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## SOME THOUGHTS ABOUT INTERCORPORATE GUARANTIES, FAIR CONSIDERATION, AND REASONABLY EQUIVALENT VALUE

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TABLE OF CONTENTS



Guaranty agreements are important components of many commercial transactions because they allow for the availability of credit in cases where it might otherwise be denied. For example, a business' structure may involve more than one corporate entity, and often neither assets nor cash needs are distributed proportionately among them. A bank may be unwilling to lend money to the corporation which needs it based solely on its credit rating and available collateral. The bank, however, may be willing to fund the loan if a

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related corporation with substantial assets, such as a majority shareholder or subsidiary, guaranties the loan.

The guaranty is usually accomplished by having the related corporation sign a guaranty of payment agreement.[1] Often the guaranty agreement is itself secured by the guarantor's assets. As a result of the guaranty, not only are the additional assets of the guarantor now available to repay the loan, but the guaranty also gives the lender additional security in case of the debtor's bankruptcy. If the debtor declares or is declared bankrupt, the guarantor, as a separate entity, cannot invoke the automatic stay provision contained in section 362 of the Bankruptcy Code.[2] (The automatic stay prevents creditors of the debtor from taking any action *against the debtor* to collect debts.[3]) Thus, even if one of the lender's worst nightmares comes true—that is, the debtor goes bankrupt—the lender can still look to the guarantor for immediate payment.[4]

Notwithstanding the recognized importance of guaranty agreements, commentators[5] and courts[6] have unnecessarily called into question the en-

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1. *See infra* notes 16-26 and accompanying text.

2. 11 U.S.C. §§ 101-151326 (1982).

3. 11 U.S.C. § 362(a) (1982).

4. *Id. But see* Kuney, *The Bank Guaranty Agreement: Emerging Threat of Bankruptcy Stay*, 41 Bus. Law. 77 (1985). Kuney suggests that the guarantor of a bankrupt may be able to obtain relief similar to the automatic stay of § 362.

5. *See* Rosenberg, *Intercorporate Guaranties and the Law of Fraudulent Conveyances: Lender Beware*, 125 U. Pa. L. Rev. 235, 256 (1976); Alces, *The Efficacy of Guaranty Contracts in Sophisticated Commercial Transactions*, 61 N.C.L. Rev. 655, 680 (1983); Carl, *Fraudulent Transfer Attacks on Guaranties in Bankruptcy*, 60 Am. Bankr. L.J. 109, 124-25 (1986); Note, *Guarantees and Section 548(a)(2) of the Bankruptcy Code*, 52 U. Chi. L. Rev. 194, 216 (1985) (written by Robert K. Rasmussen); Walls, *Promises to Keep: Intercorporate Guaranties and Fraudulent Transfers in Bankruptcy*, 19 U.C.C.L.J. 219, 235 (1987).

Commentators have continued to question the enforceability of up and cross-stream guaranties under the Uniform Fraudulent Transfer Act (UFTA), 7A U.L.A. 639 (master ed. 1985). *See generally* Blumberg, *Intragroup (Upstream, Cross-stream, and Downstream) Guaranties Under the Uniform Fraudulent Transfer Act*, 9 Cardozo L. Rev. 685 (1987); Schwarz, *The Impact of Fraudulent Conveyance Law on Future Advances Supported by Upstream Guaranties and Security Interests*, 9 Cardozo L. Rev. 729 (1987). For a brief discussion of the UFTA *see infra* note 14.

6. Rubin v. Manufacturers Hanover Trust, 661 F.2d 979 (2d Cir. 1981) (court held that guaranties for the benefit of affiliates were not for fair consideration); Ear, Nose & Throat Surgeons, Inc. v. Guaranty Bank & Trust Co. (*In re* Ear, Nose & Throat Surgeons, Inc.), 49 Bankr. 316 (Bankr. D. Mass. 1985); *In re* Jones, 37 Bankr. 969 (Bankr. N.D. Tex. 1984); Lawless v. Eastern Milk Producers Coop. Ass'n (*In re* Stop-N-Go, Inc.), 30 Bankr. 721 (Bankr. W.D.N.Y. 1983); Hemphill v. T & F Land Co. (*In re* Hemphill), 18 Bankr. 38 (Bankr. S.D. Iowa 1982); Whitlock v. Max Goodman & Sons Realty, Inc. (*In re* Goodman Indus., Inc.), 21 Bankr. 512 (Bankr. D. Mass. 1982); Pirrone v. Toboroff (*In re* Vaniman Int'l, Inc.), 22 Bankr. 66 (Bankr. E.D.N.Y. 1982); *In re* Winslow Plumbing, Heating & Contracting Co., 424 F. Supp. 910, 914 (D. Conn. 1976) (referring to the general rule that transfers made to benefit third parties are clearly not made for a fair consideration, the court stated, "this rule is certainly sound when applied in cases . . . involving the gratuitous payment . . . of a parent corporation's debt by its subsidiary"); Zeller Paper Co. v. Valley Nat'l Bank, 13 Ariz. App. 431, 477 P.2d 550 (1970) (the

forceability of two important types of intercorporate[7] guaranties: upstream and cross-stream guaranties.[8] This has created unnecessary fear concerning the enforceability of these guaranties.[9] The fear is that these guaranties may be characterized as unenforceable fraudulent conveyances.[10] At best, this fear has unnecessarily complicated corporate borrowing; at worst, it has unnecessarily limited the credit available to corporate borrowers.[11] This article

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court invalidated a guaranty by the corporation of a debt of its shareholder). *See also* 4 COLLIER ON BANKRUPTCY § 67.33 at 514.1-514.2 (14th ed. 1978) (citing cases supporting the proposition that transfers made to benefit third parties are not made for fair consideration); Comment, *Avoidability of Intercorporate Guaranties Under Sections 548(a)(2) and 544(b) of the Bankruptcy Code*, 64 N.C.L. REV. 1099 (1985-86) (author discusses cases refusing to enforce up and cross-stream guaranties).

7. An intercorporate guaranty refers to a guaranty given by a related corporate entity. The analysis suggested by this article assumes that the entities are affiliated prior to the creation of the guaranty.

The analysis suggested here does not deal specifically with guaranties given as part of a leveraged buyout (LBO). A LBO is a type of corporate acquisition characterized by use of the acquired (or Target) corporation's assets to finance the acquisition. There are many ways to structure a LBO; one involves the acquiring (Raider) corporation's acquisition of all the stock of Target by giving its shareholders unsecured notes. Then Raider borrows the amount of the note from Lender and Target provides a guaranty of the loan and secures its guaranty. The result of a LBO is the same regardless of the form used; the former shareholders of Target have their shares purchased with the proceeds of a loan secured by Target's assets. To the extent that a guaranty is involved in a LBO, the analysis suggested here for intercorporate guaranties will apply. That is, while other aspects of the overall LBO transaction may be fraudulent, the grant of the guaranty and its attendant grant of security will usually not be a fraudulent conveyance. The beneficiaries of the guaranty are the former shareholders of Target and Raider, not the Lender. *Cf. infra* notes 89-92 and accompanying text. For a discussion of the law of fraudulent conveyance in the LBO context, see generally Murdoch, Sartin & Zadek, *Leveraged Buyouts and Fraudulent Transfers: Life After Gleneagles* 43 BUS. LAW 1 (1987); Kirby, McGuinness & Kandel, *Fraudulent Conveyance Concerns in Leveraged Buyout Lending* 41 BUS. LAW. 27 (1987); Baird & Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV.. 829 (1985).

8. The phrase "upstream guaranty" describes situations in which a subsidiary guaranties an obligation of its parent corporation. When the parent guaranties an obligation of its subsidiary, it is referred to as a "downstream guaranty." A "cross-stream guaranty" refers to a situation in which one corporation guaranties an obligation of another corporation whose stock is also owned by the guarantor's parent. *See* Rosenberg, *supra* note 5, at 257.

9. As a result of this fear, commentators in the area have suggested that one should avoid up- or cross-stream guaranties whenever possible. *See* Walls, *supra* note 5, at 235; *Guarantees and Section 548(a)(2) of the Bankruptcy Code, supra* note 5, at 216; Alces, *supra* note 5, at 680; NASSBERG, THE LENDER'S HANDBOOK 73 (1986); HILLMAN, COMMERCIAL LOAN DOCUMENTATION 230 (2d ed. 1986).

10. *See supra* note 9; WEISSMAN, LENDER LIABILITY: HOW TO PROTECT YOURSELF AGAINST UNWARRANTED SUITS 15-23, 107-09 (1988).

11. *See* NASSBERG, *supra* note 9; HILLMAN, *supra* note 9 (both Nassberg and Hillman suggest restructuring the transaction to avoid upstream guaranties); Kirby, McGuinness & Kandel, *supra* note 7, at 44-49; Berstein, *Leveraged Buyouts: Legal Problems and Practical Suggestions*, in LEVERAGED BUYOUTS 119, 136-38 (S. Diamond ed. 1985); WEISSMAN, *supra* note 10. Weissman recommends that a transaction involving an upstream guaranty should include: (1) a pro forma statement on a nonconsolidated basis of assets and liabilities of the borrower, dated

argues that the characterization of an intercorporate guaranty as up-, cross-, or downstream is not relevant to the determination whether it is a fraudulent conveyance.[12] Up- or cross-stream guaranties, like downstream guaranties, will rarely result in fraudulent conveyances.[13]

Part I of this article discusses the legal background of guaranty agreements and fraudulent conveyance law and examines the relevant provisions of the Uniform Fraudulent Conveyance Act[14] (hereinafter referred to as

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as of the closing date, certified as accurate by the chief financial officer of the borrower, and explaining how the valuation of the assets was reached; this statement should set forth all debts, including subordinated, contingent, unmatured, and disputed obligations such as guaranties, underfunded pension liabilities, and projected tort and contract liabilities, and should also explain how these figures were determined by the borrower; (2) a conservative cash flow projection for the borrower, made on a nonconsolidated basis, and certified as accurate by the chief financial officer of the guarantor; (3) a certification by the chief financial officer that all nondisputed payables are current; and (4) an opinion given by borrower's counsel that the guaranty is enforceable in accordance with its terms. *Id.* at 22-23. Weissman also suggests that "capping the guaranty" may reduce the risk that it will be characterized as a fraudulent conveyance. According to Weissman, capping the guaranty involves limiting the guarantor's liability under the guaranty at some amount which will preserve its solvency. Weissman gives the following provision as an example:

> Notwithstanding the generality of the foregoing definition of indebtedness, the liability of each Guarantor hereunder is limited to the lesser of the following amounts minus, in either case, one dollar ($1.00);
>
> 1. The lowest amount which would render this Guaranty a fraudulent conveyance under the Uniform Fraudulent Conveyance Act, or other similar or analogous law or statute of the appropriate jurisdiction; and
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> 2. The lowest amount which would render this Guaranty a fraudulent transfer under Section 548 of the Bankruptcy Code of 1978, as amended.

