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Generic Fraud and the Uniform Fraudulent Transfer Act

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INTRODUCTION

Holmes imagined the "bad man,"1 a creature of legal analysis designed to focus the judge's or lawmaker's or even attorney's attention on the practical ramifications of a particular legal rule.2 So long as Holmes could see how a bad man would perceive the legal landscape, Holmes could appraise the formulation of a given proscription or set of proscriptions and prescriptions and understand the law's operation. The Uniform Fraudulent Transfer Act ("UFTA") is such a set of proscriptions and prescriptions.3 But the bad man to which I allude is not necessarily bad, except perhaps from the perspective of an all-assets secured creditor.4 It seems the way for large institutional secured creditor interests to evaluate the UFTA's provisions is to imagine how counsel for an unsecured creditor of the debtor/transferor might attack a transfer of a security interest in all or substantially all of the debtor's assets. If counsel for the transferees in such transactions can anticipate the arguments of unsecured creditors' attorneys,

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1 Holmes, The Path of the Law, 10 Harv. L. Rev. 457 (1897).
2 Holmes explains:
   Take the fundamental question, What constitutes the law? You will find some text writers telling you that it is something different from what is decided by the courts of Massachusetts or England, that it is a system of reason, that it is a deduction from principles of ethics or admitted axioms or what not, which may or may not coincide with the decisions. But if we take the view of our friend the bad man we shall find that he does not care two straws for the axioms or deductions, but that he does want to know what the Massachusetts or English courts are likely to do in fact. I am much of his mind. The prophecies of what the courts will do in fact, and nothing more pretentious, are what I mean by the law.
   Id. at 460-61.
4 Commercial finance all-assets lending contemplates a significant extension of credit, repayment of which is secured by all or virtually all of the debtor's personal and real property. The loan is made against the strength of the debtor's assets and not solely on the basis of his general reputation or business performance. See Alces, The Efficacy of Guaranty Contracts in Sophisticated Commercial Transactions, 61 N.C.L. Rev. 655, 660 n.29 (1983) (citing PLI, Commercial Finance, Factoring and Other Asset-Based Lending 11 (1980)).
those arguments may be preempted by careful structuring of transactions in order to avoid fraudulent transfer attack. If state legislatures believe that particular imaginative arguments of junior creditors should not prevail, the legislature can draft or amend the fraudulent transfer law in order to assure the results deemed most commercially desirable.

To more concretely and particularly explain the nature of the issues considered in this Article, put yourself in the position of counsel for a creditor who discovers that a corporation to which the creditor has advanced trade or unsecured credit is unable to discharge its obligation to your unsecured creditor client. It quickly becomes apparent that while your client will be left with a specious claim against the debtor, ABC Finance Company ("ABC") will cash out its claim against the debtor at roughly one hundred cents on the dollar because ABC has a security interest in substantially all of the debtor's assets. The ostensible inequity of that result troubles your client, even after you explain to him the social and microeconomic attraction of Uniform Commercial Code article 9.5

The client asks if anything can be done to help him realize something from the debtor's carcass. Here's where the "bad man" theory becomes a useful analytical tool. What would the unsecured creditor's counsel (the bad man) think up in order to attack ABC's security interest? Recent developments6 and scholarship7 in commercial law suggest that courts may gaze fondly upon the creative theories developed by counsel on behalf of unsecured or otherwise downtrodden creditors.

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creditors. In the course of reviewing the available theories, you come across the UFTA, which has recently become law in your jurisdiction. After perusing the several sections of the new Act, you find nothing either expressly in the text or more subtly in the comments directly addressing your client's dilemma. As best as you can discern, your client's position deteriorated at the time the debtor granted an all-assets security interest to ABC. For purposes of this Article, assume that the security interest was granted either (1) as a part of a leveraged business acquisition, or (2) to secure debtor's upstream or cross-stream guaranty of the indebtedness of a parent or affiliate corporation.

This Article will suggest how enterprising commercial counsel might conjure up a construction of the UFTA to make a disappointed unsecured creditor whole when an upstream or cross-stream guaranty or a leveraged business acquisition has impaired the unsecured creditor's position. I suggest that generic fraud principles, working in tandem with the UFTA's actual or intentional fraud provisions, provide the basis for attacking the grant of an all-assets security interest in the

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9 See Alces & Dorr, A Critical Analysis of the New Uniform Fraudulent Transfer Act, 1985 U. Ill. L. Rev. 527, 558-64.
guaranty and LBO settings. Trust me; this is not entirely alchemy. And the point is not so much to provide plaintiff’s counsel a theory as it is to demonstrate the uncertain scope of fraud principles and to suggest means by which the UFTA’s drafters could and should have confronted secured guaranties and LBO’s head-on rather than settling for the status quo.

First, this inquiry will explain more completely the secured guaranty and LBO contexts in order to provide an accurate picture of the interests implicated and to suggest the policy choices involved. The Article will then treat generic fraud law, built, as it is, upon principles drawn from the law of misrepresentation and deceit. The means of incorporating generic fraud into the intentional fraudulent transfer calculus are considered: only then can fraud law’s pervasive nature be appreciated and a commercially plausible concept of intent be framed. I conclude by suggesting how the UFTA might be adjusted either to foreclose or expressly sanction the accommodation of the interests considered in this Article.

Distinguishing Fraudulent Intent from Intent to Defraud

It does not make sense to consider the application of the UFTA and generic fraud principles without reference to particular commercial transactions. Before a useful analysis of such an application can be understood by those representing commercial transactors, it is necessary to describe the parties to the transaction and the context in which their interests become entangled. Therefore, I begin with a description of potentially fraudulent guaranty transactions and leveraged business acquisitions. It is necessary to treat the business setting, the scholarly commentary which has considered fraudulent transfer issues, and developing case law.

A. Secured Guaranties as Fraudulent Transfers

In his classic article, Professor Rosenberg distinguished between three types of guaranty transactions: downstream guaranties (parent guarantees obligation of subsidiary), cross-stream (sister corporation guarantees obligation of sister corporation), and upstream

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11 But see W. Shakespeare, Hamlet III, act iii, scene 2, lines 229-30. (“Ham: Madam, how like you this play? Queen: The [law professor] doth protest too much, methinks.”).
guaranties (subsidiary guarantees obligation of parent). 13 When a parent guarantees a subsidiary’s obligation, there is no constructive fraudulent transfer problem. As an investor in the subsidiary, the parent merely protects and enhances the value of its investment by guaranteeing the subsidiary’s debt. In return for the obligation incurred—the grant of a security interest in assets of the parent—the parent derives an equal and direct benefit—enhancement of the value of its investment in the subsidiary.

