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COMMENT

Avoidability of Intercorporate Guarantees Under Sections 548(a)(2) and 544(b) of the Bankruptcy Code

I. INTRODUCTION

A corporation seeking to borrow funds is often unable to provide a prospective lender with independent assurance that it will repay the indebtedness. Consequently, the lender may require a loan guarantee¹ from a third party before extending credit to the corporate borrower. More specifically, the lender may request guarantees of repayment from the borrower's principal shareholders, parent corporation,² subsidiary corporations,³ or affiliated corporations.⁴ Intercorporate guarantees⁵ are a common means of assuring a lender that its loan will be repaid.⁶ Nevertheless, reliance on intercorporate guarantees does not eliminate all risks to the lender. In addition to the clear possibility that the guarantor may not possess sufficient assets to satisfy its obligation if and when the borrower defaults, there is a risk that the guarantor may avoid its obligation in bankruptcy because guarantees are obligations subject to avoidance as fraudulent conveyances under sections 548⁷ and 544(b)⁸ of the Bankruptcy Code ("Code").

This Comment is intended as a guide for analyzing the avoidability of inter-

1. A "guarantee" is

[a] promise to answer for payment of debt or performance of obligation if person liable in first instance fails to make payment or perform obligation. An undertaking by one person to be answerable for the payment of some debt, or the due performance of some contract or duty, by another person, who himself remains liable to pay or perform the same.

BLACK'S LAW DICTIONARY 634 (5th ed. 1979).

A general discussion of the law of guarantee contracts is beyond the scope of this Comment. For an examination of the topic, see Alces, *The Efficacy of Guaranty Contracts in Sophisticated Commercial Transactions*, 61 N.C.L. REV. 655 (1983).

2. A "parent corporation" is a corporation "which has working control through stock ownership of its subsidiary corporations." BLACK'S LAW DICTIONARY 1004 (5th ed. 1979).

3. A "subsidiary corporation" is a corporation "in which another corporation (i.e., parent) owns at least a majority of the shares, and thus has control." *Id.* at 1280.

4. "Affiliated" or "brother-sister" corporations are "[t]wo or more corporations owned and effectively controlled by one or more individuals." *Id.* at 174.

5. "Intercorporate guarantee," as used in this Comment, refers to a guarantee by one corporation of the debt of a related corporation.

6. Professor Rosenberg has written that an alternative to intercorporate guarantees is "joint and several liability among all the entities in the corporate group." He has noted that joint and several liability, however, is not a solution to the fraudulent conveyance problems discussed in this Comment. Joint obligors share liability equally, but usually do not receive equal benefits from having guaranteed the intercorporate debt; therefore, the transaction is vulnerable to fraudulent conveyance attack in the same manner as discussed in this Comment with respect to guarantees. Rosenberg, *Intercorporate Guaranties and the Law of Fraudulent Conveyances: Lender Beware*, 125 U. PA. L. REV. 235, 235 n.1 (1976).

7. 11 U.S.C.A. § 548 (West 1979 & Supp. 1986).

8. 11 U.S.C. § 544(b) (1982).

corporate guarantees under sections 548(a)(2) and 544(b) of the Code.⁹ The law in this area is relevant both to those who represent a debtor in bankruptcy¹⁰ that has incurred guarantee obligations and to those representing lenders considering guaranteed loan transactions.

Part II of this Comment briefly discusses who may challenge an obligation under Code sections 548 and 544(b). Part III examines the law concerning the avoidability of intercorporate guarantees under section 548(a)(2), which authorizes the trustee in bankruptcy to avoid certain transfers or obligations deemed to be constructively fraudulent under the Code. Part IV discusses section 548(c) which, in some cases, permits the obligee of an obligation deemed fraudulent under section 548(a) to enforce the obligation to the extent the obligee gave value. Part V examines the avoidability of guarantees under section 544(b), which permits the trustee to avoid conveyances and obligations deemed to be fraudulent under applicable state law. Last, Part VI presents several recommendations for the lender and lender's counsel when entering into loan guarantee transactions. By incorporating these recommendations into the loan guarantee process, a lender can minimize the vulnerability of such guarantees to fraudulent conveyance challenges.

II. WHO MAY CHALLENGE AN OBLIGATION UNDER SECTIONS 548 AND 544(b)?

Bankruptcy Code sections 548 and 544(b) both explicitly authorize the trustee in bankruptcy to maintain an action to avoid certain transfers and obligations of the debtor.¹¹ Further, in Chapter 11¹² cases the debtor in possession may exercise the avoidance powers conferred in sections 548 and 544(b).¹³ The Code does not expressly permit creditors to assert fraudulent conveyance claims.¹⁴ The courts, however, have implied such a right under certain circum-

9. Avoidability of guarantees under fraudulent conveyance law is also discussed in the following articles: Alces, *supra* note 1 (general discussion of the law of guarantee contracts that includes an examination of the insolvency requirement of § 548(a)(2) of the Code); Cherin, Ash & Burlingame, *Enforceability of Guarantees and Other Credit Support Provided Among Members of a Corporate Group: A Bibliography*, 34 BUS. LAW. 2029 (1979) (bibliography of articles and cases concerning guarantees and the law of equitable subordination and fraudulent conveyances); Coquillette, *Guaranty of a Security for the Debt of a Parent Corporation by a Subsidiary Corporation*, 30 CASE W. RES. L. REV. 433 (1980) (examination of several pitfalls posed by upstream guarantees that includes a discussion of the vulnerability of such guarantees to fraudulent conveyance challenge under the Uniform Fraudulent Conveyance Act); Rosenberg, *supra* note 6 (discussion of guarantees and the Uniform Fraudulent Conveyance Act); Comment, *Guarantees and Section 548(a)(2) of the Bankruptcy Code*, 52 U. CHI. L. REV. 194 (1985) (theoretical discussion cogently advocating an application of § 548(a)(2) that has not been adopted by the courts).

10. A "debtor" is a "person or municipality concerning which a case under [the Code] has been commenced." 11 U.S.C. § 101(12) (1982). The term "'person' includes individual, partnership, and corporation, but does not include governmental unit." 11 U.S.C.A. § 101(33) (West Supp. 1986).

11. Both §§ 548 and 544(b) begin: "The trustee may avoid [certain] transfer[s] and] . . . obligation[s] . . . made or incurred . . ." by the debtor. 11 U.S.C.A. §§ 544(b), 548(a) (West 1979 & Supp. 1986) (emphasis added).

12. *Id.* §§ 1101-1174. Chapter 11 governs bankruptcy reorganizations.

13. With a few exceptions not relevant to this discussion, a debtor in possession has all the rights, powers, and duties of a bankruptcy trustee. 11 U.S.C.A. § 1107 (West Supp. 1986).

14. See 11 U.S.C.A. §§ 544(b), 548(a) (West 1979 & Supp. 1986) .

stances. Generally, a creditor or creditors' committee may bring an action to avoid a transfer or obligation when the trustee or debtor in possession has failed to bring the action, thereby not fulfilling the statutory duty to collect the assets of the estate.¹⁵ A debtor in possession, for example, may be reluctant to bring an avoidance action against its shareholders or against creditors whose cooperation is necessary to a successful reorganization.¹⁶ The creditor or creditors' committee may not bring the action on its own behalf; the action must be brought on behalf of the debtor.¹⁷ Some jurisdictions require court approval before a creditor or creditors' committee may bring an adversary proceeding to recover a fraudulent conveyance.¹⁸

Several courts have examined a bankruptcy court's power to review the actions of a trustee or debtor in possession for abuse of discretion, and have implied from this power a right of creditors to bring an avoidance action.¹⁹ Other courts have implied such a right in Chapter 11 cases from section 1109(b) of the Code, which provides that "[a] party in interest, including . . . a creditors' committee . . . [or] a creditor . . . may raise and may appear and be heard on any issue in a case under this chapter."²⁰

15. See, e.g., *William B. Tanner Co. v. United States (In Re Automated Business Sys.)*, 642 F.2d 200, 201 (6th Cir. 1981) ("Generally, if a trustee in bankruptcy defaults in the performance of any duty, such as seeking to set aside a fraudulent transfer, 'the court may upon application direct him in his duty or, if he be recalcitrant, remove him for disobedience, or permit a creditor to act in his name.' " (quoting 2A COLLIER ON BANKRUPTCY ¶ 47.03, at 1744.1 (14th ed. 1978))); *Creditors' Comm. for Jermoo's Inc. v. Jermoo's Inc. (In Re Jermoo's Inc.)*, 38 Bankr. 197 (Bankr. W.D. Wis. 1984); *In Re Jones*, 37 Bankr. 969, 973 (Bankr. N.D. Tex. 1984) (permitting creditors' committee to assert preference and fraudulent conveyance claims when debtor in possession "eschewed" right to do so); *In Re Evergreen Valley Resort, Inc.*, 27 Bankr. 75 (Bankr. D. Me. 1983); *Official Comm. of Unsecured Creditors of Joyanna Holitogs, Inc. v. I. Hyman Corp. (In Re Joyanna Holitogs)*, 21 Bankr. 323 (Bankr. S.D.N.Y. 1982); *Committee of Unsecured Creditors v. Monsour Medical Center (In Re Monsour Medical Center)*, 5 Bankr. 715 (Bankr. W.D. Pa. 1980).

16. *In Re Calvary Temple Evangelistic Ass'n*, 47 Bankr. 520, 523 (Bankr. D. Minn. 1984).

17. See, e.g., *American Nat'l Bank v. Mortgage America Corp. (In Re Mortgage America Corp.)*, 714 F.2d 1266 (5th Cir. 1983); *William B. Tanner Co. v. United States (In Re Automated Business Sys.)*, 642 F.2d 200 (6th Cir. 1981); *Creditors' Comm. for Jermoo's Inc. v. Jermoo's Inc. (In Re Jermoo's Inc.)*, 38 Bankr. 197 (Bankr. W.D. Wis. 1984); *Official Comm. of Unsecured Creditors of Joyanna Holitogs, Inc. v. I. Hyman Corp. (In Re Joyanna Holitogs, Inc.)*, 21 Bankr. 323 (Bankr. S.D.N.Y. 1982); *Committee of Unsecured Creditors v. Monsour Medical Center (In Re Monsour Medical Center)*, 5 Bankr. 715 (Bankr. W.D. Pa. 1980).