Weissman is quick to point out that "caps are not a panacea." WEISSMAN, *supra* note 10, at 108. Indeed, the cap neutralizes much of the risk-reducing effect of the guaranty. Moreover, it is not possible to estimate the number of transactions which have failed to go forward due to the perceived risk associated with the guaranties or the inability of the guarantor to comply with requirements suggested by the commentators to strengthen the guaranties. For a discussion of intercorporate guaranties under the UFTA, see generally Blumberg, *supra* note 5, Schwartz, *supra* note 5.

12. *See infra* notes 70-125 and accompanying text.

13. *See id.*

14. Uniform Fraudulent Conveyance Act, 7A U.L.A. 427-638 (master ed. 1985) [hereinafter UFCA]. The UFCA has been adopted by the following jurisdictions: Ariz. (1919); Cal. (1939); Del. (1919); N.J. (1919); N.M. (1959); N.Y. (1925); N.D. (1943); Ohio (1961); Okla. (1965); Pa. (1921); S.D. (1919); Utah (1925); Vt. (1957); Wash. (1945); Wis. (1919); Wyo. (1929). *Id.* at 427.

The UFCA was promulgated by the Conference of Commissioners on Uniform State Laws in 1918. It was the source of § 67(d) of the 1898 Bankruptcy Act, repealed in 1978. *See* Bankruptcy Act of 1898, ch. 541, § 67(d), 30 Stat. 544, 564, *amended by* Chandler Act, ch. 575, § 67(d), 52 Stat. 840, 877 (1938) (repealed 1978). It was also the source of § 548 of the Bankruptcy Reform Act of 1978. 11 U.S.C. § 548 (1982).

In 1979 the Conference appointed a committee to study the Act and prepare a revision. The Committee named the revised Act the Uniform Fraudulent Transfer Act, 7A U.L.A. 639 (master ed. 1985) [hereinafter UFTA], in recognition of its applicability to transfers of personal

UFCA) and the 1978 Bankruptcy Reform Act[15] (hereinafter referred to as the Code). Part II analyzes the application of the fair consideration and reasonably equivalent value requirements in the context of upstream guaranties; while Part III analyzes whether the prohibition against fraudulent conveyances was designed to save the creditors of the guarantor from the risk associated with an upstream guaranty. Finally, Part IV concludes with the suggestion that intercorporate up- and cross-stream guaranties are desirable risk reducing tools whose efficacy should no longer be in doubt.

## I. Background

A guaranty is a conditional promise to perform another's duty, liability, or obligation.[16] The promise is conditioned on the nonperformance of the principal obligor, also called the debtor. A suretyship is also an agreement, ensuring performance of the obligation of another.[17] Traditionally the difference between a suretyship and a guaranty concerned the steps the creditor was required to take before demanding payment from the guarantor or surety.[18] According to the general rule, the guarantor was not liable until

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property as well as real property. The basic structure and approach of the UFCA are preserved in the UFTA. For a discussion concerning the similarities and differences of the two Acts see UFTA, 7A U.L.A. (master ed. 1985) at 639-42; Kennedy; *The Uniform Fraudulent Transfer Act*, 18 U.C.C.L.J. 195 (1986).

The UFTA has been adopted in the following eight states, California, North Dakota, and Oklahoma having repealed the UFCA and adopted the UFTA in its place: Calif. (1986); Maine (1986); Hawaii (1985); N.D. (1985); Okla. (1986); Or. (1985); R.I. (1986); W.V. (1986). *Id.* (supp. 1985).

15. 11 U.S.C. §§ 101-151326 (1982).

16. *See* Commercial Credit Corp. v. Chisholm Bros. Farm Equip. Co., 96 Idaho 194, 525 P.2d 976 (1974). *See also* Restatement of Security § 82 and comment (g) (1941); Black's Law Dictionary 634 (5th ed. 1979).

17. "While the words 'surety' and 'guarantor' are often used indiscriminately as synonymous terms and while both agree to pay the debt of another there are points of distinction between them." A. Stearns, The Law of Suretyship 4 (5th ed. 1951). *See also* Restatement of Security § 82 comment (g) (1941).

18. *See* Howell v. Comm'r, 69 F.2d 447 (8th Cir. 1934). In *Howell* the court notes that "the liability of a guarantor is secondary and collateral, and its enforcement depends upon certain conditions." "The liability of a surety is original, primary and direct." *Id.* at 450. *See also* Picket v. Rigsbee, 252 N.C. 200, 113 S.E.2d 323 (1960); S.N.M.L. Corp. v. Bank of N.C., 41 N.C. App. 28, 254 S.E.2d 274 (1979); General Finance Corp. v. Welborn, 98 Ga. App. 280, 105 S.E.2d 386, 389 (1958). *See generally* L. Simpson, Handbook on the Law of Suretyship 8-11 (1950). Simpson notes that at common law and in equity the main distinctions are: (1) an action may be maintained jointly against a principal debtor and surety, while a principal debtor and a guarantor cannot be sued jointly, unless authorized by statute; (2) a surety is primarily and jointly liable with the principal while a guarantor's obligation is secondary and is generally fixed only upon unsuccessful demand upon the principal debtor and notice to the guarantor; and (3) a surety's obligation is created concurrently and usually together with the principal's obligation, while a guarantor's obligation is a separate contract (even though it may be incorporated into the same document) which need not arise concurrently with the principal's obligation. *Id.*; Radin, *Guaranty and Suretyship*, 17 Calif. L. Rev. 605 (1929).

collection efforts had been exhausted against the debtor without complete success, while the surety was obligated to pay immediately upon the default of the debtor.[19] Today these terms are often used without regard to the traditional distinction.[20] Today the distinction is best indicated by use of the terms "guaranty of collection" or "guaranty of payment."[21] In this article the term "guaranty" will refer to both guaranty and suretyship agreements; where the traditional distinction between a surety and guaranty is intended, the terms "guaranty of collection" or "guaranty of payment" will be used. In addition, a guaranty—like any contract—can be structured as the parties see fit,[22] and thus may be conditional[23] or absolute,[24] continuing[25] or limited.[26] This article will focus on the typical guaranty found in commercial loans, which is an absolute and continuing guaranty of payment.

As a result of guarantying an obligation, the guarantor automatically receives certain equitable rights.[27] These rights are exoneration, reimbursement, subrogation, and contribution. Exoneration is the right of the guarantor to compel the principal debtor to pay, if he is able, and to compel co-

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19. *See supra* note 18.

20. *See* A. Sterns, *supra* note 17.

21. A clear definition of these terms is contained in the Uniform Commercial Code (U.C.C.) § 3-416 (1977):

> Contract of Guarantor
>
> (1) "Payment guaranteed" or equivalent words added to a signature mean that the signer engages that if the instrument is not paid when due he will pay it according to its tenor without resort by the holder to any other party.
>
> (2) "Collection guaranteed" or equivalent words added to a signature mean that the signer engages that if the instrument is not paid when due he will pay it according to its tenor but only after the holder has reduced his claim against the maker or acceptor to judgment and execution has been returned unsatisfied, or after the maker or acceptor has become insolvent . . . .

Article 3 of the U.C.C. (which has been adopted in all fifty states) deals specifically with the law of negotiable instruments. However, the definitions of 3-406 are also useful with respect to the law of guaranty. *See* Alces, *supra* note 5, at 658-60 n.18.

22. *See* Restatement of Security § 88 and comments (a), (b), & (c) (1941). *Cf. infra* notes 134-43 and accompanying text.

23. Under a conditional guaranty the guarantor's obligation will not arise until certain conditions occur, or the obligation is subject to being discharged upon the occurrence of certain events.

24. An absolute guaranty, in theory, can be enforced notwithstanding the occurrence of any event.

25. When a continuing guaranty is used, the guarantor guaranties *all indebtedness* arising either at the time of the transaction or in the future between the primary debtor and the lender.

26. If a limited guaranty is used, the guarantor is liable only for repayment of a particular note or pursuant to a particular loan transaction.

27. *See* A. Stearns, *supra* note 17, at 439, 478, 505, 515; H. Arant, Handbook of the Law of Suretyship and Guaranty 31—21, 333 (1931); L. Simpson, *supra* note 18, at 198-204; Carl, *supra* note 5, at 111-15.

guarantors to pay their share.[28] Reimbursement is the guarantor's right, after he has paid pursuant to the guaranty, to be reimbursed by the principal debtor for the amount paid plus interest and costs.[29] As a result of the rights of reimbursement and exoneration, the guarantor becomes a creditor of the principal debtor.[30] The right of subrogation augments the right of reimbursement. If the guarantor has paid the entire outstanding amount of the principal debt,[31] the right of subrogation entitles him to enforce against the principal debtor all the rights which the creditor had, including mortgages, security interests, liens, and the power to follow trust funds, in order to recover pursuant to his right of reimbursement.[32] In addition, the guarantor can enforce any rights the creditor has against co-guarantors or other third parties relating to the principal's obligations. Contribution is the guarantor's right, upon payment, to recover from any co-guarantors.[33] Thus every guarantor automatically receives certain assets which are its equitable rights of exoneration, reimbursement, subrogation, and contribution.

The prohibition of fraudulent conveyances is designed to protect creditors from a particular type of fraud.[34] This type of fraud can be illustrated

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28. *See* RESTATEMENT OF SECURITY § 112 (1941); L. SIMPSON, *supra* note 18, at 204, 225; A. STEARNS, *supra* note 17, at 505; W. HAGENDORN, THE LAW OF SURETYSHIP AND GUARANTY 112-13 (1938); Cathcart, *The Right of Exoneration*, 13 MISS. L.J. 513, 514 (1941).

29. *See* RESTATEMENT OF SECURITY §§ 103, 104 (1941); L. SIMPSON, *supra* note 18, at 224, 235.

30. *See* RESTATEMENT OF SECURITY §§ 103, 104, 112, 113 and comments thereto (1941). "The surety, who has paid, is himself a creditor [of the principal]." RESTATEMENT OF SECURITY § 113 comment (a) (1941). Even before payment and even before maturity, the surety is a contingent creditor of the principal debtor. *Id.* Section 113 provides: "Where the principal makes a fraudulent conveyance and the surety if the principal's obligation were due, would have a right of exoneration against the principal the surety can have the fraudulent conveyance set aside." For a discussion of the status of these claims in a bankruptcy proceeding, *see* Carl, *supra* note 5, at 134-38.

31. *But see* Carl, *supra* note 5, at 135:

> Subrogation, as defined in section 509, differs from its equitable and common law definitions. Outside of bankruptcy, a guarantor does not have a subrogation claim until the principal debt is paid in full. Section 509 provides that a guarantor "is subrogated to the rights of such creditor to the extent" the guarantor has paid the creditor. This definition may permit a guarantor to obtain subrogation rights, even though the creditor's claim has not been paid in full. (The guarantor's claim, however, will be subordinated to the creditor's claim under section 509(c) as long as the principal debt is not paid in full.) This is the view taken in the leading bankruptcy treatise: "A partial discharge of the principal debt by the codebtor is clearly covered by section 509(a)." (3 COLLIER ON BANKRUPTCY § 509.02, at 509-5 (15th ed. 1984).)

