expected Target to pay its debts by selling its assets. It would be a different case if the parties intended to use the LBO to liquidate Target. *Gleneagles* may have been such a case.²⁴⁰ In such a case, it would be reasonable to determine Target's solvency on a liquidation basis because that was how the parties expected Target to pay its debts. Liquidation is the only way Target can pay its debts. But where Target is a going concern and the parties expected it to survive as such, it is unreasonable to assess Target's ability to pay its debts by selling its assets. One can logically assume Target will pay its debts from its earnings. After all, "the value of a business lies in its ability to provide a future stream of net cash."²⁴¹ Therefore, a court should determine Target's value and solvency in terms of its capitalized earnings.²⁴²

²³⁸ See Heiman, *supra* note 36, at 21-16. Heiman noted:

The weighing of all future liability against present assets may be unrealistic. It is not uncommon today for a company to be successful in its business, productive and paying bills as they come due, while carrying a debt that has a total liability in excess of the value of its present assets. Such a corporation will be deemed insolvent by the insolvency standards of the UFCA and the Bankruptcy Code, even though by standards of the modern market place the corporation is doing well.

Id.

²³⁹ *Id.*; Vener, *supra* note 34, at 226.

²⁴⁰ The *Gleneagles* court found that the LBO lender and buyer did not expect Target to be able to generate sufficient cash flow to cover its debts. *United States v. Gleneagles Inv. Co.*, 565 F. Supp. 556, 581 (M.D. Pa. 1983), *aff'd sub nom. United States v. Tabor Realty Corp.*, 803 F.2d 1288, 1307 (3d Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987). Precisely because the lender did not expect Target's cash flow to cover interest payment, it created an "interest reserve fund" for the purpose of relieving Target of its obligation to pay periodic interest. *Id.* In addition, the loan principal was not amortized, the lender believing that Target "could somehow liquidate enough assets to generate the cash needed to pay off the principal." *Id.* at 581-82.

²⁴¹ R. HAMILTON, *FUNDAMENTALS OF MODERN BUSINESS* § 11.5, at 233 (1989).

²⁴² The court in *In re Vadrnais Lumber Supplies, Inc.* indicated a willingness to determine solvency on this basis. See *In re Vadrnais Lumber*, 100 Bankr. 127, 132 (Bankr. D. Mass. 1989). It rejected as fundamentally flawed an accountant's reliance on the values of specific assets

Determining solvency by capitalizing earnings or cash flow is fair and should give creditors no reasonable cause to complain. If Target's cash flow is sufficient to cover all its debts, creditors face little or no risk of nonpayment. Creditors do bear such risk if the expected cash flow fails to materialize because the cash flow method of valuation relies on projections. If a court accepts the projections as reasonable, creditors cannot avoid the LBO as fraudulent.²⁴³ Therefore, under the cash flow method, creditors bear the risk of loss from unexpected occurrences. Nevertheless, it is not self-evident why LBO participants should bear the consequences of unexpected occurrences. If the assumptions underlying Target's cash flow projections were reasonable at the time they were made, fraudulent transfer law should not require LBO participants to be placed in the position of insuring the LBO's success.²⁴⁴

Creditors may also object that the cash flow method substitutes projections for the leviable assets that a liquidation approach implies. Such an approach, however, would deprive Target of its capitalized value and render insolvent a potentially profitable and operating entity, thereby rendering virtually all LBOs *per se* fraudulent. Such a rule that is too protective of creditors to the complete detriment of other honest parties is not defensible. As some commentators have noted, "[c]omplete deference to creditor protection . . . makes no more sense than complete deference to debtor freedom."²⁴⁵

to determine Target's value. *Id.* Despite its willingness to use the capitalization of earnings method, however, the court did not actually use this method, apparently because the defendants were unable to show that Target had a net profit to capitalize in view of the losses it incurred before and after the challenged transfer. *See id.* at 132-33. The court also indicated that the price paid in an LBO, with necessary adjustments for the value of the LBO transfers, would be the "most probative evidence concerning solvency or insolvency." *Id.* *See also* Cate v. Nicely (*In re* Knox Kreations), 474 F. Supp. 567, 571-72 (E.D. Tenn. 1979). The *Knox Kreations* court stated:

The surest sign of the insolvency of a corporation is the worthlessness of its stock It is, therefore, critical to note that Topsy Turvy, an arms length purchaser, was willing to pay \$175,000.00 for 81% of the stock of debtor. Topsy Turvy must have felt that the assets of the bankrupt were greater than its liabilities.