18. E.g., *William B. Tanner Co. v. United States (In Re Automated Business Sys.)*, 642 F.2d 200 (6th Cir. 1981); *Unsecured Creditors' Comm. v. Farmers Sav. Bank (In Re Toledo Equip. Co.)*, 35 Bankr. 315, 320 (Bankr. N.D. Ohio 1983) (application by creditors' committee for leave to maintain action must show that the committee has requested the debtor to bring the action, that the debtor has refused, that a "colorable claim" exists, and that the debtor's refusal is an abuse of discretion); *In Re Evergreen Valley Resort, Inc.*, 27 Bankr. 75 (Bankr. D. Me. 1983); *Segarra v. Banco Central Y Economicas (In Re Segarra)*, 14 Bankr. 870 (Bankr. P.R. 1981); *Committee of Unsecured Creditors v. Monsour Medical Center (In Re Monsour Medical Center)*, 5 Bankr. 715 (Bankr. W.D. Pa. 1980); cf. *In Re Jones*, 37 Bankr. 969 (Bankr. N.D. Tex. 1984) (approving right of creditors' committee to sue for recovery of alleged preferences and fraudulent conveyances *nunc pro tunc*).

19. E.g., *Creditors' Comm. for Jermoo's Inc. v. Jermoo's Inc. (In Re Jermoo's Inc.)*, 38 Bankr. 197 (Bankr. W.D. Wis. 1984); *Unsecured Creditors' Comm. v. Farmers Sav. Bank (In Re Toledo Equip. Co.)*, 35 Bankr. 315 (Bankr. N.D. Ohio 1983); *Committee of Unsecured Creditors v. Monsour Medical Center (In Re Monsour Medical Center)*, 5 Bankr. 715 (Bankr. W.D. Pa. 1980).

20. 11 U.S.C. § 1109(b) (1982); see, e.g., *Chemical Separations Corp. v. Foster Wheeler Corp. (In Re Chemical Separations Corp.)*, 32 Bankr. 816 (Bankr. E.D. Tenn. 1983); *Official Comm. of*

III. SECTION 548(A)(2)

Section 548(a) provides two avenues for attacking fraudulent transfers and obligations. Section 548(a)(1) allows the bankruptcy trustee to avoid transfers or obligations incurred by the debtor within a year preceding the filing of a bankruptcy petition "with actual intent to hinder, delay, or defraud" creditors.²¹ Section 548(a)(2) permits the trustee to avoid transfers and obligations that are deemed constructively fraudulent.²² A transfer or obligation is constructively fraudulent if it was made or incurred (1) "on or within one year before the date of the filing of the petition,"²³ (2) in exchange for "less than a reasonably equivalent value,"²⁴ (3) at a time when the debtor was in poor financial condition.²⁵ Under section 548(a)(2), the trustee need not prove actual intent to defraud creditors.²⁶

Section 548 of the Code is in substantial part a reenactment of section 67d of the Bankruptcy Act.²⁷ It is also similar to the Uniform Fraudulent Conveyance Act (UFCA).²⁸ Accordingly, cases decided under section 67d and the UFCA often are instructive in interpreting section 548. However, because there are some important differences among the three enactments, section 67d and UFCA cases must be used with care in interpreting section 548.²⁹

Each of the three elements of a section 548(a)(2) action is discussed below. In addition to making comparisons between section 548 and section 67d and the UFCA, the discussion draws conclusions about the extent to which section 67d and UFCA precedents are useful for construction of section 548.

A. *Time At Which An Obligation Is Incurred*

In an action to avoid an obligation under section 548(a)(2), the trustee first must show that the debtor incurred the obligation "on or within one year before" the debtor filed its petition in bankruptcy.³⁰ Generally, a guarantor in-

Unsecured Creditors of Joyanna Holitogs, Inc. v. I. Hyman Corp. (*In Re Joyanna Holitogs, Inc.*), 21 Bankr. 323 (Bankr. S.D.N.Y. 1982).

Section 1103(c) of the Code enumerates the rights and powers of creditors' committees in Chapter 11 cases. The right to institute an adversary proceeding to exercise trustee avoidance powers is not among the listed powers. See 11 U.S.C.A. § 1103(c) (West 1979 & Supp 1986).

21. 11 U.S.C.A. § 548(a)(1) (West Supp. 1986). Section 548(a)(1) and the law concerning transfers made or obligations incurred with the intent to defraud creditors is beyond the scope of this Comment.

22. See 11 U.S.C.A. § 548(a)(2) (West 1979 & Supp. 1986).

23. See *id.*

24. See *id.* § 548(a) (West Supp. 1986).

25. 11 U.S.C. § 548(a)(2)(A) (1982).

26. See *id.* § 548(a)(2)(B).

27. S. REP. NO. 989, 95th Cong., 2d Sess. 89 (1978); H.R. REP. NO. 595, 95th Cong., 1st Sess. 375 (1977), reprinted in 1978 U.S. CODE CONG. & AD. NEWS 5787, 5875, 6331; see 11 U.S.C. § 107d (1976) (repealed 1978).

28. See UNIF. FRAUDULENT CONVEYANCE ACT, 7A U.L.A. 427 (1985).

29. See *infra* notes 41-44, 119, 133-141, 145-149, 152-154, 166-169, 175-176 and accompanying text.

30. 11 U.S.C.A. § 548(a) (West Supp. 1986) begins: "The trustee may avoid any transfer of an

curs an obligation when it guarantees an existing debt of another.³¹ When a guarantor guarantees a loan simultaneously with the making of the loan, it incurs an obligation within the meaning of section 548 at the time the loan is made.³² In either case, the entire guarantee is subject to avoidance if made on or within one year prior to bankruptcy.

When a guarantor guarantees a line of credit extended by a lender to a borrower, the guarantor incurs an obligation whenever the borrower draws on the credit line.³³ Thus, it follows that a guarantee of a credit line is subject to

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"

The day on which the debtor files the petition is not counted in measuring the one year period; an obligation incurred on the same date one year before the debtor filed is subject to avoidance under § 548. See *Dutcher v. Wright*, 94 U.S. 553 (1877) (interpreting the four month period prescribed by § 35 of the Bankruptcy Act of 1867); *In Re Queen City Shoe Mfg. Corp.*, 46 F. Supp. 961 (D.N.H. 1942).

31. See, e.g., *Lawless v. Eastern Milk Producers Coop. Ass'n (In Re Stop-N-Go of Elmira, Inc.)*, 30 Bankr. 721 (Bankr. W.D.N.Y. 1983). In *Stop-N-Go of Elmira, Inc. (Stop-N-Go)*, the debtor, was owned by three individuals and Maple Farms, Inc. (Maple). Maple was owned by the same three individuals. Maple executed a note as evidence of a debt it owed to Eastern Milk Producers for past deliveries of milk, and Stop-N-Go later guaranteed the note. Applying the fraudulent conveyance provision of the Bankruptcy Act, the court found that Stop-N-Go incurred an obligation when it guaranteed Maple's debt. *Id.* at 725.

32. See, e.g., *Rubin v. Manufacturers Hanover Trust Co.*, 661 F.2d 979 (2d Cir. 1981).

33. *Id.* *Rubin v. Manufacturers Hanover Trust Co.*, 661 F.2d 979 (2d Cir. 1981), involved the bankruptcy of two affiliated corporations, U.S.N., Inc. (USN) and Universal Money Order Co., Inc. (UMO). USN and UMO both were engaged in issuing and selling money orders and were wholly owned subsidiaries of International Express Co. (International), a holding company. John Trent and Eugene Skowron owned 89% of International. Trent and Skowron also owned Empire Small Business Investment Corp. (Empire), a holding company with a 50% interest in National Payroll Services Ltd. (National) and a 33 1/2% interest in Two Checking Corp. (Two). Both National and Two also were holding companies. Each wholly owned a number of check cashing corporations that, in turn, were USN sales agents. *Id.* at 980-87.

The check cashing corporations needed a continuous flow of cash with which to cash checks and sell money orders. Trent and Skowron arranged with Manufacturer's Hanover Trust Co. (MHT) for short term bank financing for the check cashers. Trent and Skowron personally guaranteed the loan lines. In 1972 MHT obtained a series of guarantees and cross-guarantees from a number of the entities in the Trent/Skowron network. USN and UMO executed cross-guarantees and guaranteed the debts of Trent and Skowron who, in turn, guaranteed the debts of USN and UMO. *Id.*

USN and UMO filed bankruptcy petitions in January 1977. The trustees sought to avoid the guarantees executed by USN and UMO under § 67d of the Bankruptcy Act. MHT argued that the debtors incurred obligations at the time they made the guarantees in 1972, more than a year before bankruptcy. The court rejected MHT's contention, noting that UMO executed another guarantee of Trent's and Skowron's debts within a year of filing the petition. The court also noted that on December 31, 1976, USN executed an additional guarantee of loans made on that day by MHT to the check cashing corporations. The court stated:

[E]ven if we were to agree with MHT that the execution of the guarantees constituted the operative statutory events, we would probably conclude that those events occurred when the last guarantees were executed late in 1976, well within the one-year period, and that the issuers "made" transfer[s]" at those times, at least to the extent that they gave new collateral.

Id. at 990.

The trustees contended that the debtors incurred obligations whenever the check cashers drew on the loan lines. In September and December of 1976, within one year of the debtors filing for bankruptcy, National and Two had drawn on the credit lines. The court agreed with the trustees, stating:

Whenever National . . . [and] Two . . . borrowed under the loan lines, they of course incurred an obligation of repayment under the terms of their financing agreements with

avoidance under section 548 to the extent that the borrower draws on the line during the year before the guarantor files a bankruptcy petition.