32. *See* RESTATEMENT OF SECURITY § 141 (1941); L. SIMPSON, *supra* note 18, at 205-13.

33. *See* RESTATEMENT OF SECURITY § 149 (1941); L. SIMPSON, *supra* note 18, at 238-46; W. HAGENDORN, *supra* note 28, at 106.

34. *See* Baird & Jackson, *supra* note 7, at 829-32; Clark, *The Duties of the Corporate Debtor to Its Creditors*, 90 HARV. L. REV. 505, 509-11 (1977); 1 G. GLENN, FRAUDULENT CONVEYANCES AND PREFERENCES §§ 58-62(b) (1940); Note, *Good Faith and Fraudulent Conveyances*, 97 HARV. L. REV. 495, 495-99 (1983).

by the following example. Assume that, as a result of a series of business reversals, and notwithstanding the fact that D has substantial assets, D's debts greatly exceed his assets. D knows that his creditors have a right to have most of his assets applied to pay the debts they are owed. However, D would rather keep the assets for himself and leave his creditors to suffer a loss. In order to accomplish this, D arranges a transaction with his friend Bill. The purpose of the transaction is to put D's assets beyond the reach of his creditors while still allowing D to use the assets. D and Bill agree that Bill will acquire all of D's assets, which have a fair market value of $200,000, for $1,000. They further secretly agree that even though Bill will be the legal owner of the assets, he will allow D to continue to use and enjoy the assets.[35] The transaction is one of form only. Now when the creditors foreclose on D's assets, they find only $1,000 and thus suffer a great loss, while D suffers a very small loss and continues to enjoy substantial wealth.

Conveyances such as the one to Bill have been recognized as unfair and fraudulent and thus have been prohibited since the statute of 13 Elizabeth in 1571[36] (hereinafter the Statute of Elizabeth). Under the Statute of Elizabeth, however, the aggrieved creditor had to prove actual fraud[37]—that is, intent on the part of the debtor to hinder, delay, or defraud his creditors.[38] Intent, being a subjective characteristic, is very difficult to prove; debtors are rarely as obvious as the one in the preceding example. As a result the courts began to develop per se rules known as "badges of fraud" which allowed the courts to treat a transaction as fraudulent even though there was no specific evidence of intent to defraud, hinder, or delay creditors.[39] Today, the two most important sources of statutory law relating to fraudulent conveyances are the UFCA[40] and the fraudulent transfer section of the Code.[41]

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35. *See, e.g.*, Twyne's Case, 3 Coke 80b, 76 Eng. Rep. 809 (Star Chamber 1601). Obviously such an agreement is fraudulent because it was entered into with actual intent to defraud creditors. *See* 11 U.S.C. § 548(a)(1); UFCA, *supra* note 14, at § 7.

36. 13 Eliz., ch. 5 (1571). For a discussion of the development of the law of fraudulent conveyances, *see generally* G. Glenn, *supra* note 34.

37. 13 Eliz., ch. 5 (1571). The statute was originally a revenue raising device providing for imprisonment and for transfer of one half of the affected property to the Crown. *Id.* The statute applied to conveyances which "are devised and contrived of malice, fraud, covin, collusion, or guile, to the end purpose and *intent, to delay, hinder or defraud creditors* . . . ." *Id.* (emphasis supplied). *See generally* G. Glenn, *supra* note 34.

38. *See supra* note 37.

39. *See* Twyne's Case, *supra* note 35 (listing six "badges of fraud"); Philco Fin. Corp. v. Pearson, 335 F. Supp. 33, 40-41 (N.D. Miss. 1971) (using "badges of fraud"). The concept is reflected in both the UFCA and the UFTA. *See* UFCA, *supra* note 14, at §§ 4, 5, 6, and UFTA, *supra* note 14, at § 4. *See also* Comment, *The Uniform Fraudulent Conveyance Act in Pennsylvania*, 5 U. Pitt. L. Rev. 161, 177 (1939).

40. *See supra* note 14.

41. 11 U.S.C. § 548(a)(2) (1982). The UFCA or the UFTA, as appropriate, may also be available to the trustee in bankruptcy pursuant to the strong-arm provision contained at 11 U.S.C. § 544. Thus, in the context of bankruptcy, one cannot simply consider the Code; state law is also relevant.

The Statute of Elizabeth was the basis for the UFCA, and the two are similar in both purpose and language.[42] Likewise, section 548 of the Code was derived from the UFCA and bears a close resemblance to it.[43]

The drafters of the UFCA intended, *inter alia*, to resolve the "confusions and uncertainties of the existing law" which they blamed in part on "the attempt to make the Statute of Elizabeth cover all conveyances which wrong creditors, even though actual intent to defraud does not exist."[44] The drafters resolved this confusion in large part by providing that any characterization of a transaction as fraudulent would be based either on a finding of actual fraudulent intent or on specific objective factors.[45] This was accomplished by eliminating reliance on the badges of fraud, revising the definition of actual fraud, and introducing specific constructive fraud provisions.[46] The effect of the constructive fraud provisions was to prohibit some transactions regardless of any intent to hinder, defraud, or delay creditors.[47] However, the expansion of the scope of fraudulent conveyance law resulting from the constructive fraud provisions was quite narrow.[48] Constructive fraud could be shown only by proof of certain objective factors concerning the value of the obligation incurred by the debtor, the value of the assets he received, and his solvency,[49] which established that the transfer could not possibly benefit a creditor.[50]

For example, when an insolvent debtor makes a gift,[51] his creditors are forced to suffer a loss which is immediate and results directly from the transfer. This type of transaction will *always* injure creditors; it can never achieve even a neutral, let alone beneficial, result for them. Such transactions do not subject creditors to a *risk* of loss; they subject creditors to an actual loss. It is this limited class of transactions which the UFCA is designed to encompass with its constructive fraud provisions and their fair consideration requirements.[52]

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42. *See Good Faith and Fraudulent Conveyances*, *supra* note 34, at n.2.

43. *See* Walls, *supra* note 5, at 219-20. The UFTA does not use the "fair consideration" terminology; it uses "reasonably equivalent value." For a discussion of the two terms *see infra* note 60.

44. *See* UFCA, 7A U.L.A. 161-62 (commissioner's prefatory note) (1978).

45. *Id. See* Rosenberg, *supra* note 5, at n.33.

46. *See supra* note 45.

47. *See* Baird & Jackson, *supra* note 7, at 829-32.

48. *Id.*

49. 11 U.S.C. § 548(2) (1982); UFCA, *supra* note 14, at §§ 4, 5, 6.

50. *See* Baird & Jackson, *supra* note 7, at 831-32.

51. *See infra* note 56 and accompanying text.

52. *See* Baird & Johnson, *supra* note 7, at 832-36. The authors comment:

> If a case did not concern a transfer in which the possibility of a deliberate effort to hinder, delay or defraud was high, typically it concerned a gratuitous transfer that never could have redounded to the benefit of the creditors and that the creditors would have prohibited given the opportunity. Most of the transactions that creditors sought to set aside were close either to the sham transfers that were at the heart of

To illustrate, consider the preceding example involving D and his friend Bill. Even if D were actually willing to give up ownership of his assets, he might prefer to benefit someone other than his creditors; in fact, he might prefer to benefit anyone other than his creditors. If, for example, he sold all of his assets to a charity for $1000, his creditors would still be harmed. This wouldn't change even if he were perfectly honest about what he was doing.[53]

The prohibition against fraudulent conveyances was never designed to be an omnibus creditor's protection law, protecting creditors from any possible loss.[54] For example, the UFCA was not designed to prevent ordinary preference payments, where the debtor prefers some creditors to others.[55] Fraudulent conveyance law was designed to ensure that, in the case of the debtor's ill financial health, a creditor, as opposed to a friend of the debtor or the debtor himself, would receive the debtor's assets.[56] Fairness *among* creditors is the concern of the bankruptcy laws.[57]

Both the UFCA[58] and the Code[59] prohibit a debtor in poor financial

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> the Statute of 13 Elizabeth or to the gifts to relatives or friends that were addressed by the drafters of the Uniform Fraudulent Conveyance Act.

*Id.* at 832.

> Fraudulent conveyance law is a restraint that the law imposes upon debtors for the benefit of creditors by giving creditors the power to void transactions. The power of creditors to set aside transactions after the fact limits the ability of debtors to engage in the transactions in the first instance. This power is unobjectionable if the transaction—such as a gift by an insolvent debtor—always injures creditors.

*Id.* at 834.

53. *See* Clark, *supra* note 34, at 509-10; Baird & Jackson, *supra* note 7, at 831-32.

54. *See generally* Baird & Jackson, *supra* note 7; *Good Faith and Fraudulent Conveyances*, *supra* note 34; McCoid, *Constructively Fraudulently Conveyances: Transfers for Inadequate Consideration*, 62 Tex. L. Rev. 639 (1983).

55. *See* Baird & Jackson, *supra* note 7, at 848-49; *Good Faith and Fraudulent Conveyances*, *supra* note 34, at n.5 and accompanying text.

56. *See* Baird & Jackson, *supra* note 7, at 848-49; *Good Faith and Avoiding Conveyances*, *supra* note 34, at 502-03; Jackson, *Avoiding Powers in Bankruptcy*, 36 Stan. L. Rev. 725, 777 (1984). *But see Blumberg*, *supra* note 5, at 702-07. The author discusses § 5(b) of the UFTA as designed to deal with insider preferential transfers. *Id.* at 702. The author notes that such transfers can be reached under the UFCA via the good faith component of the fair consideration standard. *Id.* at 705-06; *see also infra* note 60. However, it is difficult to envision a lack of good faith which would not constitute fraud. The wisdom of allowing preference rather than fraudulent payments to be attacked outside of bankruptcy is questionable. Indeed, any action maintained by an individual creditor under the UFTA to defeat a preference would be likely to result in a preference. *See* Baird & Jackson, *supra* note 7, at 848-49 ("Outside a compulsory, collective proceeding, treating simple preferences as fraudulent conveyances would not prevent one creditor from being paid at the expense of the other. It would merely prefer the creditor who was second in time rather than the one who was first") (citations omitted).

57. *See supra* note 56.

58. The operative provisions of the UFCA are §§ 4, 5, 6:

> Sec. 4. Every conveyance made and every obligation incurred by a person who is or will be thereby rendered insolvent is fraudulent as to creditors without regard to his actual intent if the conveyance is made or the obligation is incurred without a fair consideration.

health from transferring property or incurring an obligation unless in return he receives fair consideration or reasonably equivalent value. (In the balance of this article the phrase "fair consideration" will be used to refer to both the fair consideration requirement under the UFCA and the reasonably equivalent value requirement under the Code and UFTA unless a distinction between the two is intended.[60]) The relevance of this prohibition, for

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UFCA § 4, 7A U.L.A. 474 (master ed. 1985).