Id.

²⁴³ Credit Managers Ass'n v. Federal Co., 629 F. Supp. 175, 184 (C.D. Cal. 1985) ("The question the court must decide is *not* whether GECC's projection was correct, for it clearly was not, but whether it was reasonable and prudent at the time it was made.").

²⁴⁴ *See id.* at 187 (court noting that fraudulent transfer does not require Target to be "sufficiently well capitalized to withstand any and all setbacks to [its] business").

²⁴⁵ Baird & Jackson, *supra* note 8, at 836.

A liquidation approach is too deferential to creditors. It is also likely to curtail or eliminate a debtor's freedom to engage in profitable transactions. Such a standard would not be fair to debtors. Few owners would sell a business for its liquidation value. It is also important to recall that fraudulent transfer law, including the UFCA, requires valuation to be "fair."²⁴⁶

Finally, liquidation value is at odds with modern lending practices. LBO lending decisions are made on Target's value as a going concern.²⁴⁷ A liquidation approach cannot capture all of Target's assets that influence its value and debt-paying ability because assets that cannot be liquidated have no liquidation value. Most assets will have a liquidation value even though Target ceases to be a going concern. Nonetheless, valuable assets such as customer lists, unpatented process technology, and research and development costs will have no liquidation value.²⁴⁸ For this reason lenders rely on Target's going concern value in making lending decisions.²⁴⁹

Because Target's value lies in its ability to provide a future stream of net cash,²⁵⁰ lenders look to its post-LBO cash flow as the primary source of repayment.²⁵¹ As the *Credit Managers* court recognized, balance sheet ratios no longer determine a business's creditworthiness. Although LBO loans are invariably secured and assets are obviously important, a lender's evaluation of Target's cash flow is the decisive factor.²⁵² Without an acceptable cash flow to service the LBO debt and cover the costs of operation, lenders would not make a loan in the first place. Therefore, judicial reliance on a modern lender's cash flow evaluation to determine debt-paying ability would be consistent with fraudulent transfer law's goal of creditor protection and would comport with current commercial practices.

²⁴⁶ See *American Nat'l Bank & Trust Co. v. Bone*, 333 F.2d 984, 987 (8th Cir. 1964).

²⁴⁷ See Michel & Shaked, *What Every LBO Lender Must Know About Valuation*, COM. LENDING REV., Spring 1990, at 10, 12.

²⁴⁸ Cross, *supra* note 91, at 47 ("While the liquidation value of tangible assets generally is less than stated book value, the liquidation value of intangible assets is generally zero, or close to zero.").

²⁴⁹ *Id.* (noting that for the lender "the most efficient approach may be to value the enterprise as a whole.").

²⁵⁰ R. HAMILTON, *supra* note 241, § 11.5, at 233.

²⁵¹ Cross, *supra* note 91, at 47.

²⁵² *Credit Mangers Ass'n v. Federal Co.*, 629 F. Supp. 175, 187 (C.D. Cal. 1985); Cross, *supra* note 91, at 47 ("Traditional credit parameters relating to balance sheet ratios no longer are meaningful.").

B. *Cashflow as the sole test of Financial Precariousness*

Fraudulent transfer law uses "insolvency" and "unreasonably small capital" as separate tests of a debtor's debt-paying ability. By comparing the present value of assets and liabilities, insolvency measures a debtor's present ability to make a gratuitous transfer without harming existing creditors. "Unreasonably small capital," a broader test, assesses the debtor's ability to pay both existing and future debts.

Although these two tests of financial precariousness are legally distinct, the manner in which some courts have recently applied them in the LBO context suggests a synthesis. In *In re Vadnais Lumber Supply, Inc.*, the court indicated a willingness to determine Target's solvency under a going-concern value standard by a capitalization of earnings method.²⁵³ The court stated that "[i]f despite [Target's] new interest expense and other problems it had the ability to generate even a small profit immediately after the closing, any capitalization of that profit would indicate the existence of some minimal going concern value and therefore solvency."²⁵⁴ Under this method, the net profit figure selected to determine Target's capitalized value is determined by averaging past earnings, with appropriate weighting to reflect current trends.²⁵⁵

Another method to determine Target's going concern value relies on a discounted cash flow approach.²⁵⁶ Under this approach, Target's present value is determined by projecting its cash flows over a period of five to eight years (the "forecast period"), and then discounting them by the appropriate cost of capital.²⁵⁷ If its cash flow during the forecast period is positive, then under *In re Vadnais Lumber Supplies, Inc.*, Target should be solvent.