B. Reasonably Equivalent Value

Section 548(a)(2) requires that the trustee prove that the debtor received "less than a reasonably equivalent value" in exchange for the challenged obligation.³⁴ The legislative history of section 548 does not indicate the reason for this requirement.³⁵ Its apparent purpose is to limit the applicability of section 548(a)(2) to those transactions that deplete the debtor's assets. A debtor's assets are unaffected when it receives approximately equal value in return for incurring an obligation. Creditors may seek satisfaction of the debtor's obligations from the new assets rather than from the old, transferred ones. Conversely, the debtor's assets are depleted to the detriment of other creditors when it does not receive a reasonably equivalent benefit for value given.³⁶ Accordingly, such transactions are subject to avoidance even without proof of an actual intent to defraud creditors.

The Code does not define "reasonably equivalent value." The United States Court of Appeals for the Second Circuit has noted that the term means more than the "consideration" necessary to support a simple contract.³⁷ Although a contract generally is enforceable even if it is supported only by minimal consideration,³⁸ an obligation is subject to avoidance under section 548(a)(2) unless the debtor receives approximately equal value for the value given.³⁹ Section 548(d)(2)(A) of the Code defines "value" as "property, or satisfaction or securing of a present or antecedent debt of the debtor, . . . not [including] an unperformed promise to furnish support to the debtor or to a relative of the debtor."⁴⁰

In determining whether cases decided under section 67d(2) of the Bankruptcy Act are helpful in interpreting the "less than a reasonably equivalent value" requirement of Code section 548(a)(2), it should be noted that section 548(a)(2) differs from section 67d(2) in several respects. Section 67d(2) provided that an obligation incurred by a debtor was subject to avoidance "if made or

MHT. At the same time, as principal guarantors of the loan line debts under the system of guarantees, Trent and Skowron became contingently liable to discharge the check casher's obligations if those firms defaulted. Similarly, USN and UMO, as secondary guarantors, became contingently liable

Id. at 990.

34. 11 U.S.C. § 548(a)(2)(A) (1982) provides that "[t]he trustee may avoid any transfer . . . or any obligation . . . if the debtor . . . (2)(A) received less than a reasonably equivalent value in exchange for such transfer or obligation."

35. See S. REP. NO. 989, 95th Cong., 2d Sess. 89 (1978); H.R. REP. NO. 595, 95th Cong., 1st Sess. 375 (1977), reprinted in 1978 U.S. CODE CONG. & AD NEWS 5787, 5875, 6331.

36. *Rubin v. Manufacturers Hanover Trust Co.*, 661 F.2d 979, 991 (2d Cir. 1981); see also Comment, *supra* note 9, at 197-98 (discussing the avoidability of guarantees under § 548 (a)(2)).

37. *Rubin v. Manufacturers Hanover Trust Co.*, 661 F.2d 979, 991 (2d Cir. 1981); see also *In Re Nelson*, 24 Bankr. 701, 702 (Bankr. Div. Or. 1982) (noting that the meaning of "fair value" under § 548(a)(2)(A) is distinct from the contract principle of consideration).

38. See, e.g., *Jewel Box Stores Corp. v. Morrow*, 272 N.C. 659, 158 S.E.2d 840 (1968).

39. 11 U.S.C. § 548(a)(2)(A) (1982) (text quoted *supra* note 34).

40. *Id.* § 548(d)(2)(A).

incurred *without fair consideration*.”⁴¹ The Act further stated that “consideration [other than consideration received as security] . . . is fair . . . when, in *good faith*, and as a *fair equivalent* therefore, property is transferred or an antecedent debt is satisfied.”⁴² Thus, the Code’s “less than a reasonably equivalent value” requirement is less demanding than the Act’s “without fair consideration” requirement in that the Code does not insist that the obligation have been incurred in good faith.

Any difference between the Code’s “reasonably equivalent” standard and the Act’s “fair equivalent” standard apparently is insignificant.⁴³ Thus cases decided under the Act in which the finding of a lack of “fair consideration” did not depend on the absence of good faith are particularly useful in evaluating section 548 cases. Section 67d cases in which courts concluded that a transaction was supported by fair consideration are also instructive in interpreting the “less than a reasonably equivalent value” requirement of section 548(a)(2).

Section 67d of the Bankruptcy Act was patterned after sections 3 and 4 of the Uniform Fraudulent Conveyance Act (UFCA).⁴⁴ Therefore, “fair consideration” determinations under the UFCA also are useful authority for settling the issue of what is a “reasonably equivalent value” under Code section 548.

Resolving a question of “reasonably equivalent value,” although frequently a technically complex matter, is a conceptually simple task in the typical two-party transaction. For example, suppose Debtor transfers a car to Creditor in exchange for one thousand dollars. Assume that Debtor was insolvent at the time of the transfer, and that he or she filed a petition in bankruptcy six months later. In an avoidance action by the bankruptcy trustee under section 548(a)(2), the trier of fact would need only to compare the value of Debtor’s car at the time of the transaction with the amount received for the car. If the amount received is not reasonably equivalent to the value of the car, the transfer will be avoided.

Three-party transactions, involving obligations that benefit third parties, are more difficult to analyze. Consider the following example: Debtor agrees to pay Creditor one thousand dollars for giving Third Party a car. Third Party uses the car for his or her own business as well as to help Debtor in Debtor’s business. Debtor was insolvent at the time he or she incurred the obligation to

41. 11 U.S.C. § 107d(2) (1976) (repealed 1978) (emphasis added).

42. *Id.* § 107d(1)(e)(1) (1976) (repealed 1978) (emphasis added).

The Act defined “fair consideration” somewhat differently with regard to security. Section 67d(1)(e)(2) provided that “consideration . . . is fair . . . when such property or obligation is received in *good faith* to secure a present advance or antecedent debt in an amount *not disproportionately small* as compared with the value of the property or obligation obtained.” *Id.* § 107d(1)(e)(2) (1976) (repealed 1978) (emphasis added). Thus, with reference to security, the present Code appears to be stricter than the Act in that it applies the “reasonably equivalent value” standard to all transfers and obligations. *See* 11 U.S.C. § 548(a)(2)(A) (1982). On the other hand, the current provision is less demanding in that it imposes no good faith requirement. *Id.*

43. *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). It has been suggested that the framers of the Code substituted the “reasonably equivalent value” terminology for the Act’s “fair consideration” language simply to effect a clean break from the good faith component of the Act’s “without fair consideration” requirement. *See* 9A AM. JUR. 2D *Bankruptcy* § 564 (1980).

44. UNIF. FRAUDULENT CONVEYANCE ACT §§ 3, 4, 7A U.L.A. 448, 474 (1985).

Creditor and filed a petition in bankruptcy within a year of the transaction. The question whether the bankruptcy trustee may avoid the obligation depends on whether Debtor received a reasonably equivalent value for the one thousand dollar payment even though the payment benefited Debtor only indirectly.

As a general rule, obligations incurred solely for the benefit of third parties are not supported by a reasonably equivalent value.⁴⁵ In *Rubin v. Manufacturers Hanover Trust Co.*⁴⁶ the United States Court of Appeals for the Second Circuit stated: "The cases recognize, however, that a debtor may sometimes receive . . . [a reasonably equivalent value] even though the consideration given for his property or obligation goes initially to a third person."⁴⁷ Section 548(a)(2) does not require that an obligation benefit the obligor directly. Rather, value the obligor received indirectly as a result of incurring the obligation may be considered in determining whether it received a reasonably equivalent value.⁴⁸ The obligor need not be contractually entitled to benefits before those benefits may be counted in the reasonably equivalent value equation. Any economic benefits⁴⁹ derived as a result of the transaction may be considered.⁵⁰

45. See, e.g., *Rubin v. Manufacturers Hanover Trust Co.*, 661 F.2d 979, 991 (2d Cir. 1981); *Klein v. Tabatchnick*, 610 F.2d 1043, 1047 (2d Cir. 1979); *Central Nat'l Bank v. Coleman (In Re B-F Bldg. Corp.)*, 312 F.2d 691, 694 (6th Cir. 1963); *Davis v. Hudson Trust Co.*, 28 F.2d 740, 742 (3d Cir.) (while "the agreement of a creditor to extend his debtor's time for payment, or to forbear suing on a claim, constitutes a valuable consideration for the promise of a third party to pay the debt," it is not "fair consideration" within the meaning of the Bankruptcy Act), cert. denied, 278 U.S. 655 (1928); *Ear, Nose & Throat Surgeons, Inc. v. Guaranty Bank & Trust Co. (In Re Ear, Nose, & Throat Surgeons, Inc.)*, 49 Bankr. 316, 320 (Bankr. D. Mass. 1985); *Gill v. Brooklier (In Re Burbank Generators, Inc.)*, 48 Bankr. 204, 206 (Bankr. C.D. Cal. 1985); *Beemer v. Walter E. Heller & Co. (In Re Holly Hill Medical Center, Inc.)*, 44 Bankr. 253, 255 (Bankr. M.D. Fla. 1984); *Garrett v. Falkner (In Re Royal Crown Bottlers, Inc.)*, 23 Bankr. 28, 30 (Bankr. N.D. Ala. 1982); 4 COLLIER ON BANKRUPTCY ¶ 548.09, at 548-106 to 548-108 (15th ed. 1979).

46. 661 F.2d 979 (2d Cir. 1981).

47. *Id.* at 991.