> Sec. 5. Every conveyance made without fair consideration when the person making it is engaged or is about to engage in a business or transaction for which the property remaining in his hands after the conveyance is an unreasonably small capital, is fraudulent as to creditors and as to other persons who become creditors during the continuance of such business or transaction without regard to his actual intent.

UFCA § 5, 7A U.L.A. 504 (master ed. 1985).

> Sec. 6. Every conveyance made and obligation incurred without fair consideration when the person making the conveyance or entering into the obligation intends or believes that he will incur debts beyond his ability to pay as they mature, is fraudulent as to both present and future creditors.

UFCA § 6, 7A U.L.A. 504 (master ed. 1985).

Similar provision is made in §§ 4(a)(2) and 4(a)(2)(ii) of the UFTA, 7A U.L.A. 653 (master ed. 1985). For a discussion of the differences between these sections and their counterparts in the UFCA see Kirby, McGuinness, & Kandel, *supra* note 7, at nn.11-15 and accompanying text.

59. The relevant provision of the Code is § 548:

> (a) The Trustee may avoid any transfer of any interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition if the debtor—
>
> . . . .
>
> (2)(A) received less than a reasonable equivalent value in exchange for such transfer or obligation: and
>
> (B) (i) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;
>
> (ii) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or
>
> (iii) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured.

11 U.S.C. § 548 (1982).

60. The National Bankruptcy Act, 11 U.S.C. § 1-1255 (1976) (repealed 1978), used the phrase "fair consideration" in § 67d(2) to refer to the requirement that a transferee receive assets equal in value to the obligation incurred or interest transferred. As long as fair consideration was received the transferee's creditors were not harmed by the transfer. *See supra* notes 44-56 and accompanying text. The UFCA generally followed the Act and used the same "fair consideration" terminology. The Bankruptcy Reform Act of 1978 ("Code") dropped the "fair consideration" terminology and replaced it with "reasonably equivalent value" in § 548(a)(2). Part of the motivation for promulgation of the UFTA was to achieve consistency with the Code, and as a result the UFTA also uses the "reasonably equivalent value" terminology.

However, no significant change in the concept or meaning of "fair consideration" seems to have been intended by the new "reasonably equivalent value" terminology. *See, e.g.,* Beemer v. Walter E. Heller & Co. (*In re* Holly Hill Medical Center), 44 Bankr. 253, 255 (Bankr. M.D. Fla. 1984) ("fair consideration" and "reasonably equivalent value" have very similar meanings). Commentators have suggested that the change in terminology was designed to emphasize the Code's abandonment of the good faith component of the Act's fair consideration requirement present purposes, derives from the fact that a guaranty is an obligation (albeit conditional) incurred by the guarantor,[61] and if the guaranty is secured, then it involves a transfer of an interest in property.[62] If the transaction is considered fraudulent, the creditors of the guarantor can have the conveyance set aside or the obligation annulled, or they can levy upon the property conveyed.[63]

Under both the Code and the UFCA, two requirements must be met in order to constructively characterize a guaranty as a fraudulent conveyance. One of the requirements concerns the financial health of the guarantor; it must have been insolvent[64] at the time it entered into the guaranty and security agreement, or it must have been rendered insolvent thereby,[65] or it must have been left undercapitalized,[66] or it must intend to incur debts which are beyond its ability to pay when due.[67] The other requirement is that the guaranty or security agreement must have been entered into in exchange for less than a fair consideration.[68] The tests used to determine financial health or lack of it under the Code and the UFCA are difficult to ascertain and apply.[69] Thus, even if an analysis of the financial health of the

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(the Act provided that fair consideration must be transferred in good faith).

*See* Comment, *supra* note 6, at n.43; Blumberg, *supra* note 5, at 704-07. The "fair consideration" terminology will be used for both the UFCA's fair consideration requirement and the Code's and UFTA's reasonably equivalent value requirement.

61. *See* Rubin v. Manufacturers Hanover Trust, 661 F.2d 979 (2d Cir. 1981); Zellerbach Paper Co. v. Valley Nat'l Bank, 13 Ariz. App. 431, 477 P.2d 550 (1970). *See also* Rosenberg, *supra* note 5, at 241.

62. Rubin v. Manufacturers Hanover Trust, 661 F.2d 979 (2d Cir. 1981); Zellerbach Paper Co. v. Valley Nat'l Bank, 13 Ariz. App. 431, 477 P.2d 550 (1970). *See also* Rosenberg, *supra* note 5, at 241; Coquillette, *Guaranty of and Security for the Debt of a Parent Corporation by a Subsidiary Corporation*, 30 Case W. Res. L. Rev. 433, 450 (1980).

63. UFCA, *supra* note 14, at § 9; 11 U.S.C. § 548(a) (1982).

64. UFCA, *supra* note 14, at § 4; 11 U.S.C. § 548 (a)(2)(B)(i) (1982).

65. UFCA, *supra* note 14, at § 4; 11 U.S.C. § 548(a)(B)(i) (1982).

66. UFCA, *supra* note 14, at § 5; 11 U.S.C. § 548(a)(B)(ii) (1982).

67. UFCA, *supra* note 14, at § 5; 11 U.S.C. § 548(a)(B)(iii) (1982).

68. UFCA, *supra* note 14, at § 3; 11 U.S.C. § 548(a)(2)(A) (1982). The UFCA fair consideration requirement is not the same as the contract law consideration requirement. Under the common law of contracts consideration, among other things, is required for a contract to be enforceable. *See* J. Calamari & J. Perillo, The law of Contracts § 4-1 at 132-35 (2d ed. 1977).

In a typical guaranty contract the requirements for consideration are easily complied with as long as the guaranty is entered into prior to or simultaneously with the creation of the underlying obligation. Note that common law consideration is different from the statutory concept of fair consideration and that common law consideration is only needed when the guaranty is accomplished by use of an informal contract. If a formal contract is used (*e.g.*, where a guarantor co-signs or endorses a negotiable instrument), or if no contract is involved, common law consideration is not necessary but the UFCA requirement of fair consideration is still relevant. *See generally* Nation, *Guaranty Agreements: At Risk Due to Conflicting Laws*, I Selected Papers Am. Bus. Law Assoc. Nat. Proc. 513-25 (1987).

69. For example, under the Code insolvency exists when "the sum of such entities' debts

guarantor is made in connection with the creation of the guaranty, not much confidence can be placed in it. Therefore, the primary focus of potential creditors who are considering lending against up- or cross-stream guaranties and related security interests is on the fair consideration requirement. If the consideration given in exchange for the guaranty is not fair as defined in the statutes, then the enforceability of the guaranty is uncertain and its usefulness as a risk reducing tool is greatly diluted. But as long as the consideration given to the guarantor is fair, the transaction cannot be characterized as a fraudulent conveyance absent proof of actual fraudulent intent. The rest of this article analyzes the definition and application of the fair consideration test.

## II. The Fair Consideration Requirement in the Context of an Upstream Guaranty

Under the UFCA the definition of fair consideration varies depending on whether the property is transferred or an obligation is assumed to secure a present advance or as a result of an outright sale.[70] With respect to a non-security transfer of property or assumption of an obligation, fair consideration is defined as a transfer in good faith[71] to the transferor (the guarantor)

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is greater than all of such entities' property at a fair valuation . . . ." 11 U.S.C. § 101(26) (Supp. V 1982). Under the UFCA insolvency exists when "the present fair salable value of his assets is less than the amount that will be required to pay his probable liability . . . ." UFCA, *supra* note 14, at § 3. These fair valuation and present fair salable value tests are types of fair market value tests, and thus a balance sheet prepared in accordance with generally accepted accounting principles, which require the use of historical cost, is useless for determining insolvency. Moreover, it appears that the UFCA test for insolvency is inconsistent with the Code test. For example, the Code's fair valuation implies that assets which are of value to a specific entity but not salable could be assigned a value for purposes of determining insolvency, while the UFCA's "present fair salable value" seems to proscribe assigning such assets any value. Moreover, it could be argued that "present fair salable value" implies liquidation value while "fair valuation" contemplates going concern value.

The liability side of the equation also is unclear. For example, the Code contains the following definition of debt: "liability on a claim." *See* 11 U.S.C. § 101(11) (1982). Claim is defined as "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured . . . ." *See* 11 U.S.C. § 10(4)(A)(1982). Thus, even though the guarantor's liability on the guaranty is conditional, one could argue that the full extent of possible liability must be taken into account to determine insolvency. The same question must be asked with respect to many other possible liabilities (*e.g.*, threatened litigation). Another approach, however, would be to discount all contingent or unmatured liabilities by an appropriate amount. For a discussion of the difficulties involved in determining insolvency, see Rosenberg, *supra* note 7, at 252-57; Coquillette, *supra* note 61, at 440-60; Alces, *supra* note 5, at 676-82; Note, *Guaranties and Section 548(a)(2) of the Bankruptcy Code*, *supra* note 5, at 212-13; Walls, *supra* note 5, at 240; Carl, *supra* note 5, at 125-34.

70. UFCA, *supra* note 14, at § 3(a)(b).

71. UFCA, *supra* note 14, at § 3(a). Under the UFCA, good faith is a required element of fair consideration. Technically, according to the statutory language, a transfer by an insolvent,

of a "fair equivalent" for the property conveyed or obligation assumed.[72] With respect to a transfer of property or an assumption of an obligation for security, fair consideration is defined as a transfer in good faith to the guarantor of an amount not "disproportionately small" as compared with the value of the property transferred or obligation assumed.[73] Under the Code the concept of fair consideration is addressed by the reasonably equivalent value requirement, thus the Code requires that the guarantor receive something which is not "less than a reasonably equivalent value" of the property transferred or obligation assumed.[74]

The application of the fair consideration requirement to an upstream guaranty can be illustrated by the following example. Assume Corporation A owns one hundred percent of the stock of Corporation B. In addition, A seeks to borrow one million dollars for working capital. Bank C, though it will not lend to A based solely on A's own credit rating, has determined that the creditworthiness of the business as a whole—that is, the assets and financial standing of A and B combined—is sufficient to support the credit. Thus the loan is made to A, and B provides a guaranty. In addition, B gives security for its guaranty by granting C a security interest in all of its assets.

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even in exchange for a fair equivalent, could be fraudulent if it was made in bad faith. *See Good Faith and Fraudulent Conveyances, supra* note 34, at 505.

The good faith requirement seems anomalous given the fact that a major reason for the creation of the UFCA was to move away from the subjective requirement of fraudulent intent. *Id.* at 498-99. If read literally this requirement introduces a subjective test into the otherwise objective requirements of the constructive fraud provision. *Id. See also* Rosenberg, *supra* note 5, at 248-52.