The same cash flow projections that determine Target's solvency in the foregoing manner may also be used to determine the reasonableness of its capitalization. *Credit Managers* is instructive in this regard. The *Credit Managers* court held that if Target could generate a positive cash flow to meet its future needs, it could not be unreasonably capitalized.²⁵⁸ The court did not consider Target's

²⁵³ 100 Bankr. 127, 132 (Bankr. D. Mass. 1989).

²⁵⁴ *Id.*

²⁵⁵ *Id.*

²⁵⁶ *Id.*; see *supra* text accompanying notes 104-112 for a discussion of the going-concern value approach.

²⁵⁷ Michel & Shaked, *supra* note 247, at 12.

²⁵⁸ 629 F. Supp. 175, 183, 188 (C.D. Cal. 1985).

present value to determine solvency, apparently because there were no existing creditors who could avoid the LBO on that basis.²⁵⁹ Even if there had been unpaid existing creditors, however, the approach the court used suggests that its conclusion regarding Target's solvency would have been the same.

If Target could generate a positive cash flow during the forecast period, capitalizing that cash flow would necessarily establish solvency. If Target's cash flow is positive, it is difficult to see logically how existing creditors would be hurt by the LBO. Moreover, if insolvency *ipso facto* establishes unreasonably small capital, as several courts have held, the converse should also be true: a finding of reasonable capitalization should *ipso facto* establish solvency. Again, it is difficult to see logically how a reasonably capitalized business can be deemed insolvent except on the basis of liquidation. Target's cash flow should be sufficient as a test for determining fraudulent transfer liability in an LBO.

Reliance on cash flow projections as the sole test of an LBO's compliance with fraudulent transfer law depends on the integrity and reliability of the assumptions underlying the projections. A risk arises that LBO participants may engage in optimistic assumptions.²⁶⁰ Consequently, courts should evaluate rigorously the reasonableness of these assumptions. The most important assumptions relate to two basic risks that Target may face during the forecast period.

One risk is the chance of Target's failure as a result of operating losses caused by a business decline in the industry of which it is a part. Assumptions relating to business risk are often difficult to evaluate. Cash flow estimates are affected by key assumptions, such as the growth rate of revenues and expenses, capital outlays required, inflation, and interest rate.²⁶¹ Projections of cash flow, however, which fail to incorporate the effect of worst-case scenarios, such as a rise in the interest rate, a slowdown, or an economic recession should be unreasonable *per se*.²⁶²

The other risk that Target may face during the forecast period is the probability of default because Target cannot meet the fixed

²⁵⁹ *Id.* at 180 (noting that the attacking creditors did not hold "substantial" claims on the date of the LBO).

²⁶⁰ *Id.* at 12. Campeau Corporation's purchase of Allied Stores is an example of a LBO where "overoptimistic" assumptions were made. *Id.* at 16. The cash flow projections assumed a 9.0% compound growth rate over the forecast period, whereas the growth rate in sales in the recent past had been 6.8%. *Id.*

²⁶¹ Michel & Shaked, *supra* note 247, at 12.

²⁶² See *id.* at 15, 17.

changes imposed by its capital structure.²⁶³ By definition, the risk of default associated with an LBO is high. Therefore, in determining the reasonableness of the financial risk assumed by Target, courts should determine whether the lender performed sensitivity, or "what if," analyses to determine the stability of Target's cash flow to pay interest and service fixed charges at different combinations of debt and equity capitalization.²⁶⁴ The wider the margin for error, the smaller the risk of insolvency and, therefore, the more reasonable the lender's assumption. Courts should hold it *per se* unreasonable, however, for a lender to rely on GAAP as a measure of the kind of liabilities it should consider in determining Target's risk of insolvency. Because the risk of insolvency is a matter of economics, not accounting, such risk should be assessed by including all of its potential liabilities, including off-balance sheet liabilities such as Target's unfunded pension liabilities.²⁶⁵ Similarly, Target's expected cash flow should be sufficient to cover all reasonably foreseeable claims, including those of trade creditors.