48. *Rubin*, 661 F.2d at 991; *Klein v. Tabatchnick*, 610 F.2d 1043, 1047 (2d Cir. 1979); *Beemer v. Walter E. Heller & Co. (In Re Holly Hill Medical Center, Inc.)*, 44 Bankr. 253, 255 (Bankr. M.D. Fla. 1984); *In Re Jones*, 37 Bankr. 969, 975 (Bankr. N.D. Tex. 1984); *Howco Leasing Corp. v. Alexander Dispos-Haul Sys., Inc. (In Re Alexander Dispos-Haul Sys., Inc.)*, 36 Bankr. 612, 616 (Bankr. D. Or. 1983); *Garrett v. Falkner (In Re Royal Crown Bottlers, Inc.)*, 23 Bankr. 28, (Bankr. N.D. Ala. 1982).

49. *Rubin*, 661 F.2d at 993 ("[T]he court must attempt to measure the economic benefit, if any."); cf. *United States v. Gleneagles Inv. Corp.*, 565 F. Supp. 556 (M.D. Pa. 1983) (new management is not a benefit to be considered in determining whether obligor received fair consideration); *McNellis v. Raymond*, 287 F. Supp. 232 (N.D.N.Y. 1968), modified, 420 F.2d 51 (2d Cir. 1969) (postponement of bankruptcy indirectly resulting from challenged transfer held to be fair consideration). But cf. *Wilson v. Upreach Ministries (In Re Missionary Baptist Found.)*, 24 Bankr. 973 (Bankr. N.D. Tex. 1982) (good will resulting from donations to defendant constituted a reasonably equivalent value).

50. See, e.g., *Rubin*, 661 F.2d at 993 (holding that collateral benefits of debtor's guarantees of loans to affiliated corporation might support finding of fair consideration); *Beemer v. Walter E. Heller & Co. (In Re Holly Hill Medical Center, Inc.)*, 44 Bankr. 253, 254-55 (Bankr. M.D. Fla. 1984) (interest payments made by debtor on loan to affiliated corporation were supported by a reasonably equivalent value when affiliate voluntarily used the loan to advance the debtor's operations); *In Re Jones*, 37 Bankr. 969, 975 (Bankr. N.D. Tex. 1984) (trickledown benefit to debtor-guarantor from loan made to affiliated corporation constituted a reasonably equivalent value); *Howco Leasing Corp. v. Alexander Dispos-Haul Sys., Inc. (In Re Alexander Dispos-Haul Sys., Inc.)*, 36 Bankr. 612, 616-17 (Bankr. D. Or. 1983) (benefits voluntarily bestowed on debtor by principal shareholder after debtor guaranteed obligations of shareholder constituted a reasonably equivalent value).

Section 548(a)(2)(A) is silent as to the time at which reasonably equivalent value must be measured. See 11 U.S.C. § 548(a)(2)(A) (1982) (text quoted *supra* note 34). This feature contrasts with

The courts recognize three sets of circumstances in which an obligor receives reasonably equivalent value even though it has incurred the obligation for the benefit of a third party.⁵¹ First, an obligation is balanced by a reasonably equivalent value when the benefit initially obtained by the third party is simply passed on to the obligor. When the third party acts merely as a conduit for transferring value from the obligee to the obligor, the obligor's financial condition is unaffected and the transaction is supported by a reasonably equivalent value.⁵² The court's conclusion in *Beemer v. Walter E. Heller & Co. (In Re*

the explicit provision for the time at which insolvency is to be determined—at the time the obligation is incurred. See 11 U.S.C. § 548(a)(2)(B)(i) (1982) (text quoted *infra* note 118). The leading treatise on bankruptcy law states: "The critical time is when the transfer is 'made.' Neither subsequent depreciation nor appreciation in the value of consideration affects the question of whether reasonably equivalent value was given." 4 COLLIER ON BANKRUPTCY ¶ 548.09, at 548-102 (15th ed. 1979). This rule is consistent with contract law, which insists that the bargain be evaluated at the time it was made. If an obligation could be avoided later because it proved unprofitable, the obligor could escape all risk in undertaking the obligation. The rule also serves the underlying objective of § 548(a)(2)—to permit avoidance of those obligations that deplete the obligor's assets to the detriment of the obligor's creditors. If the obligor obtains a reasonably equivalent value at the time it incurs an obligation, its assets are not depleted. To evaluate the benefits of a transaction retrospectively would allow the obligor's creditors to place the entire risk of the transaction on the obligee. Comment, *supra* note 9, at 211-12.

The rule that reasonably equivalent value must be measured at the time of the obligation appears to be well-settled with respect to two-party transactions. See, e.g., *Jacobson v. First State Bank (In Re Jacobson)*, 48 Bankr. 497, 499 (Bankr. D. Minn. 1985) (value of property must be evaluated as of time of foreclosure sale to determine whether debtor received reasonably equivalent value); *Willis v. Borg-Warner Acceptance Corp. (In Re Willis)*, 48 Bankr. 295, 301 (Bankr. S.D. Tex. 1985); *Day v. Central Fidelity Bank (In Re Appomattox Agri-Service, Inc.)*, 6 BANKR. CT. DEC. (CRR) 1239, 1241 (Bankr. W.D. Va. 1980). The cases involving three-party transactions, in which the obligor receives value indirectly, however, are less than clear on this point; the opinions do not explicitly address the issue. The decisions do not require benefits to be bargained for before they may be counted in the reasonably equivalent value equation, which suggests that courts are evaluating benefits retrospectively. The language in many of the cases in fact suggests that courts are making *ex post facto* determinations. See, e.g., *Rubin*, 661 F.2d at 993 ("The trustee . . . could establish lack of fair consideration under § 67(d) by proving that the value of what the bankrupt *actually received* was disproportionately small compared to the value of what it gave.") (emphasis added); *Klein v. Tabatchnick*, 610 F.2d 1043, 1047 (2d Cir. 1979) ("we cannot say that [debtor] *received* no benefit" from the transaction) (emphasis added); *United States v. Gleneagles Inv. Co.*, 565 F. Supp. 556, 575 (M.D. Pa. 1983) ("Because [defendant] *could not and in fact did not* repay the notes to the [debtors], these notes cannot be considered as valuable assets.") (emphasis added); *Ear, Nose & Throat Surgeons, Inc. v. Guaranty Bank & Trust Co. (In Re Ear, Nose & Throat Surgeons, Inc.)*, 49 Bankr. 316, 320 (Bankr. D. Mass. 1985) ("The benefit *received* by [debtor] cannot be said to be reasonably equivalent in value to the security interest granted . . . and to the guarantee.") (emphasis added); *In Re Jones*, 37 Bankr. 969, 975 (Bankr. N.D. Tex. 1984) ("[I]t is unchallenged that [the proceeds of the loan guaranteed by debtor] *were in fact used* by [debtor].") (emphasis added); *Garrett v. Falkner (In Re Royal Crown Bottlers, Inc.)*, 23 Bankr. 28, 30 (Bankr. N.D. Ala. 1982) ("There was no evidence of how much aid *was given* to the debtor, except 'substantial.'") (emphasis added); *cf. Howco Leasing Corp. v. Alexander Dispos-Haul Sys., Inc. (In Re Alexander Dispos-Haul Sys., Inc.)*, 36 Bankr. 612, 615-16 (Bankr. D. Or. 1983) (court valued guarantor's equitable rights as of time of guarantee, but apparently considered other benefits retrospectively). *But cf. Telefest, Inc. v. VU-TV, Inc.*, 591 F. Supp. 1368, 1378 (D.N.J. 1984) ("it was *intended* that a benefit would flow to [subsidiary] through the loans to [parent and affiliate] ultimately guaranteed by [subsidiary]") (emphasis added); *In Re Nelson*, 24 Bankr. 701, 702 (Bankr. D. Or. 1982) (court discussed value of guarantor's equitable rights as of time of guarantee); *Whitlock v. Max Goodman & Sons Realty (In Re Goodman Indus.)*, 21 Bankr. 512, 520 (Bankr. D. Mass. 1982) (court valued cross-guarantee of debtor's obligation as of time of transaction). A student commentator has suggested that the obligor's reasonable expectation of gain at the time of the transaction should define the reasonably equivalent value inquiry. Comment, *supra* note 9, at 213.

51. *Rubin*, 661 F.2d at 991-92.

52. See *McNellis v. Raymond*, 420 F.2d 51, 53 (2d Cir. 1970) (payments by debtor on loans made to related enterprise supported by fair consideration when debtor received "full benefit" of the

Holly Hill Medical Center, Inc.)⁵³ is illustrative. In *Beemer* the debtor made the payments on a loan extended by defendant financial institution to the debtor's affiliate. The affiliate used the loan proceeds exclusively to fund the debtor's operations. The court held that the loan was supported by a reasonably equivalent value.⁵⁴

Second, an obligor receives reasonably equivalent value when it is indebted to the beneficiary of the obligation for an amount similar to, or greater than, the cost of the obligation and the obligation is deemed to satisfy the prior indebtedness. The obligor's financial condition in these circumstances is similarly unaffected, and the transaction is supported by a reasonably equivalent value.⁵⁵ For example, in *Germia v. First National Bank of Boston*⁵⁶ the court held that the transfer of funds by the debtor to its parent corporation was supported by a reasonably equivalent value when the debtor was also indebted to the parent at the time of the transfer.⁵⁷ An obligation incurred in satisfaction of an antecedent debt, however, may have the effect of preferring the beneficiary of the obligation over other creditors of the obligor.⁵⁸ Consequently, under these circumstances the obligation may constitute a preference that is avoidable under section 547 of the Code.⁵⁹

Last, when the third party and the obligor share an "identity of interest," an obligation incurred by the obligor for the benefit of the third party is supported by reasonably equivalent value. That is, when the debtor's business activities are commingled with those of the third party, the debtor receives approximately equal value in return for an obligation incurred for the benefit of the third party.⁶⁰ In *Mayo v. Pioneer Bank & Trust Co.*,⁶¹ for example, the court held that the debtor's repayment of a loan made by defendant to another party was supported by fair consideration because "[t]here was such a degree of identity and commingling of affairs between [debtor and the third party] that [they] cannot be regarded as separate legal entities."⁶²

loans); *Beemer v. Walter E. Heller & Co. (In Re Holly Hill Medical Center, Inc.)*, 44 Bankr. 253, 254-55 (Bankr. M.D. Fla. 1984) (payment by debtor of installments on loan made to affiliated corporation held supported by reasonably equivalent value when affiliate used loan "strictly to fund the operation of the debtor").