In the cross-stream and upstream contexts fraudulent transfer law may rear its ugly head. When a subsidiary grants an all-assets security interest to collateralize a guaranty of its parent’s debt, the subsidiary is incurring an obligation, i.e., the security interest, without a counterbalancing benefit. The secured party has normally made loan funds available to the parent, and the subsidiary’s financial position is not directly enhanced by the parent’s receipt of those funds. Rosenberg further argues that hypothecation of assets without any consideration will be subject to attack as a constructively fraudulent transfer if the subsidiary is rendered insolvent as a result of the grant of the security interest. 14 In the normal course, any corporation asked to secure its guaranty obligation will be rendered insolvent because the guaranty obligation constitutes a liability and the asset represented by the loan proceeds will appear on the parent’s financial statement. 15 The same conclusion follows from the dynamic of a cross-stream guaranty. Because one of two affiliated corporations does not directly benefit from the other’s receipt of loan funds, an affiliate that grants an all-assets security interest to secure its guaranty of the affiliate’s indebtedness is rendered insolvent. 16

It should not shock anyone to hear that the commercial community, or at least that portion of it represented by lender’s counsel, found Rosenberg’s analysis flawed. It seems that he had not properly factored in the value represented by the guarantor’s “valuable” com-

13 See id. at 238-39, 262-65.
14 Section 5(a) of the UFTA states:
A transfer made or obligation incurred by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made or the obligation was incurred if the debtor made the transfer or incurred the obligation without receiving a reasonably equivalent value in exchange for the transfer or obligation and the debtor was insolvent at that time or the debtor became insolvent as a result of the transfer or obligation.
15 The asset represented by the loan proceeds will be balanced on the parent’s financial statement by the security interest the parent had to grant to secure repayment.
16 See Rosenberg, supra note 12, at 252-57.
mon law contribution\textsuperscript{17} and subrogation\textsuperscript{18} rights. If, indeed, the guarantor were called upon to perform under the guaranty and the creditor/guaranteed party had to look to the guarantor's assets, the guarantor would then be subrogated to the rights of the secured creditor against the principal debtor. If there were other guarantors, the cross-stream or upstream guarantors could collect their pro-rata share of the discharged indebtedness by operation of contribution principles. William Coquillette explained how Rosenberg erred,\textsuperscript{19} after describing the desirability of upstream guaranties.\textsuperscript{20}

Perceived more as a problem of valuation than of legal substance, the guaranty-as-fraudulent-transfer debate became a matter which could be treated on an ad hoc basis; valuations urged by interested parties could determine whether fraudulent transfer law would void the security interest granted by the guarantor.\textsuperscript{21}

Cases in which fraudulent transfer issues were presented in the guaranty context did little to advance the analysis posited by commentators. Rosenberg argued that the contingent subrogation and contribution rights were actually worth nothing or virtually nothing because the guarantor would only be called upon to perform under the guaranty after the principal obligor was already or very nearly insolvent.\textsuperscript{22} While the practical wisdom of that observation is not unassailable, it does to a considerable extent conform to the realities attending the documentation of a secured guaranty as part of an all-assets commercial finance transaction. \textit{In re Ollag Construction}\textsuperscript{17}

\textsuperscript{17} See Schwartz v. Commissioner, 560 F.2d 311 (8th Cir. 1977) (right of contribution from third party is an asset); Wingert v. Hagerstown Bank, 41 F.2d 660 (4th Cir. 1930) (right of contribution is an asset); O'Grady v. First Union Nat'l Bank, 296 N.C. 212, 250 S.E.2d 587 (1978) (right of contribution may vary with change in contract).

\textsuperscript{18} See Manufacturers & Traders Trust Co. v. Goodman (\textit{In re Ollag Constr.}), 578 F.2d 904 (2d Cir. 1978) (subrogation rights may be valued as assets to determine solvency); First Nat'l Bank v. Jefferson Sales & Distribrs., 341 F. Supp. 659 (S.D. Miss. 1971) (subrogation right applied where equity requires), aff'd, 460 F.2d 1059 (5th Cir. 1972); Sterling Factors Corp. v. Freeman, 50 Misc. 2d 715, 271 N.Y.S.2d 343 (Sup. Ct. 1966) (guarantor's rights subrogated to creditor's claims to inventory in exchange for creditor's foregoing mortgage foreclosure), aff'd, 27 A.D.2d 956, 279 N.Y.S.2d 577 (1967).


\textsuperscript{20} Id. at 435-38 (describing situations where upstream guaranties might be desirable, as when parent/holding company owns several subsidiaries enabling superior financing terms than individual subsidiaries could achieve). See also Note, Upstream Financing and Use of the Corporate Guaranty, 53 Notre Dame L. Rev. 840 (1978); Note, The Corporate Guaranty Revisited: Upstream, Downstream, and Beyond—A Statutory Approach, 32 Rutgers L. Rev. 312 (1979).

\textsuperscript{21} Alces, supra note 4, at 681 (suggesting "going-concern" valuation of debtor's assets in bankruptcy).

\textsuperscript{22} Rosenberg, supra note 12, at 256.
Equipment\textsuperscript{23} refused to follow Rosenberg's analysis. Judge Kaufman, writing for the Second Circuit Court of Appeals, concluded that, at least on the facts of Ollag, the contingent contribution and subrogation rights should be considered as having some value.\textsuperscript{24}

The problem, of course, is with the time at which the valuation should be done for purposes of determining whether the assumption of guaranty liability renders the guarantor insolvent. A guaranty is a form of insurance; at least that is how lenders perceive it. If the principal obligor is unable to repay the creditor, the creditor will proceed against either the guarantor, the hypothecated assets of the guarantor, the assets of the principal obligor, or all three and any additional available sources. It is impossible to fix the value of the contingent contribution and subrogation rights at the time the guaranty liability is assumed. Indeed, were the lender certain that the guaranty would not be enforced there would be no reason (save leverage)\textsuperscript{25} to insist upon it, and were the lender certain that it would be enforced, it is exceedingly unlikely that the lender would enter into the transaction in the first place. Moreover, the lender knows that uncertainty at the outset. But does it matter that the guarantor would know of it also? After all, by the time fraudulent transfer litigation is initiated it is clear that the guarantor's judgment was not infallible. The object is to effect the most equitable distribution to creditors—all of the creditors.

But it is not enough that the contribution or subrogation rights are so discounted as to render the guarantor insolvent. Assumption of guaranty liability may only be attacked as a constructive fraudulent transfer if the guarantor did not receive "a reasonably equivalent value in exchange for the" guaranty.\textsuperscript{26} Rosenberg's whole point was that in the cross-stream and upstream guaranty contexts, the guarantor really did not receive anything of value, much less reasonably equivalent value.\textsuperscript{27}

A recent guaranty case took a different view of the value received by the guarantor.\textsuperscript{28} A doctor who had incorporated himself caused the professional corporation to execute a guaranty of his indebtedness to lender; the guaranty was secured by the professional corporation's

\textsuperscript{23} 578 F.2d 904 (2d Cir. 1978).
\textsuperscript{24} Id. at 908. See also Syracuse Eng'g Co. v. Haight, 97 F.2d 573, 576 (2d Cir. 1938) (claim's value in subrogation against the principal must be counted as an asset); Updike v. Oakland Motor Car Co., 53 F.2d 369, 371 (2d Cir. 1931) (contingent claim based on guaranteed customer notes excluded as a liability).
\textsuperscript{25} See Alces, supra note 4, at 660.
\textsuperscript{27} Rosenberg, supra note 12, at 240-57.
\textsuperscript{28} In re Ear, Nose & Throat Surgeons, 49 Bankr. 316 (Bankr. D. Mass. 1985).
accounts receivable. The doctor used the loan proceeds for personal purposes and the guarantor-corporation did not benefit by any more than an $8,000 discharge of tax indebtedness.