C. *Unreasonably Small Capital and the Rights of Subsequent Creditors*

Requiring Target's cash flow projections to reflect the claims of subsequent creditors conflicts with some recent court decisions. These decisions either hold or strongly suggest that subsequent creditors cannot attack an LBO because they assumed the risk of nonpayment in extending credit to Target with knowledge of its LBO.²⁶⁶

Denying legal protection to post-LBO creditors is not self-evident. As a purely technical matter, the fraudulent transfer statutes do not support it. Nothing in these statutes conditions a creditor's standing to challenge a transfer on a showing that it did not know of the LBO or did not assume the risk of its failure.²⁶⁷ An unpaid subsequent creditor is merely required to show that Target made a gratuitous transfer without adequately providing for subsequent creditors. The fraudulent transfer statutes impose the duty of com-

²⁶³ Stacey, *Asset-Based Loans in Leveraged Buyouts*, J. COM. BANK LENDING, May 1983, at 55.

²⁶⁴ See Michel & Shaked, *supra* note 247, at 13 (noting that lenders often perform sensitivity analysis with "less than appropriate care and diligence").

²⁶⁵ Mavredakis & Greene, *supra* note 134, at 70.

²⁶⁶ See *supra* text accompanying note 211 for a discussion of judicial discomfort in applying constructive fraud to protect subsequent creditors.

²⁶⁷ See 11 U.S.C. § 548 (1988); UFCA § 5 7A U.L.A. 504 (1985); UFTA § 4 7A U.L.A. 652-53 (1985).

plying with the requisite financial condition on Target, regardless of a creditor's knowledge. The statutes impose no duty on such creditors to investigate a debtor's financial condition, perhaps because debtor is in the best position to assess its financial condition and appreciate the effect of a gratuitous transfer on its financial viability. The apparent incongruity, however, of remedying a subsequent creditor's injury at the expense of the LBO lender, an innocent third party, has given some courts pause.

When a court avoids an LBO at the behest of a subsequent creditor because the transaction does not satisfy the "unreasonably small capital" requirement, lender, not Target, bears the consequences of avoidance—invalidation of its security interests. It might seem inequitable to penalize the lender for Target's breach of its duty of maintaining reasonable capital for the protection of its creditors. Arguably, the lender should bear the brunt of invalidation rather than denying subsequent creditors any form of protection.²⁶⁸

The lender in an LBO is, or should be seen as, a "gatekeeper."²⁶⁹ Although the lender is not the primary author or beneficiary of Target's misconduct, it is the major supplier of financing and therefore is in the best position to avoid violation of the law.²⁷⁰ In making its lending decision, a lender typically relies on a solvency opinion addressing the viability of Target's financial condition. Thus, if a lender is unsatisfied with Target's financial condition, it can withdraw from the LBO transaction or require the participants to adjust their terms so as to reduce Target's risk of insolvency.²⁷¹

Moreover, the lender is the least cost determiner of Target's financial situation. As a financial creditor, it possesses the greatest degree of specialization in appraising credit risk.²⁷² It also has the greatest incentive to investigate Target's creditworthiness. Although some subsequent creditors, particularly trade creditors, are also

²⁶⁸ The problems of risk allocation inherent in avoiding a lender's security interests because of "inadequate consideration" are discussed in McCoid, *supra* note 17, at 658-69.

²⁶⁹ The term originates from Kraakman, *Gatekeepers: The Anatomy of a Third Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53; 53 (1986). A gatekeeper is a party who, although not the primary author or beneficiary of misconduct, has the ability to prevent it. *Id.*

²⁷⁰ Because the lender provides a major portion of the financing for the LBO, the transaction cannot be completed without its blessing. If the lender determines that the LBO is too highly priced, it can easily cause the deal to fall through by withdrawing from the transaction.

²⁷¹ Sherwin, *supra* note 6, at 493.

²⁷² The general approach of differentiating among types of creditors in terms of their information costs is discussed in Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499, 522-23 (1976).

"professional" creditors, the cost to them of investigating Target's financial situation will be relatively high. Unlike the lender, they have no role whatsoever in the LBO transaction. In addition, they have less incentive to investigate because the amount of their credit is relatively small.