53. 44 Bankr. 253 (Bankr. M.D. Fla. 1984).

54. *Id.* at 254-55.

55. See *Germia v. First Nat'l Bank*, 653 F.2d 1, 7 (1st Cir. 1981); *Barr & Creelman Mill & Plumbing Supply Co. v. Soller (In Re Dolomite 3 Corp.)*, 109 F.2d 924 (2d Cir. 1940).

56. 653 F.2d 1 (1st Cir. 1981).

57. *Id.* at 7.

58. See 11 U.S.C.A. § 547 (West 1979 & Supp. 1985).

59. *Id.*

60. See *McNellis v. Raymond*, 420 F.2d 51, 53 (2d Cir. 1970); *Mayo v. Pioneer Bank & Trust Co.*, 270 F.2d 823, 830 (5th Cir. 1959), *cert. denied*, 362 U.S. 962 (1962); *In Re Security Prods. Co.*, 310 F. Supp. 110 (E.D. Mo. 1969); *Ear, Nose & Throat Surgeons, Inc. v. Guaranty Bank & Trust Co. (In Re Ear, Nose & Throat Surgeons, Inc.)*, 49 Bankr. 316, 320 (Bankr. D. Mass. 1985); *In Re Nelson*, 24 Bankr. 701, 702 (Bankr. D. Or. 1982); *Garrett v. Falkner (In Re Royal Crown Bottlers, Inc.)*, 23 Bankr. 28, 30 (Bankr. N.D. Ala. 1982); *Briggs v. United States Nat'l Bank*, 11 Bankr. 524, 527-28 (Bankr. D. Neb. 1980).

61. 270 F.2d 823 (5th Cir. 1959).

62. *Id.* at 830.

The court in *Rubin* commented that "although these 'indirect benefit' cases frequently speak as

The act of executing a guarantee is part of a three-party transaction. The guarantor, by contracting to guarantee a loan from a lender to a borrower, agrees to answer for the debt of the borrower in the event the borrower defaults on its primary obligation to the lender.⁶³ The guarantor's obligation benefits the borrower in either or both of two ways. First, if the borrower's creditworthiness is inadequate to justify the amount of credit desired, the guarantee may be necessary to enable the borrower to obtain the loan. Second, the guarantee may permit the borrower to obtain the loan at a more favorable interest rate than it could have obtained on the strength of its own creditworthiness. The lender also benefits from the guarantee by obtaining additional assurance that its extension of credit will be repaid. This benefit may be partially offset by a reduction in the interest rate charged to the borrower, given the reduction in risk resulting from the guarantee.⁶⁴

The legislative history of section 548 reflects Congress' intent that "case law . . . determine when an attack on a guarantee or endorsement by the debtor is proper on the ground that the debtor did not receive a reasonably equivalent value."⁶⁵ The courts generally have continued to treat guarantees challenged under section 548 of the Code as they were treated under section 67d of the Bankruptcy Act.⁶⁶ Fraudulent conveyance challenges to guarantee contracts are analyzed in the same way as are obligations incurred for the benefit of third parties generally.⁶⁷

Three types of intercorporate guarantees exist: (1) a guarantee by a parent corporation or principal shareholder of a subsidiary's debt (a "downstream" guarantee); (2) a guarantee by a subsidiary of its parent's or principal shareholder's debt (an "upstream" guarantee); and (3) a guarantee by a corporation

though an 'identity of [economic] interest' between the debtor and the third person sufficed to establish fair consideration . . . the decisions in fact turn on the statutory purpose of conserving the debtor's estate for the benefit of creditors." *Rubin*, 661 F.2d at 992.

63. See *supra* note 1.

64. See Comment, *supra* note 9, at 206-07.

65. COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, REPORT OF THE COMM. ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 137, 93d Cong., 1st Sess. 177 (1973).

66. For cases decided under the Code, see *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); *In Re Nelson*, 24 Bankr. 701 (Bankr. D. Or. 1982); and *Whitlock v. Max Goodman & Sons Realty, Inc.* (*In Re Goodman Indus., Inc.*), 21 Bankr. 512 (Bankr. D. Mass. 1982). For cases decided under the Act, see *Rubin*, 661 F.2d 979 (2d Cir. 1981); and *Lawless v. Eastern Milk Producers Coop. Ass'n, Inc.* (*In Re Stop-N-Go, Inc.*), 30 Bankr. 721 (Bankr. W.D.N.Y. 1983).

67. For cases dealing with fraudulent conveyance challenges to guarantees, see *Rubin*, 661 F.2d 979 (2d Cir. 1981); *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, Inc.* (*In Re Stop-N-Go, Inc.*), 30 Bankr. 721 (Bankr. W.D.N.Y. 1983); *In Re Nelson*, 24 Bankr. 701 (Bankr. D. Or. 1982); and *Whitlock v. Max Goodman & Sons Realty, Inc.* (*In Re Goodman Indus., Inc.*), 21 Bankr. 512 (Bankr. D. Mass. 1982). For cases dealing with fraudulent conveyance challenges to nonguarantee three-party transactions, see *Gill v. Brooklier* (*In Re Burbank Generators, Inc.*), 48 Bankr. 204 (Bankr. C.D. Cal. 1985); *Beemer v. Walter E. Heller & Co.* (*In Re Holly Hill Medical Center*), 44 Bankr. 253 (Bankr. M.D. Fla. 1984); and *Garrett v. Falkner* (*In Re Royal Crown Bottlers, Inc.*), 23 Bankr. 28 (Bankr. N.D. Ala. 1982).

of an affiliated corporation's debt (a "cross-stream" guarantee).⁶⁸ A guarantee by a parent corporation of its subsidiary's debt generally poses no fraudulent conveyance problem. A subsidiary corporation is an asset of its parent; a benefit to the subsidiary presumably is also a benefit to the parent.⁶⁹ Accordingly, a downstream guarantee generally may be presumed to be supported by a reasonably equivalent value.

Upstream and cross-stream guarantees are more problematic. As is true of obligations incurred for the benefit of third parties generally, intercorporate guarantees contracted solely for the benefit of other corporations normally are not supported by a reasonably equivalent value.⁷⁰ The three exceptions that apply to obligations incurred for the benefit of third parties generally also pertain to guarantee contracts—a guarantee incurred for the benefit of a borrower is not avoidable when the borrower simply passes the loan proceeds to the guarantor,⁷¹ when the guarantor incurs the obligation in satisfaction of an antecedent debt owed to the borrower,⁷² or when the guarantor and borrower share an identity of interest.⁷³

Even if none of these exceptions is applicable, a guarantee incurred for the benefit of a third party nevertheless may be supported by a reasonably equivalent value. Weighing the value of the guarantee against the value received indirectly from the borrower, however, can be a difficult task. The first step in the valuation process is to ascertain the cost of the guarantee. The cases are notably silent on how the value of a guarantee can be measured. A guarantee can be valued in one of two ways. First, it may be valued at its actual cost. The actual cost of a guarantee is the amount of debt guaranteed less the amount of the debt that the principal obligee will probably repay. The courts, however, have neither accepted nor rejected such a formula.⁷⁴ Second, a guarantee constitutes a debt, as defined in the Code, of the guarantor;⁷⁵ the cost of a guarantee thus may equal the amount of debt guaranteed absent any discount for the amount likely to be repaid by the principal debtor. Again, the courts have not explicitly adopted this formula; nonetheless, its application has arguably been implied in a number

68. See Cherin, Ash & Burlingame, *supra* note 9, at 2030; Rosenberg, *supra* note 6, at 238.

69. Rosenberg, *supra* note 6, at 238; see also Garrett v. Falkner (*In Re Royal Crown Bottlers, Inc.*), 23 Bankr. 28, 30 (Bankr. N.D. Ala. 1982) ("the subsidiary corporation is an asset of the parent corporation, and what benefits the asset will ordinarily accrue to the benefit of its owner").

70. See *supra* note 45 and accompanying text.

71. See *supra* notes 52-54 and accompanying text.

72. See *supra* notes 55-59 and accompanying text.

73. See *supra* notes 60-62 and accompanying text.

74. See Rubin, 661 F.2d 979 (2d Cir. 1981); United States v. Gleneagles Inv. Co., 565 F. Supp. 556 (M.D. Pa. 1983); 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, Inc. (*In Re Stop-N-Go, Inc.*), 30 Bankr. 721 (Bankr. W.D.N.Y. 1983); *In Re Nelson*, 24 Bankr. 701 (Bankr. D. Or. 1982); Whitlock v. Max Goodman & Sons Realty, Inc. (*In Re Goodman Indus., Inc.*), 21 Bankr. 512 (Bankr. D. Mass. 1982).

75. A "debt" includes any "liability on a claim." 11 U.S.C. § 101(11) (1982). The Code defines a "claim" to include a "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." 11 U.S.C. § 101(4) (1982) (emphasis added).

of decisions.⁷⁶

Once the cost of a guarantee has been determined, it must be balanced against the benefits accruing to the guarantor to determine whether the guarantor received a reasonably equivalent value in exchange for incurring the guarantee. In any guarantee transaction, the guarantor automatically obtains the equitable rights of exoneration,⁷⁷ subrogation,⁷⁸ and reimbursement⁷⁹ against the principal. The guarantor also receives a right of contribution against any coguarantors.⁸⁰ These rights have value only if the borrower is solvent or if the lender is at least partially secured with collateral in the borrower's assets at the time of the loan. To the extent that a guarantor's equitable rights have value, they are assets that a court may consider in determining whether the guarantor received a reasonably equivalent value.