In deciding whether the guaranty obligation could be avoided as a fraudulent conveyance under the Bankruptcy Code,\textsuperscript{29} the court had to consider whether the professional corporation had received reasonably equivalent value in exchange for the guaranty.\textsuperscript{30} The bankruptcy court noted the general rule that a debtor has not received reasonably equivalent value "where it transfers its property in exchange for a consideration which passes to a third party."\textsuperscript{31} However, Judge Glennon also recognized an exception to that rule: "where the debtor and the third party 'are so related or situated that they share an "identity of interests" because what benefits one will, in such case, benefit the other to some degree.'"\textsuperscript{32}

Once again, valuation is the focus. A court must decide whether there was sufficient vicarious benefit by considering the value actually realized by the guarantor. In the \textit{Ear, Nose and Throat Surgeons} matter, the bankruptcy court decided that the professional corporation, the doctor/guarantor, received "significantly less than the value" received by the principal obligor, the doctor/individual.\textsuperscript{33} The court decided that as a result of undertaking the guaranty liability, the contingent liability represented by the guaranty effectively made the guarantor insolvent.

\textit{Ear, Nose and Throat Surgeons} concerned constructive fraud, and supports Rosenberg's perception of the economic and legal reality surrounding upstream guaranties, though not in the intercorporate setting. The case well illustrates the standard fraudulent transfer analysis, even though it did not treat the valuation of subrogation and contribution rights issues considered in \textit{Oltag}.\textsuperscript{34} Together, however, the two opinions capture the contours of the issue, though the opinions seem to subscribe to inconsistent views of the underlying policy issues.\textsuperscript{35} These policy concerns are reconsidered in the next section of

\textsuperscript{31} 49 Bankr. at 320 (citing \textit{In re Royal Crown Bottlers, Inc.}, 23 Bankr. 28, 30 (Bankr. N.D. Ala. 1982)).
\textsuperscript{33} 49 Bankr. at 320.
\textsuperscript{34} See cases cited supra note 18.
this Article. But first, consider the equities and policies surrounding fraudulent transfer treatment of leveraged business acquisitions.

An illustration of the garden variety LBO accommodates analysis of the issues.

The aging management and shareholders (sellers) of a privately held company approach a group interested in acquiring the company. Ambition-rich but relatively cash-poor, the acquisition group arranges financing through a bank or commercial finance company. The lender advances the loan proceeds against the assets (accounts receivable, inventory, equipment, real property) of the acquired company. The acquisition group pays for the sellers' interest in cash (and perhaps a promissory note). Sellers transfer ownership of the company and its assets to the acquisition group subject to the security and perhaps mortgage interest of the lender. The individual members of the acquisition group, at the insistence of the secured lender, often will execute personal (usually secured) guaranties of the acquisition loan.36

The problem from the perspective of junior unsecured creditors is that the corporate entity to which they had been supplying credit is no longer as financially viable as it was before the LBO. The corporation whose assets have been leveraged purportedly benefits from the infusion of new management. The issue should be familiar: does the benefit of new management constitute value reasonably equivalent to the value of the assets hypothecated to secure repayment of the acquisition financing? It depends whom you ask.

In their article questioning the very legitimacy of fraudulent transfer law ab initio, Professors Baird and Jackson allow "[e]ven under the narrowest view of fraudulent conveyance law, the leveraged buyout may be a fraudulent conveyance."37 They go so far as to suggest that the transactions might constitute intentional fraud on junior unsecured creditors.38 But then they dismiss such investigations of intent as a "messy inquiry" and move onto the constructive fraudulent transfer issues. I'll come back to that mess in the next section. Baird and Jackson conclude that LBOs do not clearly prejudice unsecured creditors' rights: "[w]ith the buyout may come more streamlined and more effective management."39 Moreover, if the corporation's creditors who had antipledge covenants in their agree-

36 Alces & Dorr, supra note 9, at 560. See also Carlson, Leveraged Buyouts in Bankruptcy, 20 Ga. L. Rev. 73, 80-83 (1985) (very helpful description of typical leveraged business acquisition contexts).
38 Id.
39 Id. at 853.
ments with the corporation did not accelerate the corporation's indebtedness at the time of the LBO, the transaction was probably in the best interests of all junior unsecured creditors (or at least those with enough clout to insist upon an antipledge covenant).

Carlson does not subscribe to the Baird and Jackson analysis, though he does agree with their conclusion. Carlson's LBO article considers such acquisitions in the bankruptcy context, focusing on the “savings provision” of section 548(c), not its actual or constructive fraudulent conveyance provisions. Because bankruptcy law is necessarily federal law, Carlson is able to rely on federal precedent to support his conclusion that an LBO should only be set aside as a fraudulent transfer when the creditor who supplied the acquisition financing in exchange for an all-assets security interest did so knowing that the debtor corporation was insolvent and knowing that bankruptcy proceedings were on the horizon. It is not at all clear, however, that state uniform fraudulent transfer law will follow federal precedent; indeed, it is likely that some would question Carlson's reading of federal precedent.

It is difficult to read too much into the case law concerning LBOs. One of the more infamous cases, striking down an LBO, includes a truly unsavory cast of characters. Arguably, however,

40 Carlson, supra note 36, at 102-03.
41 Id. at 102 n.95.
43 U.S. Const. art. I, § 8, cl. 4.
44 See Dean v. Davis, 242 U.S. 438 (1917) (mortgage interest securing outstanding unsecured loan fraudulent because lender knew of debtor's imminent bankruptcy).
45 Carlson, supra note 36, at 76-77. See also id. at 120-21 (“The LBO lender should have a defense against fraudulent conveyance liability whenever the lender believes in good faith that it is financing a corporate acquisition with a decent chance of survival.”).
46 To limit the Dean proscription to cases in which the lender knew of the debtor's imminent bankruptcy, Professor Carlson cited Justice Brandeis' dictum: The mortgage may be made in the expectation that thereby the debtor will extricate himself from a particular difficulty and be enabled to promote the interest of all other creditors by continuing his business. The lender who makes an advance for that purpose with full knowledge of the facts may be acting in perfect "good faith.”

Carlson, supra note 36, at 88-89 (citing Dean, 242 U.S. at 444). Indeed, it is upon a construction of that dictum that a good deal of Carlson's thesis depends. But the Court's Dean decision largely defers to the lower court's factual determinations and does not suggest that only showing lender knowledge of imminent bankruptcy would support avoiding the transaction as intentionally fraudulent. The Court noted that “[i]t is a question of fact in each case what the intent was with which the loan was sought and made.” 242 U.S. at 444. The Court cited several cases to support the conclusion "that a mortgage is a fraudulent conveyance where taken as security for a loan which the lender knows is to be used to prefer favored creditors . . . .” Id. at 445 n.1.
47 See United States v. Glenegas Inv. Corp., 565 F. Supp. 556 (M.D. Pa. 1983) (former labor union president Jimmy Hoffa provided collateral for loan transaction that looked suspi-
LBOs might in some circumstances be assailable even if the plaintiff is not able to imply organized crime connections. But a recent California federal district court case suggests that plaintiffs seeking to set aside LBOs as fraudulent transfers might have a tough row to hoe. In Credit Managers Association v. Federal Co., the court construed California's fraudulent conveyance statute as not providing a basis to avoid the LBO as constructively fraudulent. Reluctant to tackle the larger issue—whether the scope of fraudulent conveyance law is broad enough to reach LBOs at all—the court found that on the facts presented, the plaintiffs were unable to show that the acquired corporation was undercapitalized after the transaction. But the key to the opinion is in the court's discussion of the plaintiffs' standing to attack the LBO:

These [plaintiff] creditors made a post-buyout decision to extend credit on new terms to a new entity, an entity with a very different financial structure than its predecessor. As the creditors plaintiff represents did not have any substantial stake in [the acquired corporation] at the time of the buyout, there does not appear to be a strong reason to give these creditors the right to attack the buyout as harmful to them. It would seem that if leveraged buyouts are to be susceptible to attack on fraudulent conveyance grounds, only those who were creditors at the time of the transaction should have a right to attack the transaction.