Some courts might differentiate among subsequent creditors on the basis of creditor knowledge of the LBO, denying protection to those who had such knowledge.²⁷³ But mere knowledge of the LBO does not place subsequent creditors in the position to assess fully and appreciate the risks associated with the LBO. It would be a different matter if they extended credit after being fully informed of the details of the transaction. Absent such knowledge, it seems unfair for LBO participants to pass on the risks of the LBO to those from whom they expect credit. They know that the LBO's success depends on the availability to trade credit. Therefore, it seems only fair to hold them responsible for risks that they created.

Moreover, LBO participants would be liable only if they failed to act reasonably in estimating Target's cash flow, not if their projections proved incorrect. Liability under such a standard is a far cry from making them the insurers of the LBO's success. Furthermore, a rule that excluded from protection subsequent creditors with knowledge of the LBO is unlikely to serve the best interests of the lender or other LBO participants. Such a rule might discourage trade creditors from dealing with Target except on a cash-only basis, which could deprive Target of needed sources of trade credit and exacerbate its cash flow problems. LBO participants would not necessarily embrace such a rule.

Even if the rule did not discourage extensions of trade credit, it would arguably increase the costs of such credit. Trade creditors might offer smaller amounts of credit, or require larger down payments, shorter payoff periods, or higher rates of interest,²⁷⁴ all calculated to minimize the impact of a rule denying them recourse if they know about an LBO and extended credit to that LBO. Again, any of these adjustments would be unlikely to help Target's cash flow.

Finally, denying subsequent creditors standing to challenge an LBO is at odds with the usual approach in bankruptcy proceedings,

²⁷³ See, e.g., *Ohio Corrugating Co. v. DPAC, Inc. (In re Ohio Corrugating Co.)*, 91 Bankr. 430, 435 (Bankr. N.D. Ohio 1988).

²⁷⁴ For example, in *Credit Managers Association v. Federal Co.*, trade creditors "demanded quicker payment" from Target. 629 F. Supp. 175, 180 (C.D. Cal. 1985).

which treats all creditors on a collective, aggregated basis.²⁷⁵ Under well-established doctrine,²⁷⁶ the existence of one creditor with the right of avoidance is sufficient for the trustee in bankruptcy to overturn the LBO for the benefit of all creditors.²⁷⁷

V. CONCLUSION

An LBO stands or falls based on an assessment of Target's financial condition. The process of determining financial conditions is far less objective than it might appear. The standards to guide such assessment are vague and unpredictable. As a result, judicial assessment of Target's financial condition is subject to the court's view regarding the acceptable reach of fraudulent transfer law.

A court's evaluation of Target's financial condition also reflects its conclusion whether unsecured creditors or LBO participants should more fairly assume losses arising from a failed LBO. Courts more solicitous of creditors, particularly creditors holding claims at the time of an LBO, are more likely to employ a liquidation approach. Conversely, courts that entertain serious reservations about applying constructive fraud to an LBO are likely to approach issues of valuation from a going concern perspective or in other ways that limit fraudulent transfer law's impact. Some courts simply exclude subsequent trade creditors from protection.

Fraudulent transfer law exists to protect creditors. Valuation under it should relate to this underlying purpose. From the standpoint of protecting creditors, judicial invocation of a liquidation standard may appear justified. Such a standard is inappropriate, however, because it determines a business's debt-paying ability based on a sale of its assets. An ongoing business pays its debts out of earnings, not the sale of individual assets.

Target's cash flow measures its debt-paying ability and its value as a going concern. As a result, evaluation of Target's cash flow best accommodates the need to protect both creditors and the reasonable commercial expectations of participants in an LBO. Its cash flow should sufficiently measure an LBO's compliance with fraudulent transfer law. If Target's future cash flow is positive, then it should be deemed solvent in the balance sheet sense as well as reasonably capitalized.

²⁷⁵ See Posner, *supra* note 272, at 523.

²⁷⁶ 284 U.S. 4 (1931).

²⁷⁷ Queenan, *supra* note 6, at 7, 23.

Target's cash flow projections, however, should be carefully evaluated to determine the reasonableness of the assumptions upon which they are made. It is not reasonable to assume the cost of debt will not vary over the forecast period. Moreover, it is not reasonable to rely on Target's balance sheet, even one prepared according to GAAP, to measure all of Target's potential liabilities. Finally, it is not reasonable to omit considerations of subsequent trade creditors and to fail to make adequate provisions to satisfy their claims.