In *Howco Leasing Corp. v. Alexander Dispos-Haul Systems, Inc. (In Re Alexander Dispos-Haul Systems)*⁸¹ a bankruptcy court included the guarantor's equitable rights as a benefit for purposes of determining whether the guarantor had received a reasonably equivalent value in exchange for its guarantee. The case involved the sale of a refuse business by the Plew family to Harold Alexander. Alexander and his wife were the owners of Alexander Dispos-Haul Systems, Inc. (ADS). Many of the assets were sold subject to equipment leases and installment purchase contracts entered into by the Plews and plaintiffs. Plaintiffs agreed to the transfer of the encumbered assets to Alexander. Alexander assumed the Plews' obligations to plaintiffs and, on behalf of ADS, executed a guarantee of performance on the leases and installment purchase contract payments. The Plews remained liable as principals on the obligations. Within a year after the sale of the refuse business, ADS filed a petition in bankruptcy. In discussing whether ADS had received a reasonably equivalent value in exchange for its guarantee, the court stated:

The debtor's right of exoneration and right of indemnity against the

76. See cases cited *supra* note 74.

77. Exoneration is a right held by the guarantor prior to paying the principal's debt. The principal owes the guarantor a duty to pay the debt at maturity. If the principal does not fulfill its primary obligation to pay the debt at maturity, the guarantor may bring suit against the principal to compel it to perform. A guarantor also has a right of exoneration against its coguarantors. If the coguarantors fail to pay their share of the principal's debt on maturity of the debt and default by the principal, the guarantor may bring suit to compel them to do so. L. SIMPSON, *HANDBOOK ON THE LAW OF SURETYSHIP* 198-204 (1950).

78. Subrogation is a guarantor's right, after paying the entire debt on which the principal has defaulted, to be substituted to all the rights of the creditor against the principal and any coguarantors. *Id.* at 205-223; A. STEARNS, *THE LAW OF SURETYSHIP* § 11.1-17, at 439-78 (J. Elder 5th ed. 1951).

79. A guarantor, when required to pay the principal's debt, is entitled to reimbursement (also referred to as "indemnification") from the principal of the amount paid. The guarantor need not have paid the principal's debt in full to exercise its right to reimbursement. L. SIMPSON, *supra* note 77, at 224-37; A. STEARNS, *supra* note 78, § 11.35-47, at 505-28.

80. Contribution is the right of a guarantor to receive payment from coguarantors of their share of the principal's debt paid by the guarantor. A guarantor may avail itself of this right only to the extent it has paid more than its share of the principal's debt. Each coguarantor must bear a ratable portion of the entire debt, unless the guarantee instruments provide otherwise. L. SIMPSON, *supra* note 77, at 238-53; A. STEARNS, *supra* note 78, § 11.18-34, at 478-505.

81. 36 Bankr. 612 (Bankr. D. Or. 1983).

principals had value while the debtor's right of subrogation probably had no value because of the debtor's insolvency and inability to ever acquire a right of subrogation by paying off plaintiffs in full. The value of ADS's potential rights of exoneration and indemnity depend upon the financial ability of Harold Alexander and the Plews [at the time the guarantee was executed]. The trustee had the burden under 11 U.S.C. § 548(a)(2)(A) of showing that the principals could not pay their potential obligations to the debtor as surety or were insolvent. The trustee failed in this burden. The financial statements which were prepared by the Alexanders in connection with the Plews' sale and personal loan applications establish sufficient net worth at the time of the sale to finance any then-reasonably foreseeable deficiency resulting from the sale⁸²

Thus, the court found that the absence of a reasonably equivalent value had not been proven because the principals' financial condition at the time of the guarantee, which was determinative of the value of the guarantor's equitable rights, was not shown to be such that the principals could not satisfy their primary obligations.⁸³

The courts generally have not considered the value of a guarantor's equitable rights in determining whether the guarantor has received reasonably equivalent value in exchange for its obligation.⁸⁴ *Alexander*⁸⁵ and *In Re Nelson*,⁸⁶ both decided by the United States Bankruptcy Court for the District of Oregon, are exceptional in that the court evaluated the guarantor's equitable rights in determining whether the guarantor received a reasonably equivalent value in return for its guarantee. The difficulty in valuing a guarantor's equitable rights, which is compounded by the uncertainty as to the time at which they are to be measured,⁸⁷ may explain the reluctance of most courts to do so. If value to the guarantor is to be measured as of the time of the guarantee, the principal's financial status at that time must be evaluated.⁸⁸ Reconstructing the

82. *Id.* at 616.

83. *Id.*; see also *In Re Nelson*, 24 Bankr. 701, 702 (Bankr. D. Or. 1982) (court considered value of guarantor's equitable rights in determining whether guarantor had received a reasonably equivalent value).

84. See *Rubin*, 661 F.2d 979 (2d Cir. 1981); *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, Inc.* (*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. 166 (Bankr. E.D.N.Y. 1982).

85. 36 Bankr. 612 (Bankr. D. Or. 1983).

86. 24 Bankr. 701 (Bankr. D. Or. 1982). *Nelson* involved a guarantee by the debtor of a debt owed by a corporation of which the debtor's husband was a principal shareholder. The court stated:

The debtor's assumed right to be subrogated to [the creditor] might, under normal circumstances, constitute fair equivalent value if [the creditor] held or received equivalent security or if the corporate principal was solvent at the time of the initial guaranty Assuming that [the principal] was insolvent at all times and there was no equivalent security granted to [the creditor], the right of subrogation would not supply equivalency

Id. at 702.

87. See *supra* note 50.

88. See *Alexander*, 36 Bankr. at 616.

principal's financial condition at the time of the guarantee often presents difficult evidentiary problems.⁸⁹

When a court finds that a guarantor has received reasonably equivalent value based on a valuation of the nonequitable benefits of the guarantee transaction, the equitable benefits need not be evaluated.⁹⁰ On the other hand, when the nonequitable benefits conferred on the guarantor do not constitute a 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. The courts' consistent failure to consider the guarantor's equitable rights in the reasonably equivalent value inquiry may be a result of counsels' failure to advance the argument.

In addition to receiving the equitable rights that pertain to any guarantee, a guarantor may benefit in a number of other ways: the corporate coguarantor of a loan made to an affiliate may receive monthly income as a result of the borrower's operations;⁹¹ a guarantor of its parent corporation's debt may be leased assets and given customer lists of a corporation whose acquisition by the parent was made possible by the guaranteed loan;⁹² and a guarantor may receive a reciprocal, contemporaneous guarantee of its debts in exchange for guaranteeing the debts of its affiliate, whose guarantee was "probably" more valuable than the debtor's.⁹³

In *Rubin v. Manufacturers Hanover Trust Co.*⁹⁴ the guarantors, two corporations in the business of issuing and selling money orders, guaranteed a line of credit extended by defendant trust company to several check cashing corporations. The check cashers were affiliates of the guarantor. The United States Court of Appeals for the Second Circuit held that on remand, the trial court might find fair consideration if the loans to the guarantor's affiliates benefited the guarantors by enabling the affiliates to pay their accounts with the guarantors on a more timely basis. More timely payments, in turn, would increase the monies available to the debtors' operations and would lengthen the "float" [time] from which [the guarantor's] profits were derived."⁹⁵

In a few cases, the courts have avoided a debtor's guarantee for lack of reasonably equivalent value. In *Ear, Nose & Throat Surgeons, Inc. v. Guaranty Bank & Trust Co. (In Re Ear, Nose & Throat Surgeons, Inc.)*⁹⁶ the United States Bankruptcy Court for the District of Massachusetts held that the debtor corporation's guarantee of a one hundred and thirty five thousand dollar loan and

89. See *id.*

90. See, e.g., *In Re Jones*, 37 Bankr. 969 (Bankr. N.D. Tex. 1984); *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).

91. See *In Re Jones*, 37 Bankr. 969 (Bankr. N.D. Tex. 1984).

92. *Alexander*, 36 Bankr. at 612.

93. See *Whitlock v. Max Goodman & Sons Realty, Inc. (In Re Goodman Indus., Inc.)*, 21 Bankr. 512 (Bankr. D. Mass. 1982).

94. 661 F.2d 979 (2d Cir. 1981). For a detailed summary of the facts of *Rubin*, see *supra* note 33.

95. 661 F.2d at 992.

96. 49 Bankr. 316 (Bankr. D. Mass. 1985).

credit line to the debtor's owner was not supported by a reasonably equivalent value when the owner spent only eight thousand dollars of the loan on the debtor's behalf. The owner used the balance of the loans to satisfy his personal obligations.⁹⁷ In *Lawless v. Eastern Milk Producers Cooperative Association, Inc. (In Re Stop-N-Go, Inc.)*⁹⁸ the United States Bankruptcy Court for the Western District of New York found that a guarantee was unsupported by fair consideration when the debtor had received no benefit in exchange for guaranteeing certain debts of its parent corporation.⁹⁹ In neither of these cases did the court examine the value of the guarantor's equitable rights.