That point is well-taken, and further discussion of Credit Managers below explores the ramifications of the court's analysis and the coincidental generic fraud principles implicated.

Whether it is appropriate to view corporate guaranties and leveraged business acquisitions in terms of constructive fraud issues, it seems clear that scholarship and recent case law have adopted that

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49 The plaintiff did not allege intentional fraud but urged three alternative legal theories which the court acknowledged. Id. at 177.
50 The court chose not to confront the "important conceptual question" of whether fraudulent conveyance law applies to leveraged buyouts at all. Id. at 179 (citing Baird & Jackson, supra note 37, at 832-33, 852).
51 629 F. Supp. at 183.
52 Id. at 180.
perspective, though perhaps without thoroughly considering the intentional fraud issues. Recent decisions concerning upstream and cross-stream guaranties respond, albeit sub silentio, to Rosenberg's constructive fraud suggestions. 54 Similarly, Credit Managers contained several references to Baird and Jackson's LBO article 55 which dismissed summarily any suggestion that application of intentional fraudulent conveyance law would advance the inquiry. I endeavor, in the next sections of this Article, to follow the road less traveled. 56

B. Overview of Apposite Generic Fraud Principles

By generic fraud I mean no more than the common law of misrepresentation and deceit. 57 For example, Koch represents to Cuomo that he, Koch, has marketable title to the Brooklyn Bridge and induces Cuomo to purchase the Bridge for the reasonable sum of $500,000. After the transaction, Cuomo discovers that he has been taken and brings a misrepresentation action against Koch because Koch did not in fact have marketable title to the Bridge and took advantage of Cuomo. In such a case, a misrepresentation action would probably exist, subject to Koch's defense based on plaintiff's inability to show reasonable reliance. Elements of the fraud or misrepresentation action have been formulated in various terms. Essentially, the action requires that plaintiff show defendant made a false representation of a material fact, which defendant knew to be false when made, upon which plaintiff reasonably relied, and as a result of which plaintiff suffered damages. 58

Cases construing and applying those elements in commercial and non-commercial settings are myriad and, predictably, have nothing to do with upstream guaranties of leveraged business acquisitions. If a


55 See Credit Managers, 629 F. Supp. at 177, 179-80, 182.

56 See R. Frost, The Road Not Taken, stanza 4, lines 19-20.


guaranty or LBO plaintiff can convince a court to apply UFTA section 4(a)(1)—proscribing transfers made or obligations incurred by a debtor “with actual intent to hinder, delay, or defraud any creditor of the debtor”—a misrepresentation action could be stated. If generic fraud law is not the source of the “defraud” alternative, and a worthwhile measure of its impact, I have trouble seeing what else could determine the term’s proper construction.

The problems presented by engrafting the essential elements of fraud wholesale onto the intentional fraudulent transfer law may be overcome by analyzing application of fraud principles in stages. First, in the Brooklyn Bridge example, the similarity between the bridge’s seller and the secured lender in the guaranty and LBO contexts must be established. Vis-à-vis the junior unsecured creditors of the guarantor or acquired corporation, the lender’s action often profoundly undermines their interests. Before the transaction the unsecured creditors were doing business with a solvent entity. After the transaction it is unclear whether the debtor can fulfill its obligations to unsecured creditors. The corporation’s liabilities have been increased without the addition of a counterbalancing asset. Even the Credit Managers court, in the LBO context, acknowledged as much.

Second, generic fraud generally requires a misrepresentation or its equivalent. In the guaranty and LBO cases it is difficult to see what might be construed as a misrepresentation, or even a representation at all. But several recent fraud cases have confronted this very problem—a situation in which one party seems to have taken advantage of another without uttering a word. For instance, in Johnson v. Smith, a not atypical fraud case, a buyer of real property took advantage of the seller by including a bilateral death provision in the note which the seller would accept in payment for the property. The clause provided that upon the purchaser’s death the property would revert to the seller, and upon the seller’s death the debt evidenced by the note would automatically extinguish. When the note was executed, the buyer was twenty-five and the seller was seventy-five years old. The court determined that inserting the death clause in the note was fraudulent: “Misrepresentation . . . is not the only method through which fraud is practiced. To the contrary, fraud may be acted as well as spoken.”

60 Or, at least more likely solvent.
61 Credit Managers, 629 F. Supp. at 186.
63 Id. at 632.
The misrepresentation element may be satisfied without a representation at all in failure-to-disclose cases because silence may be actionable. That result is arguably inconsistent with the common law, and therefore is strictly circumscribed. The elements of fraudulent concealment have been recited in the cases: concealment of material fact which should be disclosed; defendant’s knowledge of the concealment; plaintiff’s ignorance of fact concealed; defendant’s intention that the concealment be acted upon by plaintiff; damage to plaintiff. Before courts will impose a duty to disclose, they often need to find some special relationship between the party who should have disclosed a fact and the nondisclosure’s victim. This should not be confused with the constructive fraud cases, considered below, in which the existence of a fiduciary relationship must be shown. While a fiduciary relationship would satisfy the relationship requisite in failure-to-disclose cases, a less intimate relation will often suffice. In determining whether a given relationship gives rise to the duty to disclose, the courts look to the nature of the information not disclosed. In Coface v. Optique Du Monde, Ltd., for example, a guarantor failed to disclose to the creditor that the principal obligor was insolvent and would be unable to discharge its obligation. The court, relying on New York precedent and a Second Circuit opinion in accord with that precedent, refused to find a debtor-creditor relationship sufficient to trigger the duty to disclose.

As a surrogate for any type of confidential or fiduciary relationship, some courts take a more direct approach to redress the bargaining imbalance which is the substance of failure-to-disclose cases. One’s “superior knowledge” sometimes imposes a duty to disclose. In SFM Corp. v. Sundstrand Corp., a federal district court in Illinois

66 See infra notes 85-96.
71 Coface, 521 F. Supp. at 504.
applied Illinois law to what was essentially a breach of contract action, recognizing that "[a]ny prediction of future events (or statement of intention) or opinion may be deemed fraudulent if the person making the representation has or professes to have superior knowledge." The SFM defendant was a manufacturer of non-conforming equipment which caused loss to the plaintiff-buyer. Certainly the manufacturer would be in a better position than its customers to know the capabilities of the machinery it sells. The "superior knowledge" approach has been used by other courts.

As an intermediate position between the failure-to-disclose and the constructive fraud cases, some states have fashioned a form of strict liability for the consequences flowing from entirely innocent misrepresentation. Some states provide for such liability by statute. Authority in other jurisdictions suggest that in some circumstances plaintiff need not even show that defendant should have appreciated the inaccuracy of a misrepresentation which caused plaintiff damage. Susser Petroleum Co. v. Latina Oil Corp. relied on section 552 of the Restatement (Second) of Torts and construed that section, perhaps somewhat creatively, to provide strict liability:

This section imposes liability upon a party that supplies false information in the course of business for the guidance of others in their business transactions and it is immaterial whether or not such misrepresentation was made innocently or deliberately or with a fraudulent or dishonest intent. To be actionable, the representation need only be false either by accident or intent.