The application of the good faith requirement does not vary with respect to whether a down-, up-, or cross-stream guaranty is involved. For this reason it is not discussed extensively here. The good faith test probably poses little threat to lenders entering into new lending relationships. Courts are most likely to find a lack of good faith in cases involving insiders and preference payments. *See generally Good Faith and Fraudulent Conveyances, supra* note 34. However, even in this context, a finding of lack of good faith should require a finding that the consideration received by the guarantor is beyond the reach of its creditors and that the party who received the guaranty sought it for reasons other than his desire for repayment of his claim. *Id.* at 508-10. It may cause more concern in a default or workout situation. *See* Rosenberg, *supra* note 5, at 250-51.

However, the fact that it poses any threat at all adds to the unnecessary fear surrounding intercorporate guaranties. I submit that, in the context of intercorporate guaranties, the UFCA would better serve its purpose if the good faith element of fair consideration were simply ignored. Some courts have taken this approach; *see Good Faith and Fraudulent Conveyances, supra* note 34, at 504 n.54.

Note that neither the Bankruptcy Code nor the UFTA requires good faith in order to establish their reasonably equivalent value counterpart to fair consideration. *See* 11 U.S.C. § 548(a)(2)(A) (Supp. III 1985); UFTA §§ 4(a)(2), 5(a), 7A U.L.A. 653, 657 (master ed. 1985); *Good Faith and Fraudulent Conveyances, supra* note 34, at 503 n.49; *see also supra* note 60.

72. UFCA, *supra* note 14, at § 3(a).

73. UFCA, *supra* note 14, at § 3(b).

74. 11 U.S.C. § 548(a)(2)(A) (1982).

Under the conventional analysis[75] B's guaranty lacks fair consideration because the loan proceeds do not go to B and B cannot control A.[76] Thus, the reasoning goes, B has not received fair consideration in exchange for its guaranty and security interest.[77] However, if the transaction is rearranged so that it results in a downstream guaranty—by, for example, having C lend to B while A provides a guaranty—then under the conventional analysis there would be fair consideration.[78] A necessarily benefits from the loan because A controls B and thereby controls the loan proceeds. The loan proceeds provide the fair consideration.

With respect to upstream guaranties the conventional analysis is incorrect. In the upstream situation the subsidiary has received fair consideration. The assets received by the subsidiary are the rights of exoneration, reimbursement, subrogation, and contribution.[79] As a result, the subsidiary has become a creditor of the parent with an interest in the loan proceeds via its rights of exoneration and reimbursement, and will often be a secured creditor via its right of subrogation.[80] The value of these assets, in most circumstances,[81] is equal to the value of the guaranty and security interest and

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75. *See supra* notes 5, 6.

76. *See* Rosenberg, *supra* note 5, at 238-39; Alces, *supra* note 5, at 676-80; Coquillette, *supra* note 61, at 452-54; Carl, *supra* note 5, at 124-25; *Guarantees and Section 548(a)(2) of the Bankruptcy Code, supra* note 5, at 216; Comment, *supra* note 6, at 110.

77. Many courts require that the guarantor receive direct economic benefit, usually measured in terms of balance sheet assets, for a finding of fair consideration. *See* Rosenberg, *supra* note 5, at 243-48 (citing cases).

However, some courts have begun to recognize that indirect business benefits—benefits which are not necessarily measurable nor salable—may provide fair consideration. *See* Telefest, Inc. v. VU-TV, Inc., 591 F. Supp. 1368 (D.N.J. 1984). The court in upholding both up-and downstream guaranties stated, "the lack of perceptible direct benefit to a subsidiary guaranteeing the loan of its parent should not be viewed as tantamount to a lack of 'fair consideration' . . . ." *Id.* at 1379. For a discussion of indirect benefits in upstream guaranties, see Walls, *supra* note 5, at 220-23, 228-35; Blumberg, *supra* note 5, at 724; Comment, *supra* note 6, at 1106; *see also* Kirby, McGuinness & Kandel, *supra* note 7, at 32-40 (discussing indirect benefits in the LBO context).

78. *See, e.g., In re* Royal Crown Bottlers, 23 Bankr. 28, 30 (Bankr. N.D. Ala. 1982) ("the passing to a subsidiary of the consideration for a transfer by a debtor-parent may be presumed to be substantial, because the subsidiary corporation is an asset of the parent corporation, and what benefits the asset will ordinarily accrue to the benefit of its owner"); *In re* W.T. Grant Co., 699 F.2d 599 (2d Cir. 1983) (benefits received by a subsidiary of the parent-debtor are attributable to the parent for purposes of determining whether fair consideration was received for a guaranty). *See also* Rosenberg, *supra* note 5, at 238; Alces, *supra* note 5, at 677-78; Carl, *supra* note 5, at 115; Walls, *supra* note 5, at 224-28. *See generally Guarantees and Section 548(a)(2) of the Bankruptcy Code*, supra note 5.

79. *See supra* notes 27-33 and accompanying text.

80. *See supra* notes 27-33 and accompanying text.

81. The only situation, other than actual fraud, in which fair consideration would consistently be found lacking is where the loan is overpriced. A loan is overpriced when the same amount of money could be borrowed from other lenders on the same terms at a lower rate of interest. In such a situation, which will occur rarely with respect to the creation of a new lend-

thus the fair consideration requirement is satisfied.[82]

Most courts and commentators, however, have been unwilling to assign a value to the rights of exoneration, reimbursement, subrogation, and contribution.[83] The following quotation, from a commentator[84] in this area, illustrates the conventional analysis:

> The notion that the guaranty of a solvent obligor is offset by a contingent asset based on the right of subrogation is simply not realistic; when and if the guarantor is called upon to perform, the value of that contingent asset in all likelihood would be discounted severely because it probably would be no longer collectible. Otherwise, the guarantor would not have been called upon to perform. Thus, on the critical date for the determination of solvency—the date on which the guaranty is given—it is nearly impossible to justify a more than token value for the contingent asset.[85]

This analysis is incorrect. The critical problem is one of timing.[86] While the author quoted above correctly states that "the critical date [is] the date on which the guaranty is given," he proceeds to determine the value of the equitable rights on the hypothetical date of enforcement of the guaranty rather than on the critical date. The value of these rights should be determined at the time the guaranty is created.[87] The fact that the value of the

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ing relationship, but which may be more likely in a default situation or workout context, neither the guaranty nor the *borrower's* promise to repay would satisfy the fair consideration test. In this context the guarantor's right of reimbursement is not necessarily equal to its obligation because the loan proceeds which are available to the principal to fund its obligation of reimbursement are by definition not equal to the loan obligation. In this case, however, a downstream guaranty would also fail the fair consideration test.

82. *See infra* note 89 and accompanying text.

83. *See supra* notes 5 and 6 and accompanying text. *But see* cases and commentators discussed *infra* at notes 94 and 96 and notes 97-116 and accompanying text.

84. *See* Rosenberg, *supra* note 5.

85. *Id.* at 256.

86. Alces, *supra* note 5, criticizes this analysis, noting: "In the case of guaranties of payment, however, the form of guaranty typically required by creditors, the commentator's analysis breaks down . . . ." *Id.* at 680. *Cf.* the introductory pages of this article, discussing the usefulness of a guaranty agreement in light of the Code's automatic stay.

87. *See* Baird & Jackson, *supra* note 7, at 842: Comment, *supra* note 6, at n.50; COHEN, BANKRUPTCY, SECURED TRANSACTIONS AND OTHER DEBTOR-CREDITOR MATTERS 121 (1981). The following cases with comments are cited by Professor Cohen at n.55:

> *See*, e.g. *Wagoner v. Wallace Turnball Corp. & Lumber Terminals*, 306 Pa. 442, 160 A. 105 (1932) (although stock given in exchange for bankrupt's property lost value after the transaction, the transfer was not fraudulent because value at the time of transfer is the proper measure); *Halsey v. Winant*, 258 N.Y. 512, 180 N.E. 253 (N.Y. App. 1932) (decline of value of the consideration after the transfer has occurred does not affect determination of fair consideration); *Langan v. First Trust & Deposit Co.*, 101 N.Y.S.2d 36, 277 App. Div. 1090 (1950); *aff'd*, 100 N.E.2d 189 (N.Y. App. 1951) (evidence of subsequent change in value of real property purchased by transferee from debtor was excluded from evidence in suit by trustee against the creditor).

*See also* COLLIER ON BANKRUPTCY § 67.33 n.21 (15th ed. 1975); *Guaranties and Section* assets received decreases after this date, even if this results in a loss to creditors, does not warrant a presumption that the guaranty transaction pursuant to which they were acquired was fraudulent.[88]

If the fair consideration test is applied at the correct time, up- or cross-stream guaranties are no more likely to fail it than downstream guaranties. The maximum value of the obligation incurred and the security interest

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*548(a)(2) of the Bankruptcy Code*, *supra* note 5, at 212 n.54.

A slight modification of the analysis of fair consideration is required when, as is common, the guaranty or security interest secures not only amounts loaned when the guaranty and security interest were created but also amounts which may be loaned in the future (future advances). Article 9 of the Uniform Commercial Code specifically recognizes that a security interest may secure future advances. In the commercial loan context it is very common for the guaranty to secure future advances.

The Second Circuit's opinion in Rubin v. Manufacturers Hanover Trust Co., 661 F.2d 979 (2d Cir. 1981), is support for the proposition that the fair consideration issue should be reanalyzed every time an advance is made. Commentators have criticized this approach, arguing that, at least in the case of non-discretionary future advances, the fair consideration analysis should only be done when the guaranty or security interest is created. *See generally* Schwarz, *The Impact of Fraudulent Conveyance Law on Future Advances Supported by Upstream Guaranties and Security Interests*, 9 CARDOZO L. REV. 729. The UFTA also rejects *Rubin*, providing at § 6 that "an obligation is incurred when the writing executed by the obligor is delivered to or for the benefit of the obligee." *See* UFTA § 6(5), 7A U.L.A. 659 (1985).

However, in the context of a commercial loan, it seems doubtful whether any future advances contemplated as part of the transaction are truly discretionary. Schwarz, *supra* at 740, argues that the relevant standard is whether the lender has "sole and unfettered discretion" in determining whether to make the requested future advances. But, in light of both statutory and common law obligations of good faith, it is doubtful whether any future advances are discretionary under Schwartz's definition. UCC 1-203 ("every contract within this Act imposes an obligation of good faith in its performance or enforcement"); K.M.C. Co. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985) (the court held that the lender's right to refuse to advance funds under a discretionary advance provision was limited by an implied obligation of good faith); *cf.* Spencer Companies, Inc. v. Chase Manhattan Bank, 81 B.R. 194 (6 UCC Rep. Serv. 2d 330 (Callaghan)) (D. Mass. 1987) (exercise of lender's rights under demand feature provision of promissory note requires actual demand but is not limited by good faith); *contra In re* Martin Specialty Vehicles v. Bank of Boston, U.S. Bankr. Ct., June 16, 1988, Nos. 86-40095, 86-4012 (6 UCC Rep. Serv. 2d (Callaghan)) (D. Mass. 1988) (exercise of lender's rights under demand feature provision of promissory note is limited by obligation of good faith). Thus, usually the fair consideration analysis should be made only once, when the guaranty and security interests are created.