The preceding discussion indicates that the courts have provided little in the way of concrete guidelines for determining whether a guarantor has received reasonably equivalent value in exchange for a guarantee. Perhaps the most that can be said is that the courts, faced with significant evidentiary problems in determining the value of a guarantee,¹⁰⁰ the value of equitable rights,¹⁰¹ and the value of other benefits¹⁰² have chosen a somewhat imprecise but workable approach over a more precise but less practical test. The inquiry whether "a reasonably equivalent value" has been received by the guarantor is a question of fact to be decided based on the particular circumstances of each case, and the trier of fact is entitled to great latitude in making its calculation.¹⁰³ It is worth noting that in *Ear, Nose & Throat Surgeons* and in *Stop-N-Go*, both cases in which a guarantee was avoided, reasonably equivalent value was manifestly lacking.¹⁰⁴ The guarantors in those cases received little or no nonequitable benefits, and the principals' financial status at the time of the guarantees was such that the equitable rights probably were nearly worthless.¹⁰⁵

Leveraged stock acquisitions or leveraged buyouts (LBOs), in which the assets of the acquired business are used to pay, secure, or guarantee the buyer's obligations to the seller, present a distinct area of concern under sections 548(a)(2) and 544(b). Consider, for example, a straightforward LBO in which Purchaser borrows funds from Lender to finance its purchase of Target Corporation. Target Corporation guarantees Purchaser's debt to Lender. Assume further that the guarantee, combined with the already existing debts of Target Corporation, renders Target Corporation insolvent. In this example the guarantee clearly is unsupported by a reasonably equivalent value—Target Corporation receives no benefit in exchange for its guarantee. Therefore, the guarantee is avoidable under section 548(a)(2) if the guarantor enters bankruptcy within a year following the transaction.¹⁰⁶

97. *Id.* at 320.

98. 30 Bankr. 721 (Bankr. W.D.N.Y. 1983).

99. *Id.* at 725.

100. See *supra* notes 74-76 and accompanying text.

101. See *supra* notes 84-90 and accompanying text.

102. See *supra* notes 91-99 and accompanying text.

103. See 4 COLLIER ON BANKRUPTCY ¶ 548.09, at 548-100 (15th ed. 1979).

104. *Ear, Nose & Throat Surgeons*, 49 Bankr. at 316; *Stop-N-Go*, 30 Bankr. at 721.

105. *Ear, Nose & Throat Surgeons*, 49 Bankr. at 316; *Stop-N-Go*, 30 Bankr. at 721.

106. See *Pirrone v. Toburoff (In Re Vaniman Int'l, Inc.)*, 22 Bankr. 166 (Bankr. E.D.N.Y. 1982). In *Vaniman* the debtor corporation was insolvent at the time it guaranteed the debt of its

The leading case on avoidability of a guarantee contracted for in connection with an LBO is *United States v. Gleneagles Investment Corp.*¹⁰⁷ The case was decided under the Pennsylvania Uniform Fraudulent Conveyance Act but is persuasive authority for similar questions arising under section 548(a)(2) of the Code.¹⁰⁸ *Gleneagles* involved an LBO by Great American Coal Company of the stock of four affiliated corporations. Institutional Investors Trust (IIT) loaned approximately eight and one-half million dollars to the four affiliates. Each affiliate granted IIT a security interest in its own assets. Each of the four borrowers also executed a guarantee of its affiliates' obligations to the lender, secured by a second lien on its assets. The affiliates, when considered as a whole, were insolvent at the time the loans were made.¹⁰⁹ Each affiliate loaned a portion of its borrowed funds to Great American. Great American gave each affiliate an unsecured note in exchange for the loans, and used the loan proceeds to buy the stock of the four affiliates.¹¹⁰

The court found that as between the affiliates and the lender, the loans were supported by fair consideration.¹¹¹ That is, the security interests granted by the individual borrowers and their cross-guarantees of each other's obligations were balanced by the benefit received—the loan proceeds. The court, however, disregarded the formal structure of the stock acquisition plan and treated the transaction as though the funds had been loaned directly to Great American in exchange for the security interests and guarantees of the borrowing affiliates.¹¹² The court stated:

[T]he issue of whether fair consideration was received by the [four affiliates] must be examined from the point of view of [their] creditors. . . . Because Great American could not and in fact did not repay the notes to the borrowing companies in accordance with their terms, those notes cannot be considered as valuable assets obtained by the borrowing companies from the IIT loan proceeds. The . . . IIT loan proceeds which were lent immediately by the borrowing companies to Great American were merely passed through the borrowers to Great American and ultimately to the selling stockholders and cannot be deemed consideration received by the borrowing companies.¹¹³

Accordingly, the court concluded that the borrowing affiliates did not receive fair consideration from IIT in exchange for the security interests granted in their assets and their guarantees of obligations. Thus, the court held that the security interests and guarantees were avoidable.¹¹⁴

purchaser to its sellers. The guarantee was secured by a security interest in the debtor's assets. The court held that the mortgage and note were fraudulent conveyances within the meaning of the New York Uniform Fraudulent Conveyance Act. *Id.* at 196.

107. 565 F. Supp. 556 (M.D. Pa. 1983).

108. See *supra* note 28 and accompanying text.

109. *Gleneagles*, 565 F. Supp. at 563-72.

110. *Id.*

111. *Id.* at 574.

112. *Id.*

113. *Id.* at 574-75.

114. *Id.*

In *Jones v. National City Bank of Rome (In Re Greenbrook Carpet Co.)*¹¹⁵ the United States Court of Appeals for the Eleventh Circuit reached a notably different result on facts similar to those of *Gleneagles*. *Greenbrook* was an action brought under section 548(a)(2) by the bankruptcy trustee to avoid a security interest granted by the debtor to a lender. The lender obtained the security interest in exchange for a three hundred fifty thousand dollar loan to the debtor. The debtor transferred the loan proceeds to two individuals who used them to finance their purchase of the debtor's stock. The individuals gave the debtor a nonrecourse note secured by a pledge of the debtor's stock in return for the loan proceeds. At issue was whether the debtor received a reasonably equivalent value from the lender in exchange for granting the security interest. The court declined to look behind the formal structure of the LBO plan in concluding that the transaction was supported by reasonably equivalent value.¹¹⁶ The court noted that "if the transaction between [the debtor] and the [individuals] constituted a fraudulent transfer, the trustee may sue the [individuals]."¹¹⁷

C. *Section 548(a)(2)(B)—Insolvency, Unreasonably Small Capital, and Inability to Pay Debts as They Mature*

In addition to proving that the debtor incurred the challenged obligation on or within one year of the bankruptcy petition filing and for less than a reasonably equivalent value, a trustee proceeding under section 548(a)(2) must show that the debtor was in poor financial condition at the time it incurred the challenged obligation.¹¹⁸ Section 67d(2) of the Bankruptcy Act included a similar provision.¹¹⁹ The "financial condition" requirement limits the avoidability of obligations to those that prejudice creditors.¹²⁰ An obligor that incurs an obligation while in poor financial health injures its creditors. Creditors, however,

115. 722 F.2d 659 (11th Cir. 1984).

116. *Id.* at 660-61.

117. *Id.* at 661. *Cate v. Nicely (In Re Knox Kreations, Inc.)*, No. Bk. 3-77-748, slip op. (E.D. Tenn. Aug. 7, 1978), also involved a guarantee contract in the context of a LBO. The bankruptcy debtor had guaranteed the debt owed by its parent corporation to its seller. The guarantee was secured in part by an escrow account in which the debtor placed five percent of its total monthly sales. Payments to defendant seller from the escrow account were challenged by the trustee under § 67d(2) of the Bankruptcy Act. The court held that the payments, made within a year of bankruptcy and while the debtor was insolvent, were constructively fraudulent. The court found that the payments were not balanced by fair consideration because the debtor, as a guarantor, was not liable on the guarantee under Tennessee law as he had not been afforded his Uniform Commercial Code suretyship rights of presentment, dishonor, and notice.

118. 11 U.S.C.A. § 548(a)(2)(B) (West 1979 & Supp. 1986) provides that a transfer or obligation is subject to avoidance if the debtor

(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.

119. See 11 U.S.C. § 107d(2) (repealed 1978).

120. See *Rubin*, 661 F.2d at 991; see also Comment, *supra* note 9, at 197-98 (discussing basic purpose of § 548(a)(2)).

are not harmed when the debtor can afford an obligation at the time it is incurred. Section 548(a)(2)(B) states three instances in which a debtor is deemed to have been in poor financial condition at the time the obligation was incurred.¹²¹ Each of these instances—insolvency, unreasonably small capital, and inability to pay debts—is discussed below.

1. Insolvency

Section 548(a)(2)(B)(i) of the Code provides that an obligation is subject to avoidance when the debtor was insolvent at the time the obligation was incurred or was rendered insolvent as a result of incurring the obligation.¹²² The Code defines “insolvent” as a “financial condition such that the sum of such entity’s debts is greater than all of such entity’s property.”¹²³

The Code’s test for insolvency, commonly referred to as the “balance sheet test,” requires a comparison of the debtor’s liabilities with its assets as of the date of the challenged obligation.¹²⁴ Although a guarantee of another’s debt is a contingent obligation, it nevertheless is considered a liability for purposes of the insolvency test.¹²⁵ The Code defines “debt” as a “liability on a claim”;¹²⁶

121. See 11 U.S.C. § 548(a)(2)(B) (1982).

122. *Id.* § 548(a)(2)(B)(i) (quoted *supra* note 118).

123. 11 U.S.C.A. § 101(29) (West 1979 & Supp. 1986). In its entirety, § 101(29) provides: “insolvent” means—

(A) with reference to an entity other than a partnership, financial condition such that the sum of such entity’s debts is greater than all of such entity’s property, at a fair valuation, exclusive of—

(i) property transferred, concealed, or removed with intent to hinder, delay, or defraud such entity’s creditors; and

(ii) property that may be exempted from property of the estate under section 522 of this title; and

(B) with reference to a partnership, financial condition such that the sum of such partnership’s debts is greater than the aggregate of, at a fair valuation—

(i) all of such partnership’s property, exclusive of property of the kind specified in subparagraph (A)(i) of this paragraph; and

(ii) the sum of the excess of the value of each general partner’s nonpartnership property, exclusive of property of the kind specified in subparagraph (A) of this paragraph, over such partner’s nonpartnership debts.