It is difficult to see how an innocent misrepresentation is the same as negligent misrepresentation. To hold an innocent defendant liable is a form of strict, if not absolute, liability. And plaintiff’s counsel in

73 Sometimes the line between breach of contract and fraud is hard to distinguish factually. Indeed, whether the case is tried and decided as one or the other often depends on which theory the plaintiff pursues.
75 See, e.g., Aaron Ferer & Sons, 731 F.2d at 123 (duty to disclose arises where one party possesses superior knowledge not available to the other); Ford Motor Credit Co. v. Milburn, 615 F.2d 892, 895 (10th Cir. 1980) (defendant’s superior knowledge constitutes exception to general rule that misrepresentation of law is not actionable as fraud); Magnaleasing, Inc. v. Staten Island Mall, 428 F. Supp. 1039, 1043 (S.D.N.Y.) (where one party has superior knowledge, expression of opinion may form basis for actionable fraud), aff’d, 563 F.2d 567 (2d Cir. 1977).
77 574 S.W.2d 830 (Tex. Ct. App. 1978).
78 Id. at 832.
79 Id.
states which equate innocent with negligent misrepresentation will likely pick up on the advantage such a formulation provides the party bearing the burden of proof. In *Susser Petroleum*, plaintiff alleged that defendant had misrepresented the availability of certain aviation fuel, and plaintiff relied on defendant's representations that the fuel would become available when in fact it did not. The court was not persuaded by defendant's contention that plaintiff's failure to prove negligence compromised plaintiff's maintenance of the misrepresentation action. Because the supplier-defendant was in a position to know plaintiff's needs and, by the nature of defendant's business, impliedly engaged to make only responsible and accurate representations regarding the particular matters in issue, defendant could not deny plaintiff's right to rely on the representation; the defendant's innocence or bona fides were simply not proper matters for the court's consideration.80

A bankruptcy case applying Virginia law recited the state's common law rule that innocent misrepresentation is actionable.81 The court cited a 1957 Virginia Supreme Court decision recognizing that "[w]hether the representation is made innocently or knowingly, if acted on, the effect is the same."82 In Virginia, at least according to its Supreme Court in 1957, innocent misrepresentation is a special form of constructive fraud. Though imposing liability for innocent misrepresentation has been described by venerable authority as a minority position,83 the scope of constructive fraud is broad enough to include liability for innocent misrepresentation and the cause of action for constructive fraud is recognized in the vast majority of jurisdictions.84 Constructive fraud liability is premised on a breach of duty arising from a fiduciary or confidential relationship. It is sometimes referred to as "legal" or "moral" fraud; the law imputes liability to a relatively innocent party in order to vindicate an overriding public or even private interest. The courts suggest defendant's moral guilt has nothing to do with constructive fraud.85

In practice, the decisions betray an uneasy tension between the

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80 Id.
83 37 C.J.S. Fraud § 25 (1943).
incline to limit this form of essentially strict liability and the desire to make whole a plaintiff who fell victim to her own ignorance when relying on the misrepresentations. Two considerations guide judicial application of constructive fraud principles: (1) limitations on the contexts in which liability arises—the nature of the relationship between plaintiff and defendant; and (2) limitations on plaintiff’s use of constructive liability theory—offensively, to recover damages, or merely defensively, to avoid suffering a loss in reliance.

Evidence that constructive fraud is not entirely distinct from negligent or innocent fraud is found in the cases discussing the nature of the relationship between plaintiff and defendant requisite to imposition of constructive fraud liability. There is not an established list of relationships which supply the necessary confidentiality or trust. 86 So long as the court finds that the victim reposed particular trust and confidence in the defendant-representor, the necessary relationship is established. 87 Such trust or confidence may be established by showing that defendant had greater expertise than plaintiff and that plaintiff relied on that expertise. There are references in the cases to one party’s being “dominant” or “superior” in some way. 88

In some cases the reviewing court has deemed a vendor-vendee relationship to impose a fiduciary duty on the defendant. 89 Other courts have refused to find the necessary relationship between a bank and borrower. 90 Zeilenga v. Stelle Industries 91 recited the factors to be considered in determining the existence of a confidential relationship between plaintiff and defendant: kinship, age difference, plaintiff’s health and mental condition, and the extent to which plaintiff relied on defendant in the course of plaintiff’s business and financial

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affairs. While the analogy is by no means perfect, it is useful to compare the indicia of “control” catalogued in the UFTA definition of “insider.”

Once a court has determined that defendant’s relationship with plaintiff gives rise to liability for constructive fraud, the issue remains what relief is appropriate. One possibility is that upon establishing the elements of constructive fraud, plaintiff shifts the burden of proof to defendant to show that there was no over-reaching or fraud. Generally plaintiff may rescind the contract induced by defendant’s misrepresentation. Another view is that the elements of constructive fraud are parallel to those of breach of warranty and the same remedies apply.

Debate concerning the role of punitive damages in fraud cases also sheds light on the fundamental basis of fraud liability. Virtually all states award exemplary damages in intentional fraud cases, although the conditions prerequisite to such an award differ from

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92 Id. at 757, 367 N.E.2d at 1349-50.
93 Section 1(7) of the UFTA states that “insider” includes:
   (i) if the debtor is an individual,
      (A) a relative of the debtor or of a general partner of the debtor;
      (B) a partnership in which the debtor is a general partner;
      (C) a general partner in a partnership described in clause (B); or
      (D) a corporation of which the debtor is a director, officer, or person in control;
   (ii) if the debtor is a corporation,
      (A) a director of the debtor;
      (B) an officer of the debtor;
      (C) a person in control of the debtor;
      (D) a partnership in which the debtor is a general partner;
      (E) a general partner in a partnership described in clause (D); or
      (F) a relative of a general partner, director, officer, or person in control of the debtor;
   (iii) if the debtor is a partnership,
      (A) a general partner in the debtor;
      (B) a relative of a general partner in a general partner of, or a person in control of the debtor;
      (C) another partnership in which the debtor is a general partner;
      (D) a general partner in a partnership described in Clause (C); or
      (E) a person in control of the debtor;
   (iv) an affiliate, or an insider of an affiliate as if the affiliate were the debtor; and
   (v) a managing agent of the debtor.
state to state. It is axiomatic that punitive damages are, by definition, intended to punish defendant, not to grant plaintiff a windfall. Courts have not been consistent in their requirements for punitive awards. While some courts require no less than an absolute showing of fraud, others are satisfied with establishing defendants’ heightened culpability. This inconsistency has created considerable confusion in at least one jurisdiction. Given the nature of intentional fraud, it seems ludicrous to distinguish between “wanton and willful” and less sinister varieties.

Fraud is nasty, and anyone who perpetrates it is arguably as fit for punishment as a common thief. Complications arise when less than intentional fraud is actionable because punitive damages should not flow from negligent, innocent, or mistaken misrepresentation. The problem is framing a precise definition of “intent” explicit enough to distinguish the levels of culpability delineated by different types of fraud. What constitutes intent is determined by the interpretation chosen. One interpretation may require the intent to cause injury to plaintiff; another view may focus instead on a defendant’s intent to benefit at the plaintiff’s expense. This tension is crucial when the issue is construction of the UFTA’s intent-to-defraud provision. In generic fraud law the rule seems to be that only proof of wanton, willful, malicious, oppressive, or at least reckless behavior will support exemplary recovery. So long as plaintiff’s counsel can convince the court or the trier of fact that defendant is vile, or de-

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The policy of giving punitive damages has been a subject of much controversy. They have been condemned as undue compensation beyond the plaintiff’s just deserts, in the form of a criminal fine which should be paid to the state, if anyone, with the amount fixed only by the caprice of the jury and imposed without the usual safeguards thrown about criminal procedure, such as proof of guilt beyond a reasonable doubt, the privilege against self-incrimination, and even the rule against double jeopardy—since the defendant may still be prosecuted for the crime after being mulcted in the tort action.