88. If the value of the assets were determined at any time after the date of the transaction pursuant to which they were received, then a cloud of doubt would be cast over virtually every transaction involving a promise to pay in the future. For example, assume that Corporation X purchases real estate in an area which is widely believed to be destined for development as an industrial park. In order to finance the transaction, the seller agrees to allow X to pay the purchase price over time. The seller, however, secures this obligation by taking a mortgage on the property sold. Further assume that the expected development never occurs and the value of the property decreases significantly. X must still pay the seller. If the current value of the land is compared to the obligation to pay the purchase price, fair consideration would not be present. Thus, if the fair consideration test is applied at any time other than the time of the transaction, then transactions like this, which are clearly not fraudulent, could be characterized as fraudulent conveyances. *See* Baird & Jackson, *supra* note 7, at 842.

given by the guarantor at the time the guaranty is created is equal to the amount of the loan proceeds, as this is the amount which the guarantor can be called upon to pay at that time. And the value of the right of reimbursement, at that time, is equal to the amount of the loan proceeds because the loan proceeds are available to the principal debtor to fund its obligation of reimbursement.[89]

Even if the guaranty is enforced and the principal debtor is unable to honor its obligation of reimbursement at that time (as the commentator predicts),[90] this merely establishes that something has occurred after the creation of the guaranty which has resulted in the principal debtor's loss of the loan proceeds. That something may have been a fraudulent conveyance, and if it was then the principal debtor's creditors, including the guarantor (the subsidiary), would have the right to have that subsequent transfer set aside or the obligation annulled, or to levy on the property transferred (the loan proceeds).[91] But the fact that a transfer subsequent to the creation of the guaranty was fraudulent does not make the creation of the guaranty fraudulent.[92] If the subsequent transfer is a fraudulent conveyance, the beneficiary of it, and therefore the one who ought to suffer as a result of it, is the subsequent transferee, not the entity which received the guaranty.[93]

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89. *See In re* Bowers, 215 F. 617, 618 (N.D. Ga. 1914), in which the court in a discussion of the guarantor's solvency states:

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

At the time the loan is funded, the principal is abundantly able to pay. *See also In re* Ollag Constr. Equip. Corp., 578 F.2d 904 (2d Cir. 1978), discussed *infra* at note 94.

90. *See supra* note 85 and accompanying text.

91. *See* Restatement of Security § 113 (1941) ("Where the principal makes a fraudulent conveyance and the surety if the principal's obligation were due, would have a right of exoneration against the principal the surety can have the fraudulent conveyance set aside").

92. *See supra* notes 87-88 and accompanying text.

93. *See* Jones v. National City Bank (*In re* Greenbrook Carpet Co.), 722 F.2d 659 (11th Cir. 1984). In *Jones* the bankruptcy trustee challenged, under § 548(a)(2) of the Code, a security interest given by the target debtor to a lender as part of a leveraged buyout. The lender received the security interest in exchange for a $350,000 loan made to the target debtor. The target debtor lent the loan proceeds to the acquiring entity (two individuals) in exchange for a nonrecourse note secured by a pledge of the target's stock. The acquiring entity then used the loan proceeds to purchase the target's stock. The court refused to disrupt the lender's security interest but stated: "if the transaction between [the target debtor] and [the acquiring entity] [*i.e.*, the loan of $350,000 for nonrecourse notes] constituted a fraudulent transfer the trustee can sue the [acquiring entity]." *But see* United States v. Gleneagles Inv. Corp., 565 F. Supp. 556 (M.D. Pa. 1983).

*See also* Baird & Jackson, supra note 7, at 853. Discussing this issue in the LBO context, the authors note: "To the extent that the general creditors are made worse off by facing a riskier secured loan, the beneficiaries must be the shareholders." *Id.* For example, assume that Tom is the sole shareholder of C Corporation. Tom approaches B Bank about a loan. Before it

Some courts and commentators, however, have recognized that the rights of exoneration, reimbursement, subrogation, and contribution should be assigned a value for purposes of determining the solvency of the guarantor.[94] Almost without exception, though, courts and commentators have

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will extend the requested credit the bank, in addition to Tom's promise to repay the loan and grant of security, requires the guaranty of C Corporation and a security interest in all of C Corporation's assets. The loan is funded on the bank's terms. Tom's use of the loan proceeds proves unprofitable and he is now considering bankruptcy. In order to provide for his post-bankruptcy comfort, Tom enters into the following transaction. Tom, using all of his remaining cash, purchases assets from Bill, a friend, at a price greatly in excess of the value of the assets. There is, of course, an agreement between Tom and Bill that Bill will use most of the funds received for the assets for Tom's benefit. Subsequently, Tom declares bankruptcy and the bank enforces its guaranty and forecloses on its collateral.

Notwithstanding the loss suffered by the creditors of C Corporation, the creation of the guaranty and the attendant grant of a security interest was not fraudulent. The loan proceeds and C Corporation's interest in them (via its rights of exoneration, reimbursement, and subrogation) provided fair consideration. But a fraudulent transfer has occurred: the transfer from Tom to Bill. Tom did not receive fair consideration, and assuming his poor financial health, C Corporation as Tom's creditor can have the transfer set aside or levy upon the assets transferred, pursuant to its right of reimbursement. However, the subsequent transaction between Tom and Bill should not affect the enforceability of the guaranty agreement between the bank and C Corporation. The result should be the same even if the subsequent transaction is not fraudulent but the unsecured creditors still suffer a loss.

For example, assume the following transaction which included a typical upstream guaranty. A Corporation owns all of the stock of B Corporation. A would like to borrow a large amount of money to purchase land in an area which it believes will soon be developed for a shopping mall. A approaches C Bank, which is unwilling to lend to A alone. However, C will make the loan if it receives a security interest in all of A's assets, and in addition B guaranties the loan and secures its guaranty. The loan is made and B guaranties it and grants C a security interest in all of its assets to secure the guaranty. At this moment in time B has incurred an obligation and transferred a security interest in its assets. In exchange it has received an interest in the loan proceeds as a result of its equitable rights of exoneration, reimbursement, and subrogation. The next relevant transaction is A's purchase of the real property with the loan proceeds. It will come as no surprise, in the context of this hypothetical, that the expected development never occurs and the value of the land plummets. The result is that the land is worth far less than the amount A is obligated to pay for it, and as a result A becomes insolvent. B is then called upon to pay pursuant to its guaranty and cannot honor its obligation. As a result, C forecloses on its collateral and B declares bankruptcy. C, as a properly perfected secured party, receives the value of its collateral before any of it is paid to B's unsecured creditors, and as a result the unsecured creditors suffer a loss.

Notwithstanding the loss suffered by B's unsecured creditors, they should not be able to attack the guaranty as a fraudulent conveyance. At the time the guaranty was given on the critical date, their interest in the loan proceeds provided fair consideration. Likewise the subsequent purchase of land by A was not a fraudulent conveyance. On the critical date, the date of transfer, the conveyance of the land to A provided fair consideration. *See* Baird & Jackson, *supra* note 7, at 842.

94. *See In re* Ollag Constr. Equip. Co., 578 F.2d 904 (2d Cir. 1978). The case involved an upstream guaranty; on the issue of solvency the court stated that:

> [The debtor's] only liabilities of any significance were its contingent obligations as guarantor of [parent's] note . . . . But these liabilities were tied to certain intangible assets. For example, although the face amount of Ollag's guaranty on [parent's] note

inexplicably failed to assign value to such rights in determining whether the guarantor received fair consideration.[95] Certainly if these rights are assigned a value for insolvency purposes, logic suggests that they should be assigned a value in the fair consideration context. One commentator[96] referred in a footnote to the obvious conclusion that "to the extent . . . the [guarantor] received valuable rights of subrogation or contribution as part of the guarantee transaction, it necessarily would seem to follow that such benefits would have to be considered in a determination of whether the debtor received 'reasonably equivalent value' in the transaction."[97] However, the commentator did not explore this point further. Another commentator has argued that when the obligor is solvent, "the right of subrogation fully offsets the liability under the guarantee and should constitute reasonably equivalent value."[98] This commentator, however, does not discuss the point further. A student commentator argues that under certain circumstances equitable rights should be considered in the fair consideration analysis.[99]

A few courts have advanced the argument that the value of equitable rights can provide fair consideration.[100] A case which provides direct support

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> was $200,000, Ollag had a right of subrogation to recover against [parent] on the Bank's claims. Moreover, Ollag could command contribution from the co-guarantors . . . . Learned Hand's landmark opinion in *Syracuse Eng'g Co. v. Haight*, 97 F.2d 573 (2d Cir. 1938), taught us that contingent subrogation and contribution rights must be valued as assets in determining solvency. *See also Updike v. Oakland Motor Car Co.*, 53 F.2d 369, 371 (2d Cir. 1931); *Wingert v. President Director & Company of Hagerstown Bank*, 41 F.2d 660 (4th Cir.), *cert. denied*, 282 U.S. 871 (1930).

*Id.* at 908. *See also* Telefest, Inc. v. VU-TV, Inc., 591 F. Supp. 1368, 1375 n.5 (D.N.J. 1984) (citing *Ollag*, the court noted: "contemporary thinking allows that the contingent right of subrogation and contribution are valuable assets which frequently offset the liability incurred"); *In re* Hemphill, 18 Bankr. 38, 47 (Bankr. S.D. Iowa 1982) ("If the guarantee obligation is to be included among the debtor's liabilities for purposes of determining his insolvency then the subrogation and contribution rights against other collateral must also be taken into account"); *In re* Bowers, 215 F. 617 (N.D. Ga. 1914). For a discussion of court's use of equitable rights for determining solvency, see Walls, *supra* note 5, at 240-42; Alces, *supra* note 5, at 679-80; Blumberg, *supra* note 5, at 699.

The UFTA has adopted the view that equitable rights should be considered for purposes of solvency. The Official Comment to § 1(2) (defining assets of the debtor) states: "a contingent claim of a surety for reimbursement, contribution or subrogation may be counted as an asset." UFTA § 1 comment 2, 7A U.L.A. 645 (1985). For a discussion of the use of equitable rights to determine solvency under the UFTA, see Blumberg, *supra* note 5, at 697-700.

95. *See supra* notes 5, 6, 94; Rosenberg, *supra* note 5, at 256-57; Coquillette, *supra* note 51, at 124-25; Comment, *supra* note 6, at 1112-13 ("Courts have generally not considered the value of the guarantor's equitable rights in determining whether the guarantor has received reasonably equivalent value . . .").