Id. (footnotes omitted).


100 See Zeman v. Lufthansa German Airlines, 699 P.2d 1274, 1286 (Alaska 1985) (where no evidence of malicious conduct in record, and record also foreclosed reckless indifference, airline not liable for punitive damages); Durant v. Surety Homes Corp., 582 F.2d 1081 (7th Cir. 1978); Stephenson v. Capano Dev., Inc., 462 A.2d 1069 (Del. 1983).
fendant’s behavior in the particular instance is vile, exemplary recovery will be granted.

Before drawing any conclusions concerning expanded application of the intent-to-defraud provision in the uniform law of fraudulent transfers, it is worthwhile to review a couple of other creditor liability theories suggested by commentators. Professor Clark surveyed the normative bases of fraudulent conveyance law, equitable subordination doctrine, dividend restraint statutes, and piercing the corporate veil theories to formulate the proper influence of such mechanisms on redressing imbalances among creditors of a fiscally embarrassed debtor.101 Few articles have been able to throw around concepts such as Truth,102 Respect,103 Evenhandedness,104 and Nonhindrance105 and still be taken seriously by the commercial community. Professor Clark suggested that courts were using equitable subordination and veil-piercing analysis to avoid the formal requisites of standard fraudulent conveyance analysis.106

More recently, Professor Schechter suggested that principles of agency and partnership could be utilized to aid unsecured creditors of

101 Clark, supra note 7.
102 Id. at 509 (Truth mandates that “in connection with transfers of property rights to others, a debtor is forbidden to tell lies to his creditors that will lead to the nonsatisfaction of their claims.”).
103 Id. at 510-11. Clark “somewhat hesitantly” identifies respect as a normative ideal. Its command can be captured by a cliche: be just before you are generous. The debtor has a moral duty in transferring his property to give primacy to so-called legal obligations, which are usually the legitimate, conventional claims of standard contract and tort creditors, as opposed to the interests of self, family, friends, shareholders, and shrewder or more powerful bargaining parties.
104 Id. at 512. (“Evenhandedness, in its fullest expression, has two aspects”—the debtor may not prefer one creditor over another when he is about to become insolvent and creditors should not seek such a preference.).
105 Id. at 516. Truth, Respect, and Evenhandedness combine to form the ideal of Nonhindrance.
106 Id. at 536. Clark writes:

In summary, equitable subordination is not only a functional equivalent of conventional fraudulent conveyance law occasioned by procedural and administrative factors, but also serves the purpose of expanding application of the ideals of Truth, Respect, and possibly Evenhandedness to situations which are not covered by technical fraudulent conveyance law because it is, perhaps arbitrarily, limited in its coverage to debtholder claimants against the debtor and to debtors who make or suffer transfers of benefits.
107 Id. at 553. Clark also concludes that “the agency theory enunciated in piercing [the corporate veil] cases serves a practical function similar to that of equitable subordination doctrine, in that both avoid the perceived restraints of fraudulent conveyance law. Understandably, then, the piercing cases suppress mention of that body of law.” Id. These conclusions were reached after thorough case analysis.
a debtor whose assets have been depleted at the insistence of a creditor in position to exert control. The rule he proposes is sweeping: When a creditor has exercised substantial control over its debtor's operations, and when that control has affected the payments made or costs incurred by the debtor and has also enabled the creditor to realize a potential benefit (whether or not actually received), then upon the debtor's insolvency the controlling creditor should be held liable for obligations of the debtor; such a creditor's liability extends to all obligations incurred, either (1) during the period of actual control or (2) before the exercise of control, but which resulted in the actual receipt of benefits by the creditor.

Schechter's proposal would produce consequences in the upstream guaranty and LBO contexts beyond those contemplated by application of generic fraud principles and intentional fraudulent transfer rules to attack certain guaranties and leveraged business acquisitions.

However, it seems that the object of the generic fraud law is very much the same as the liability theories reviewed by Clark and Schechter. The generic fraud cases described in this section betray judicial impatience with actions of creditors in strong bargaining positions who take undue advantage of other commercial interests, whether of parties with whom the powerful creditors deal directly or other creditors with an interest in the welfare of such parties. While generic fraud law protects B from A's misrepresentation, some of the foregoing authorities suggest it is not a great analytical jump to permit B's creditors to complain when A utilizes its superior bargaining position to prejudice those other creditors. That is precisely the situation in which unsecured creditors find themselves when a lender with significant bargaining power causes a debtor corporation to hypothecate all of its assets to secure an upstream guaranty or financing for a leveraged business acquisition.

C. A Comparison of Intentional and Constructive Fraud

As discussed above, most of the action in the guaranty and LBO contexts has involved the constructive fraud provisions of uniform fraudulent conveyance law. Courts and commentators

\[\text{References}\]

107 See Schechter, supra note 7.
108 Id. at 881 (footnote omitted).
109 See Rosenberg, supra note 12; text accompanying supra notes 13, 16, and 22.
111 See Rosenberg, supra note 12; Coquillette, supra note 19; Carlson, supra note 36.
have assumed that in the vast majority of commercial guaranty and LBO cases, only the constructive fraud provisions would come into play because, to paraphrase a commercial law giant, lunches at the bankers' club are not given to discussing how the customer might be hoisted a little higher upon his own petard.\(^{112}\) Nor should we assume that lenders ponder means to prejudice the rights of their customers' creditors. But it is not all that clear why enterprising plaintiff's counsel might not be willing to resort to the intent-to-defraud provision of the UFTA to attack a guaranty or LBO. Once the relationship between constructive fraudulent transfer law and intentional fraudulent transfer law is understood, it is no longer so clear that guaranties and LBOs should not be subject to avoidance as transactions intended to defraud the debtor/transferor's unsecured creditors.

All fraudulent transfer law in this country is a product of the Statute of 13 Elizabeth, which proscribed

feigned, covinous and fraudulent Feoffments, Gifts, Grants, Alienations, Conveyances, Bonds, Suits, Judgments and Executions, . . .

Which . . . are devised and contrived of Malice, Fraud, Covin, Collusion or Guile, to the End, Purpose and Intent, to delay, hinder or defraud Creditors and others of their just and lawful Actions, Suits, Debts, Accounts, Damages, Penalties, Forfeitures, Heriots, Mortuaries, and Reliefs. . . .\(^{113}\)

Certain indicia or badges of fraud developed only when courts became frustrated by the need to prove subjective intent in Statute of 13 Elizabeth cases.\(^{114}\) However, those constructive badges of fraud only grew from the law's need to establish certain objective factors whose presence would imply the requisite fraudulent intent. The badges became presumptions of fraud in American courts\(^{115}\) which eventually focused more on the transfer's prejudicial effect on the transferor's cred-

\(^{112}\) See Gilmore, The Uniform Commercial Code: A Reply to Professor Beutel, 61 Yale L.J. 364, 376 (1952).

\(^{113}\) 13 Eliz., ch. 5, § 1 (1570).

\(^{114}\) See Twyne's Case, 76 Eng. Rep. 809 (Star Chamber 1601) (setting aside preferential conveyance of debtor's farm and personal property). The Twyne's court catalogued six particularly significant factors: (1) the debtor made a general transfer of all property; (2) the debtor retained possession and use of the property; (3) the transfer was clandestine; (4) the transfer was made "pending the writ"; (5) the parties created a trust to govern use of the property; and (6) the deed explicitly vouched for its own validity and the parties' honesty and good faith. Id. at 812-14.

itors than on the transferor’s intent. Although the result was a purely constructive basis of liability, it was firmly grounded on the intentional fraud principles of the Statute of 13 Elizabeth.

The National Conference of Commissioners on Uniform State Laws which drafted the UFCA in 1918 was acutely aware of the relationship between intentional and constructive fraud liability. In order to make the decisions construing the badges of fraud more consistent among jurisdictions, the UFCA drafters provided that proof of certain fact combinations would compel the conclusion that the transfer should be avoided as fraudulent. The original constructive fraud provisions, then, were designed to clarify inconsistencies among the states in their application of the badges of fraud, not to supplant application of intentional fraud law. The constructive indicia incorporated into the UFCA were adequacy of the consideration received by the transferor and solvency or insolvency of the transferor at or immediately after the transfer.

The UFTA, following the model of the Bankruptcy Code, continues those same indicia of fraud. Even in the new Act there is no suggestion that constructive fraudulent transfer law should displace the operation of intentional fraud law. So, the argument here goes, once the plaintiff/unsecured creditor is able to establish generic fraud by utilizing the generic fraud construction of “intent,” the guaranty or LBO which compromises the unsecured creditor’s rights in the same way as misrepresentation or deceit would is subject to avoidance as a transfer consummated with the actual intent to hinder, delay, or defraud.

Even the UFTA’s drafters, perhaps unwittingly, have recognized the symbiotic relationship between constructive and intentional fraudulent transfer law posited here. It is not enough to consider a transaction only from the constructive fraud perspective; the aspects

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116 Professor William Draper Lewis of the University of Pennsylvania drafted the UFCA at the request of the National Conference of Commissioners on Uniform State Laws. In 1919, the American Bar Association approved the Act. It was generally well received by the legal community. See Radin, Fraudulent Conveyances in California and the Uniform Fraudulent Conveyance Act, 27 Calif. L. Rev. 1, 12 (1938) (the UFCA would add “clarity and breadth” to state law); Note, Remedies of a Creditor for Setting Aside a Fraudulent Conveyance with Recommendations for Changes, 6 S.C.L.Q. 80, 85 (1953) (UFCA is “highly desirable” because it provides a “positive course” for creditors to follow).


120 See U.F.T.A. § 4, comment 3, 7A U.L.A. 653-54 (1985); Alces & Dorr, supra note 9, at 540-41.
of the transaction which suggest an intent to hinder, delay, or defraud must also be considered. That point seems to be obvious, but that guaranty and LBO commentaries focus on constructive rather than intentional fraud intimates a lack of sensitivity to the relationship between the two bases for avoiding some commercial transfers as fraudulent. Once the relationship is obscured and transactors and their counsel focus only on the objective indicia of fraud—the constructive fraud provisions of the UFTA—important commercial interests may be compromised because the role of intentional fraud theories is ignored.

Analysis has generally focused\(^\text{121}\) on whether the transfer was for less than reasonably equivalent value\(^\text{122}\) and rendered the transferor insolvent or nearly insolvent.\(^\text{123}\) Those considerations only matter when a court is deciding whether the transfer was constructively fraudulent. The focus disregards the interrelationship between constructive indicia and intent: constructive indicia are a surrogate for intent and their absence in a given situation does not mean that intent may not be shown. To suggest otherwise is to confuse the alternative bases of avoiding fraudulent transfers, and to deny unsecured creditors in the guaranty and LBO contexts access to a viable theory. Moreover, the focus on constructive fraud necessarily emphasizes what I deem to be too often formal inquiries concerning the transferor’s solvency. Just as commercial bankruptcy law has limited the importance of insolvency, so should fraudulent transfer law.\(^\text{124}\)

Further, what constitutes reasonably equivalent value is unclear. Should the benefit realized by an acquired corporation through introduction of new management constitute value reasonably equivalent to the value of the assets hypothecated to accommodate the transaction? It would seem to depend on one’s perspective. Perhaps it would be appropriate to measure the value of that infusion of new talent by what it would demand in the marketplace.\(^\text{125}\) But even that would be an impossible task in the LBO setting.

Just because the shortcomings of constructive fraud analysis might be manifest does not necessarily mean that intentional-generic fraud analysis would be any better under the UFTA intent-to-defraud

\(^{121}\) See supra text accompanying notes 12-56.
\(^{124}\) See Alces & Dorr, supra note 9, at 542-43, 557-63.
\(^{125}\) See Carlson, supra note 36, at 95 ("LBO produces new management with a credible chance to increase cash flow, thereby further improving the position of the unsecured creditors."). Baird & Jackson, supra note 37, at 853 ("With the buyout may come more streamlined and more effective management.").
provision. In order to see how generic fraud principles could work in the UFTA to address the problems in the upstream guaranty and LBO settings, it is necessary to consider how the UFTA provisions might be adjusted to reach the most sensible results. The hypothetical bad man—counsel for the unsecured creditor—would want to use the intentional fraud provision to get unlimited relief. To avoid that result but at the same time to provide a useful framework for reviewing the impact of upstream guaranties and LBOs on unsecured creditors, it is worthwhile to consider how the UFTA might be adjusted to balance the implicated commercial interests.

D. Application of UFTA Provisions to Upstream Guaranties and Leveraged Business Acquisitions

Counsel for an unsecured creditor whose rights have been prejudiced by an upstream guaranty or LBO could urge a court to void the transaction as an intentional effort to defraud the unsecured creditor and those similarly situated. Such a “bad man” would argue that the effect of the guaranty or LBO was to remove from the unsecured creditor’s reach a considerable unencumbered asset pool and replace it with a subordinating all-assets security interest. The secured creditor took advantage of its superior knowledge and control position to impair unsecured creditors’ positions for the sake of improving the secured creditor’s own position and with no substantial benefit flowing to the debtor/transferor. Irrespective of the constructive fraud tests concerning insolvency and transfer of reasonably equivalent value, the unsecured creditors have suffered. Crucial from the perspective of generic fraud law, the all-assets secured party as well as the debtor actually intended that the guaranty or LBO would result in secured creditors being protected at unsecured creditors’ expense. In fact the debtor’s business very likely could not have continued to function and feed the lien of the all-assets secured party but for the services and materials provided by unsecured creditors.

In the upstream guaranty situation, the guarantor corporation’s assets are encumbered in order to gain an extension of credit to the parent corporation. The guarantor receives no direct benefit from the transaction, though there is some argument that the guarantor must benefit from the transaction or it would not agree to execute the guaranty.126 Even if true, such a conclusion ignores the perspective of unsecured creditors prejudiced by the upstream guaranty: the corporate guarantor has given up something in which the unsecured creditors

126 See Coquillette, supra note 19, at 435-38.
had an interest but has not given up anything of real value to the directors who executed the guaranty. The directors were not playing with their own money but with the unsecured creditors’ money. If the guarantor corporation went insolvent before the guaranty was executed, the corporation’s shareholders would stand behind the unsecured creditors’ claims; after the guaranty they stand behind the secured creditor. In either case they would receive little or nothing upon liquidation. But the share which the unsecured creditors would realize post-guaranty is significantly affected by the all-assets security interest of the lender who received the guaranty. 127

If a court would agree with the badman, unsecured creditor’s counsel, that an upstream guaranty constitutes a transaction intended to defraud the unsecured creditors, what limits, if any should be imposed on the theory’s operation? Certainly unsecured creditors whose claims mature after the guaranty should not be heard to complain because they could have searched, and perhaps did search, UCC filing records to determine whether the guarantor/debtor’s assets were encumbered. If after finding the lender’s security interest such a post-guaranty unsecured creditor was concerned with the guarantor’s financial well-being, the unsecured creditor could have inquired further of the guarantor corporation. But the case is different for unsecured creditors with mature claims prejudiced by and at the guaranty transaction. Such creditors should be able to use the intentional fraudulent transfer theory to set aside the upstream guaranty because the debtor and secured party intended to destroy their valuable claim against the debtor in favor of the all-assets secured creditor. The transaction afforded the debtor no valuable—but at best a speculative—counterbalancing benefit to which unsecured creditors could look in the event the guaranty were enforced by the secured party.