96. Walls, *supra* note 5.

97. *Id.* at n.73, citing *Alexander Dispos-Haul*, *infra* note 101, and *Emerald Hills*, *infra* note 100.

98. *See* Blumberg, *supra* note 5, at 724.

99. *See* Comment, *supra* note 6, at 1113.

100. In addition to *Alexander*, discussed *infra*, *In re* Emerald Hills Country Club, Inc., 32

for the proposition that the value of the equitable rights of exoneration, reimbursement, subrogation, and contribution can provide fair consideration is *Alexander Dispos-Haul.*[101] In *Alexander* the sole shareholder of the guarantor corporation purchased the assets of a refuse business.[102] The guarantor guarantied its sole shareholder's obligation to pay the purchase price of the assets.[103] In return the guarantor received business benefits consisting of a customer list and lease of equipment[104] and equitable rights.[105] Eight months after the transaction, the guarantor petitioned for bankruptcy.[106] The trustee sought to avoid the guaranty and security interest by characterizing them as fraudulent conveyances under section 548.[107] The court found that the guarantor was either insolvent at the time of the transaction or rendered insolvent thereby; but it also found that the guarantor had received reasonably equivalent value for the guaranty.[108] According to the court, reasonably equivalent value could have been received from any one of three sources: the entire consideration given to the sole shareholder (the assets purchased) under a theory of identity of interest between the guarantor and the sole shareholder,[109] the business benefits received by the guarantor,[110] or the equitable rights of exoneration and reimbursement received by

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Bankr. 408 (Bankr. S.D. Fla. 1983), and *In re* Nelson, 24 Bankr. 701, 702 (Bankr. D. Or. 1982), support the proposition that equitable rights can provide fair consideration. *Emerald Hills* involved a security interest granted by the debtor to secure the obligation of an unrelated entity. Three months after the transfer, the debtor petitioned for bankruptcy. The debtor in possession attempted to have the security interest set aside as a fraudulent conveyance. The court in its analysis of the fraudulent conveyance issue found that the debtor was neither insolvent at the time of the transfer nor rendered insolvent thereby. Moreover, the court found that the debtor had received reasonably equivalent value in the form of business benefits (free advertising in the *Wall Street Journal* and other local papers) and the debtor's rights of subrogation and reimbursement. *In re* Emerald Hills Country Club, Inc., 32 Banker at 412-14. The court implied that that the equitable rights had value because the principal debtor had a net worth of $4.4 million at the time the guaranty was created, *just three months before* the debtor filed for bankruptcy. *Id.* at 416, 420, 421 (emphasis added). In *Nelson* the court considered the value of the guarantor's equitable rights in determining whether the guarantor had received a reasonably equivalent value.

Other cases have recognized that an executory promise may provide fair consideration. *See* Freitag v. The Strand, 205 F.2d 778, 782-84 (3d Cir. 1953); Schlecht v. Schlecht, 168 Minn. 168, 171-72, 209 N.W. 883, 886-87 (1926); Hollander v. Gautier, 114 N.J. Eq. 485, 487, 168 A. 860, 861 (1933).

101. *In re* Alexander Dispos-Haul, 36 Bankr. 612 (Bankr. D. Or. 1983).
102. *Id.* at 613-14.
103. *Id.* at 614.
104. *Id.* at 614, 616.
105. *Id.* at 615.
106. *Id.*
107. *Id.*
108. *Id.*
109. *Id.* at 617.
110. *Id.* at 616.

the guarantor.[111] The court noted that the value of equitable rights must be determined on the date the guaranty is created:[112]

> The value of [the guarantor's] potential rights of exoneration and indemnity [reimbursement] depend upon the financial ability of [the principal debtor] on December 23, 1981 when the [guarantor] acquired the rights. The trustee had the burden under 11 U.S.C. Sec. 548 (a)(2)(A) of showing that the [principal] could not pay [its] potential obligations to the debtor as surety or [was] insolvent. The trustee failed in this burden. The financial statements which were prepared by the [principals] in connection with the . . . sale and personal loan applications established sufficient net worth at the time of the sale to finance any then reasonably foreseeable deficiency resulting from the sale . . . . There is no evidence that anyone *planned*[113] to become insolvent later.[114]

*Alexander* did not involve an intercorporate guaranty and the equitable rights were not the only basis for the court's decision. Still, the case clearly stands for the proposition that in the case of an upstream guaranty the rights of exoneration, reimbursement, subrogation, or contribution *alone* will provide fair consideration, if at the time the guaranty is created the parent can honor these obligations.[115]

However, the commentators who have analyzed this decision provide little support for the proposition that equitable rights alone should constitute fair consideration in the fraudulent conveyance context.[116] One commentator argues that transfers solely for the benefit of third parties do not provide fair consideration, and further notes that a guarantor which grants a security interest and receives only equitable rights and no business benefits in return clearly has made a transfer solely for the benefit of a third party.[117] This commentator concluded:

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111. *Id.* With respect to the guarantor's right of subrogation, the court states: "the right of subrogation probably had no value because of the [guarantor's] insolvency and inability to ever acquire a right of subrogation by paying off plaintiffs in full." *Id. But see supra* note 31.

112. *In re* Alexander Dispos-Haul, 36 Bankr. at 616.

113. *Cf. supra* notes 44-57 and accompanying text.

114. *In re* Alexander Dispos-Haul, 36 Bankr. at 616 (emphasis and footnote added).

115. *See supra* notes 101-14 and accompanying text.

116. Carl, *supra* note 5, at 124-25; Comment, *supra* note 6, at 1113 ("On the other hand when the nonequitable benefits conferred on the guarantor do not constitute reasonably equivalent value, and when the borrower was not insolvent or the lender at least partially secured by collateral in the borrower's assets, the value of those equitable rights should be considered."); *see also* text accompanying note 6.

117. Carl, *supra* note 5, at 124-25. In most intercorporate guarantees, business benefits will be present because the corporate group while composed of legally distinct entities is, from an economic and financial perspective, only one entity—what benefits one part of it will benefit the others. However, proving the existence and value of business benefits is not an easy task, and requiring such proof in every intercorporate guaranty would infect all such guaranties with uncertainty which would greatly reduce their usefulness. In certain situations, in which up- or downstream intercorporate guaranties are used, equitable rights alone may not provide fair

> This reasoning is in accord with theoretical considerations. At the time a guaranty is made, the expected value of the guarantor's equitable rights should never exceed the expected amount of the guarantor's liability because the guarantor cannot recover more than the amount of the principal debt it paid plus interest and costs . . . . For the guarantor, there is only downside risk; there is no upside gain.[118]

This analysis is incorrect with respect to both the letter and the spirit of fraudulent conveyance law. None of the statutory definitions of fair consideration requires that the guarantor receive assets of greater value than those transferred.[119] This is consistent with the fact that fraudulent conveyance law is for the protection of creditors who, unlike shareholders, have no right to participate in profits. A subsidiary which guaranties a loan to its parent is in essentially the same position as if it had lent funds to its parent.[120] It is well established that corporations have the right to make loans.[121] The creditors of the guarantor are exposed to the same risk in the case of an upstream guaranty as they are in the case of a loan to a parent. While creditors may prohibit such transactions by agreement with the debtor;[122] fraudulent conveyance law should not prohibit them.[123]

In a downstream guaranty the loan proceeds provide fair consideration.[124] In up- or cross-stream guaranties, as a result of the guarantor's rights of exoneration, reimbursement, subrogation, and contribution, the loan proceeds also provide fair consideration.[125]

## III. The Effect of an Upstream Guaranty on the Unsecured Creditors of the Guarantor

It would not further the purpose of the prohibition against fraudulent conveyances to treat intercorporate up- or cross-stream guaranties differently from downstream guaranties. Fraudulent conveyance law is designed to protect creditors from the risk of loss associated with a violation of what

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consideration (*e.g.*, where the parent is insolvent at the time the guaranty is created). In these situations business benefit is an important albeit difficult alternative. For a discussion of business benefits see *supra* note 77.

118. Carl, *supra* note 5, at 124-25.

119. *See supra* notes 70-74 and accompanying text.

120. *See* Coquillette, *supra* note 5, at 443.

121. *See* Model Business Corp. Act §§ 3 and 4(i)(g).

122. *See infra* notes 134-43 and accompanying text. *See also* Coquillette, *supra* note 5, at 443.

123. *See generally* Baird & Jackson, *supra* note 7.

124. *See supra* note 78 and accompanying text.

125. One court noted that: "Contemporary corporate practices of vertically and horizontally dividing the integrated operations of what is essentially one enterprise among a number of legally distinct entities, making it necessary for financial institutions to frequently obtain 'upstream' and 'cross-stream' collateralizations, demand that a broad view of 'fair consideration' be taken." Telefest, Inc. v. VU-TV, Inc., 591 F. Supp. 1368, 1379-80 (D.N.J. 1984).

one commentator has referred to as the debtor's obligation to respect his creditors. This is accomplished by preventing debtors from using their assets in a way which causes *certain* loss to their creditors.[126] A debtor does not violate his obligation to respect his creditors—he does not cause them *certain* loss—by entering into an upstream guaranty.

Consider the effect of an upstream guaranty on the creditors of the guarantor. Secured creditors, assuming they are properly perfected or recorded, are not affected at all by such a transaction because their rights are superior to those of the recipient of the guaranty.[127] Moreover, unsecured creditors who became creditors after the creation of the guaranty must be assumed to have been aware of it when they chose to become creditors; as a result they do not require protection.[128] Thus, the relevant perspective from which to analyze the effect of an upstream guaranty is that of the unsecured creditors of the guarantor who became creditors before the creation of the guaranty.[129] From their perspective the creation of an upstream guaranty does present a risk. The risk is that the management of the principal debtor (the parent corporation) lacks the business acumen necessary to invest the loan proceeds successfully and run its business profitably. If this risk is realized, the parent corporation will become insolvent.[130] As a result, the guarantor will be called upon to pay pursuant to its guaranty and the parent will be unable to honor its obligation of reimbursement. Thus, the guarantor will have fewer assets available to pay unsecured creditors.[131] But the risk associated with the financial management ability of those in control of the debtor (here the debtor is the subsidiary-guarantor; those in control of it are the

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126. *See* Clark, *supra* note 34, at 509-11.

127. *See generally* Uniform Commercial Code (U.C.C.) § 9-504. Generally, the creation of a security interest is governed by state law. Every state except Louisiana has adopted some form of article 9 of the U.C.C., which governs the creation, perfection, and priority of security interests in personal property. The real estate laws of the states provide for a similar result with respect to real estate collateral.