The story is much the same for leveraged business acquisitions.

127 You might wonder whether all article 9 all-assets secured transactions so prejudice unsecured creditors’ interests that they should be subject to fraudulent transfer attack. Of course the response to that speculation is that in a commercial finance transaction the debtor receives value on account of the grant of a security interest and the secured creditor can never recover more than that value should the creditor foreclose the security interest. But either an upstream guaranty or a subordinating all-assets security interest may impair unsecured creditors’ positions. Arguably, the UFTA’s drafters were sensitive to the possibility. Section 4, comment 3, focuses on the secured transaction from the perspective of the affected unsecured creditors and suggests that such an arrangement may betray an intent to defraud. If the unsecured creditor can show that the all-assets security interest was granted to “hinder, delay or defraud,” the transfer will be avoidable as intentionally fraudulent. Doesn’t an all-assets lender intend to protect its own position and often necessarily at the expense of unsecured creditors? Aggressive use of the intentional fraud provision might lead to an avoidance of a significant number of article 9 transactions. Courts should not get carried away from the perspective of 20-20 hindsight.
While the acquired company may benefit from new management, it is hard for unsecured creditors, quite literally, to bank on that. Therefore the existing unsecured creditors have, once again, been deprived of a benefit. Again, however, the problem is with limiting the scope of the intentional fraudulent transfer attack; only unsecured creditors with matured claims at the LBO should have standing to avoid the transaction.\textsuperscript{128}

To accommodate and limit the offensive strategy available to unsecured creditors seeking to avoid an upstream guaranty or LBO, the UFTA must be amended by a provision that would operate much like proximate causation in tort law. Rather than providing all creditors, both present and future, the right to avoid an upstream guaranty or LBO, section 4(a)(1) should be amended to provide that only creditors with matured claims at the time of the guaranty or LBO have the right to set aside the transaction.\textsuperscript{129} A new subsection 4(a)(1) would read: “with actual intent to hinder, delay, or defraud any creditor of the debtor to the extent that the loss suffered by such creditor was proximately caused by the transaction.” Focusing on the causal relationship between the transaction prejudicing the unsecured creditor and the loss or impairment he suffers will insulate upstream guaranties and LBOs from attack by post-transaction creditors. That conclusion is consistent with tort law because while liability for intentional wrongdoing may be sweeping, it does not entail liability for losses not caused by the malfeasance.\textsuperscript{130}

Alternatively, section 8 could be amended to provide a defense for the transferee whose acquisition of an interest in the debtor/transferee’s property did not cause a loss to the debtor’s unsecured creditors. If the creditors continued to extend unsecured credit to the debtor after the guaranty or LBO with knowledge or notice of the transaction their loss was caused by their own imprudence, not by the transferee’s actions. Also to be insulated from liability is a transferee who provides notice of the guaranty or LBO to the debtor’s creditors in a manner enabling the unsecured creditors to protect their posi-

\textsuperscript{128} This position is opposed to Schechter’s suggestion. See supra text accompanying note 108. Schechter would also allow unsecured creditors whose claims had not matured at the time of the LBO to avoid the transaction.

\textsuperscript{129} It is not at all clear, however, that the provision would concern only upstream guaranties and LBOs. Certainly all transactions which effect the same result—sacrificing the interests of trade-unsecured creditors in a manner providing them marketable value in exchange for subordination of their interests—should be proscribed by intentional fraudulent transfer law.

\textsuperscript{130} W. Keeton, D. Dobbs, R. Keeton & D. Owen, Prosser and Keeton on Torts § 41 (5th ed. 1984) (it is a fundamental proposition of tort law that an actor is not responsible for damages she did not cause).
tions. The Credit Managers Association\textsuperscript{131} court expressly noted that the acquired corporation publicized the buyout to firms that did business with it. The result in that case brought by post-LBO creditors is entirely consistent with the analysis suggested in this Article. Finally, consider the Third Circuit's recent decision in the latest round of the Gleneagles litigation,\textsuperscript{132} invalidating mortgage interests as intentionally fraudulent because they lacked consideration and the transferor and transferee knew of the creditors' claims and that the creditors could not be paid.\textsuperscript{133} Consideration to the debtor was lacking because a substantial portion of the loan proceeds were going to former shareholders, the classic leveraged business acquisition.\textsuperscript{134} The analysis suggested in this Article would clarify and vindicate that result in all upstream guaranty and LBO cases.

CONCLUSION

If nothing else, the argument suggested in this Article—likely to be made by the "bad man" counsel for unsecured creditors seeking to attack an upstream guaranty or LBO—is a bit myopic. It does not pursue a thorough policy analysis invoking the gods of microeconomic or even natural law theory to decide whether and when guaranties and LBO's should be avoidable as fraudulent transactions. Instead, I started with the premise that plaintiff's counsel should be expected to assert all available plausible arguments; then I went about describing the basis of a plausible argument from generic fraud law. Finally I observed that the argument could go too far and I suggested a way to amend the UFTA to avoid unreasonable application of generic fraud law.

There is, of course, a downside to trying to anticipate the bad man's arguments: perhaps plaintiff's counsel would be given ideas they would not have developed on their own. One might also be accused of setting up straw men for the purpose of knocking them down. Nonetheless it seems preferable to anticipate and then respond rather than to sit back and await the worst. Had the UFCA drafters

\textsuperscript{131} 629 F. Supp. 175, 180 (C.D. Cal. 1985).


\textsuperscript{133} Id. at 1304.

\textsuperscript{134} We have decided that the district court reached the right conclusion here for the right reasons. It determined that IIT did not act in good faith because it was aware, first, that the exchange would render Raymond insolvent, and second, that no member of the Raymond Group would receive fair consideration. We believe that this determination is consistent with the statute and case law. Id. at 1296.
anticipated the *Durrett*\(^{135}\) scenario, commercial law could have been spared the uncertainty which prevailed until the UFTA resolved the issue.\(^{136}\)

\(^{135}\) Durrett v. Washington Nat'l Ins. Co., 621 F.2d 201 (5th Cir. 1980) (invalidating foreclosure sale under § 67d of the Bankruptcy Act as a fraudulent conveyance because property was sold for only 57.7% of its market value).

\(^{136}\) The UFTA resolved the *Durrett* issue by declaring that all “regularly conducted” foreclosure sales were unassailable. U.F.T.A. § 3, 7A U.L.A. 650. This may resolve little. See Alces & Dorr, supra note 9. Enterprising counsel for the plaintiff need only argue that the foreclosure sale was not “regularly conducted” and a “noncollusive” one, and the issue is again open to litigation.