128. Generally, to perfect a security interest, a financing statement or mortgage must be filed or the secured party must take possession of the collateral. The filed financing statements or recorded mortgages are available to the public and are easily searched by prospective creditors. Moreover, prospective creditors often inspect the debtor's assets to determine the amount of available collateral. Thus it is well within the prospective creditor's means to determine the existence of perfected security interest or recorded mortgages prior to deciding to become a creditor.

129. It is only this group of creditors which did not, at least constructively, choose to become exposed to the upstream guaranty. *See* Rosenberg, *supra* note 5, at 239; Coquillette, *supra* note 62, at 452.

130. If the lender has taken a security interest in the items in which the borrower invests the loan proceeds, then the guarantor may not be interested in the general financial health of the borrower but only in the success or failure of the use of the loan proceeds. As long as the loan proceeds were invested well, the guarantor could recover pursuant to its right of subrogation notwithstanding the borrower's insolvency.

131. However, even in the event of the borrower's insolvency, the guarantor might still recover in full. *See supra* note 130.

parent's management) is the risk inherent in becoming a creditor, especially an unsecured creditor.[132] The exposure of creditors to such risk is not unfair, but unavoidable and desirable.[133]

The relationship between a debtor and a creditor is primarily contractual.[134] Fraudulent conveyance law is essentially a restriction on creditor conduct which the legal system inserts into every debtor-creditor contract.[135] A rule of such general application must be one which *all* creditors would find desirable.[136] While all creditors would be in favor of prohibiting transactions which cause them certain loss, not all creditors would be in favor of prohibiting transactions which merely expose them to a risk of loss. This is because concomitant with the risk of loss from bad financial management is the possibility of profit from good financial management.

A creditor decides to lend funds to a debtor because of the debtor's perceived superior ability to use the funds productively. The creditor necessarily subjects himself to the debtor's judgment regarding the investment of the loaned funds.[137] If he did not, there would be no reason to make the loan.[138] Individual creditors may decide to limit or reduce their risk of loss from the financial management ability of the debtor.[139] This can be accomplished by the appropriate use of contract law to limit, not eliminate, the debtor's financial freedom (*e.g.*, by requiring the debtor to use the borrowed funds for a specific purpose or by limiting the debtor's right to change its

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132. The interests of creditors, like those of shareholders, are tied to the financial success of the corporation, which depends on its owners and managers. The difference is that creditors have no right to share in profits but their claims are preferred to those of the shareholders. *See* Model Business Corp. Act §§ 14.06, 14.07 (1979).

133. *See infra* note 137; Baird & Jackson, *supra* note 7, at 829-43.

134. *See supra* notes 48-53 and accompanying text.

135. *See* Baird & Jackson, *supra* note 7, at 835.

136. *Id.*

137. *Id.* at 838. The authors state:

> A creditor who lends a debtor money is taking advantage of the debtor's comparative advantage in using that money productively. A creditor necessarily defers to the debtor's skill in converting the money into other assets. The risk that both the creditor and debtor take is that the use the debtor makes of the money will benefit both parties. The creditor provides the capital, the debtor provides the know-how. The creditor is relying on the debtor's skill and judgment when it makes the loan. Only by giving the debtor discretion can the creditor hope to profit. Giving a debtor discretion, however, necessarily gives him the ability not only to make good decisions, but bad ones as well.

The authors also note that the risk of bad decisions may motivate the creditor to bargain (via contract law) for limitations on the ability of the debtor to engage in certain activities the creditors deem too risky. *Id.* at 836. The fact that creditors chose not to be secured and not to restrict their debtors' conduct should be respected for the benefit of both debtors and creditors. *Id.* at 838-39. *See, e.g., supra* note 133.

138. Baird & Jackson, *supra* note 7. Requiring cash payment upon or prior to delivery is the option to be used to remove all credit risk from the transaction.

139. *See supra* note 137.

management)[140] and by taking the steps necessary to become a secured creditor.[141]

Because the creation of an upstream guaranty will not always result in certain loss to the guarantor's creditors, it should not be deemed to be prohibited by fraudulent conveyance law. If individual creditors wish to prohibit such guaranties, they should do so by contract with their debtors. Fraudulent conveyance law was not designed and should not be judicially retrofitted to insulate creditors from the risk associated with the financial management ability of their debtors.[142] Fraudulent conveyance law should protect creditors only from intentional mismanagement (actual fraud) and the abdication of management (gift by an insolvent), not simply from bad management.[143]

To illustrate, assume a typical downstream guaranty: the bank lends to the subsidiary and the parent guaranties repayment. Clearly the subsidiary's unsecured creditors cannot complain that a fraudulent conveyance has occurred.[144] But in this situation the subsidiary's unsecured creditors are exposed to the same risk as in an upstream guaranty. The risk concerns the financial management ability of the parent's management.[145] If those in

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140. For example, many commercial loan agreements contain provisions similar to the following:

> "Events of Default" when used herein means any one of the following events . . . .
>
> If __________ shall cease to be the chief executive and operating officer of the Borrower and shall not have been replaced within thirty days by a person reasonably satisfactory to Bank . . . .
>
> Upon the occurrence of an Event of Default the entire unpaid principal balance of the loan may be declared to be immediately due and payable . . . .

*See generally* HILLMAN, *supra* note 9; NASSBERG, *supra* note 9.

141. *See generally* U.C.C. art. 9 (especially §§ 203, 302, 304, 305, 312).

142. *See supra* notes 48-53 and accompanying text. Baird & Jackson, *supra* note 7, state:

> Indeed, in considering a legal rule such as fraudulent conveyance law, overbroad rules may be more pernicious than underbroad rules. It is easier for creditors to contract into prohibitions on conduct by a debtor than it is to contract out. If fraudulent conveyance law does not cover a certain kind of activity, yet creditors want to prohibit it, it can be prohibited contractually. Myriad restrictions in loan agreements, for example, perform this function. If certain activity is prohibited by a few large creditors, other creditors (including nonconsensual creditors) may be able to profit by the monitoring of the debtor undertaken by those whose contracts do prohibit such activity. Yet, contracting *out* of a rule that prohibits conduct, such as fraudulent conveyance law, is much harder. To be effective, the consent of *all* creditors must be reached. And in the unlikely case that all creditors did so agree, the trustee in bankruptcy could still seek to upset the transfer under § 548 of the Bankruptcy Code.

*Id.* at 835 (footnotes omitted).

143. *See supra* notes 48-53 and accompanying text.

144. This is a downstream guaranty. *See supra* note 78 and accompanying text.

145. The risks are technically different. In the downstream guaranty the risk is indirect in that the parent's management does not have direct control over the loan proceeds. Its control is only through the subsidiary's management. Moreover, the parent's management usually will

charge of the parent exercise bad financial management ability in selecting and setting policy for the subsidiary's management, then the subsidiary's management is likely to be unsuccessful in its use of the loan proceeds and its overall management of the corporation. If the subsidiary loses the loan proceeds as a result of an unprofitable investment and is unable to meet its loan repayment obligations, the bank will foreclose on its collateral and the assets available for unsecured creditors will be reduced.

To further illustrate, consider the following modifications to a typical upstream guaranty: assume that the parent and subsidiary merge just prior to the loan transaction between the bank and the former parent corporation. As a result of the merger, the obligations and assets of the parent and the subsidiary are now the obligations and assets of the surviving corporation.[146] If the loan which was entered into with the bank in the upstream guaranty situation were entered into after the merger, the bank would be in exactly the same position, even though there would now be no need for an upstream guaranty. That is, the bank would have a security interest in the same assets and an obligation of repayment from the same entities.[147] The position of the subsidiary's creditors, however, appears to have improved as a result of the merger. As creditors of the surviving entity they are creditors not only of the subsidiary but also of the parent.[148] Thus, they can look to both the subsidiary and the parent for repayment.[149] Clearly, if the loan was made after the merger, these creditors could not complain that it was a fraudulent conveyance.[150] However, even if the loan was made prior to the merger, and involved an upstream guaranty, the subsidiary's creditors could look to the parent's assets for repayment as a result of the subsidiary's rights of exoneration, reimbursement, and subrogation.[151]

The risk to unsecured creditors of a subsidiary resulting from an upstream guaranty and its attendant grant of security is only a particular manifestation of the general risk inherent in being a creditor.[152] Specifically, the risk is that the parent's management will fail in its efforts to successfully run its business and invest the loan proceeds.[153] It is not unfair for the un-

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have exercised Its direction with respect to the selection of the subsidiary's management before the loan is funded. The fact remains, however, that the parent and the subsidiary are one enterprise serving the financial interests of the parent's shareholders, obeying the orders of the parent's management. Moreover, the parent can change the subsidiary's management any time after the loan is funded—unless it has contractually given up that right.

146. *See* Model Business Corp. Act § 11.06 (1979).

147. *Id.*

148. *Id.*

149. *Id.*

150. The loan proceeds provide the fair consideration. *See supra* note 78 and accompanying text.

151. *See supra* notes 27-35 and accompanying text.

152. *See supra* notes 91-92 and accompanying text.

153. *See supra* notes 79-123 and accompanying text.

secured creditors of a subsidiary to be subjected to this risk.[154] To insulate creditors from this risk would necessarily be to insulate them from the possibility of profit as well. Indeed, the unsecured creditors chose to expose themselves to this risk by becoming unsecured creditors of a subsidiary.[155] A corporation is owned by its shareholders, who elect and can change its management.[156] Any creditor of a corporation has, by his own action in assuming the status of a creditor, subjected himself to the financial management ability of the corporation's management, and ultimately of the shareholders.[157] This is not a risk about which unsecured creditors have the right to complain, nor one from which the law of fraudulent conveyances was designed to save them.[158]

## IV. Conclusion

The characterization of an intercorporate guaranty as up-, cross-, or downstream should be irrelevant with respect to the possibility that it will be characterized as a fraudulent conveyance. Fair consideration is present in most upstream guaranties, just as in most downstream guaranties.[159] In the case of up- or cross-stream guaranties, it is found in the guarantor's interest in the loan proceeds and other assets of the principal debtor created by the guarantor's rights of exoneration, reimbursement, and subrogation.[160] In any instance in which fair consideration would be present with respect to the downstream guaranty, it would also be present with respect to an upstream guaranty.[161] Thus the contention that up- or cross-stream guaranties should be characterized as unenforceable fraudulent conveyances more often than downstream guaranties is unfounded. The courts and commentators should recognize that, in the context of intercorporate guaranties, an up- or cross-stream guaranty, like a downstream guaranty, should rarely be characterized as a fraudulent conveyance. Once this is accomplished, the business community could begin to use this necessary and desirable risk-reducing tool with new confidence.

154. *See supra* notes 132-51 and accompanying text.
155. *Id.*
156. *See* Model Business Corp. Act §§ 8.01, 8.03, 8.08 (1979).
157. *Id.*
158. *See supra* notes 44-56 and accompanying text.
159. *See supra* note 81 and accompanying text.
160. *See supra* notes 27-125 and accompanying text.
161. *See supra* note 81 and accompanying text.