Whether a debtor is insolvent within the meaning of the Code is relevant in several of the Code’s avoidance power provisions. Insolvency is an essential element of an action to avoid a preference under § 547. 11 U.S.C.A. § 547 (West 1979 & Supp. 1986). When a transfer attacked as a preference was made within 90 days of the filing of the bankruptcy petition, there is a rebuttable presumption of insolvency. When the challenged transaction occurred more than 90 days before but within a year of filing, the trustee must prove the debtor’s insolvency. *Id.* Section 545 provides that “the trustee may avoid the fixing of a statutory lien on property of the debtor to the extent that such lien . . . first becomes effective against the debtor . . . when the debtor became insolvent.” *Id.* § 545. Judicial opinions on insolvency under these provisions are solid authority for questions of insolvency arising under § 548.

The Code definition of “insolvent” differs from the equity sense of insolvency—the latter refers to a financial condition such that an entity cannot pay its debts as they mature. *Finn v. Meighan*, 325 U.S. 300, 303 (1944); *In Re Frigitemp Corp.*, 34 Bankr. 1000 (Bankr. S.D.N.Y. 1983); *In Re Keydata Corp.*, 37 Bankr. 324 (Bankr. D. Mass. 1983).

124. See 11 U.S.C.A. § 101(29) (West 1979 & Supp. 1985) (text quoted *supra* note 123).

125. *Rubin*, 661 F.2d at 990; *Gower v. Cohn*, 643 F.2d 1146, 1158-59 (5th Cir. 1981); *Manufacturers & Traders Trust Co. v. Goldman (In Re Ollog Constr. Equip. Co.)*, 578 F.2d 904 (2d Cir. 1978); *Swartz v. Commissioner of Internal Revenue*, 560 F.2d 311 (8th Cir. 1977); *In Re Jones*, 37 Bankr. 969 (Bankr. N.D. Tex. 1984); *Alexander*, 36 Bankr. 612 (Bankr. D. Or. 1983); *Lawless v.*

"claim" is defined as a "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."¹²⁷ Accordingly, a guarantee must be listed as a debt on the guarantor's balance sheet to the full extent of the amount of debt guaranteed.

A guarantor's equitable rights are benefits to be included on the asset side of the ledger.¹²⁸ As previously discussed, a guarantor automatically obtains certain equitable rights when it executes a guarantee of another's debt. These rights, with respect to the borrower, are the rights of exoneration, subrogation, and reimbursement and, with respect to any coguarantors, the right of contribution.¹²⁹

The value of a guarantor's equitable rights as assets in the insolvency calculation depends on the financial status of the borrower and any coguarantors at the time the guarantee contract was made. The value of the equitable rights is also affected by the extent to which the lender is secured by collateral in the borrower's assets.¹³⁰ At one extreme, the guarantor's equitable rights are worthless when the primary obligor and any coguarantors have no assets at the time of the guarantee transaction. Conversely, the guaranteed debt is completely offset by the equitable rights when the borrower has assets sufficient to meet the full amount of the debt at the time it is incurred. It necessarily follows that if the lender is fully secured by collateral in the assets of the primary obligor, the guaranteed debt and the equitable assets are in balance.

Professor Rosenberg has questioned the concept of counting a contingent debt as a liability and then offsetting this debt by the guarantor's contingent equitable assets:

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.¹³¹

Professor Rosenberg has proposed counting the debtor's unmatured liabilities

Eastern Milk Producers Coop. Ass'n Inc. (*In Re Stop-N-Go, Inc.*), 30 Bankr. 721 (Bankr. W.D.N.Y. 1983); Whitlock v. Max Goodman & Sons Realty, Inc. (*In Re Goodman Indus., Inc.*), 21 Bankr. 512 (Bankr. D. Mass. 1982); Hemphill v. T & F Land Co. (*In Re Hemphill*), 18 Bankr. 38 (Bankr. S.D. Iowa 1982).

126. 11 U.S.C. § 101(11) (1982).

127. *Id.* § 101(4) (emphasis added).

128. Manufacturers & Traders Trust Co. v. Goldman (*In Re Ollog Constr. Equip. Co.*), 578 F.2d 904 (2d Cir. 1978); Swartz v. Commissioner, 560 F.2d 311 (8th Cir. 1977); *In Re Jones*, 37 Bankr. 969 (Bankr. N.D. Tex. 1984); *Alexander*, 36 Bankr. at 612; Hemphill v. T & F Land Co. (*In Re Hemphill*), 18 Bankr. 38 (Bankr. S.D. Iowa 1982).

129. See *supra* notes 77-80 and accompanying text.

130. See *Alexander*, 36 Bankr. at 612; *Nelson*, 24 Bankr. 701 (Bankr. D. Or. 1982).

131. Rosenberg, *supra* note 6, at 356-57.

discounted by the probability that they will not mature in determining insolvency. He has noted, however, that such an approach is not true to the statutory language, and "adds another element of uncertainty to the determination of insolvency."¹³²

Similarly, section 67d(2)(a) of the Bankruptcy Act provided that obligations incurred while the debtor was insolvent or which rendered the debtor insolvent were subject to avoidance.¹³³ Section 67d(2)(a) differed from the Code provision, however, in that it provided that such conveyances were fraudulent only "as to creditors existing at the time of such transfer or obligation."¹³⁴ The Act defined "insolvent" for purposes of the fraudulent conveyance provision in the same way as does the Code.¹³⁵ Therefore, judicial interpretations of section 67d(2)(a) are solid precedent for resolving questions arising under section 548(a)(2)(B)(i) of the Code, except that the existence of a creditor at the time of the transfer or obligation is no longer important.

Section 4 of the UFCA provides that "[e]very conveyance made or obligation incurred by a person who is or will be thereby rendered insolvent is fraudulent as to creditors."¹³⁶ Like Code section 548(a)(2)(B)(i), section 4 of the UFCA applies whether or not there was a creditor in existence at the time of the conveyance or obligation. The UFCA, however, provides that "[a] person is insolvent when the present fair salable value of his assets is less than the amount that will be required to pay his probable liability on his existing debts as they become absolute and matured."¹³⁷ The "present fair salable value" language of the UFCA¹³⁸ may require valuation of assets at a more immediately realizable value than does the "fair valuation" language in the Code definition of "insolvency."¹³⁹ Further, the UFCA refers to "probable liability on . . . existing debts,"¹⁴⁰ whereas the Code makes no similar provision.¹⁴¹ Because of these

132. *Id.* Professor Rosenberg's article discusses the fraudulent conveyance provision of the Bankruptcy Act. The Bankruptcy Act defined "insolvency" with regard to fraudulent conveyances in the same manner as does the Code. See 11 U.S.C. § 107d(1)(d) (repealed 1978).

133. 11 U.S.C. § 107d(2)(a) (repealed 1978) provided that a transfer or obligation was subject to avoidance "as to creditors existing at the time of such transfer or obligation, if made or incurred without fair consideration by a debtor who is or will be thereby rendered insolvent, without regard to his actual intent."

134. *Id.*

135. See 11 U.S.C. § 107d(1)(d) (repealed 1978), which stated:

[A] person is "insolvent" when the present fair salable value of his property is less than the amount required to pay his debts; and to determine whether a partnership is insolvent, there shall be added to the partnership property the present fair salable value of the separate property of each general partner in excess of the amount required to pay his separate debts, and also the amount realizable on any unpaid subscription to the partnership of each limited partner.

136. UNIF. FRAUDULENT CONVEYANCE ACT § 4, 7A U.L.A. 474 (1985) states: "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 fair consideration."

137. UNIF. FRAUDULENT CONVEYANCE ACT § 2, 7A U.L.A. 442 (1985).

138. *Id.*

139. See, e.g., *Gleneagles*, 565 F. Supp. 556, 578 (M.D. Pa. 1983).

140. UNIF. FRAUDULENT CONVEYANCE ACT § 2, 7A U.L.A. 442 (1985).

141. See 11 U.S.C.A. § 101(29) (West 1979 & Supp. 1986) (text quoted *supra* note 123).

differences, cases decided under section 4 of the Uniform Act are probably not persuasive authority for questions arising under Code section 548(a)(2)(B)(i).

2. Unreasonably Small Capital

Section 548(a)(2)(B)(ii) provides that an obligation is subject to avoidance if it was incurred at a time when the debtor "was engaged in business or a transaction, or was about to engage in business or transaction, for which any property remaining with the debtor was unreasonably small capital."¹⁴² A trustee need not show insolvency when proceeding under this clause, although proof of insolvency may by its nature constitute proof of unreasonably small capital.¹⁴³ Whether "property remaining with the debtor was unreasonably small capital" is a question of fact.¹⁴⁴

The Bankruptcy Act contained an analogous provision. Section 67d(2)(b) of the Act provided that a transfer or obligation

is fraudulent . . . as to then existing creditors and as to other persons who become creditors during the continuance of a business or transaction, if made or incurred . . . by a debtor who is engaged or is about to engage in such business or transaction, for which the property remaining in his hands is an unreasonably small capital.¹⁴⁵

Plainly, cases decided under section 67d(2)(b) are useful precedent for questions arising under section 548(a)(2)(B)(ii) of the Code. The only difference between the two enactments is that the Code provision does not limit the class of creditors as to whom an obligation is fraudulent.

Section 5 of the UFCA¹⁴⁶ is virtually identical to section 67d(2)(b) of the Bankruptcy Act in nearly all relevant respects. Section 5 of the UFCA, however, does not refer to obligations; it states only that "conveyance[s] made . . . 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."¹⁴⁷ Unless a guarantee can be brought within the meaning of "conveyance," section 5 of the Uniform Act is inapplicable to avoid guarantee contracts. The UFCA defines "conveyance" as including "every payment of money, assignment, release, transfer, lease, mortgage or pledge of tangible or intangible property and also the creation of any lien

142. 11 U.S.C. § 548(a)(2)(B)(ii) (1982) (text quoted *supra* note 118).

143. See *Gleneagles*, 565 F. Supp. at 580.

144. See *New York Credit Men's Adjustment Bureau, Inc. v. Adler*, 2 Bankr. 752 (Bankr. S.D.N.Y. 1980).

145. 11 U.S.C. § 107d(2)(b) (repealed 1978).

146. UNIF. FRAUDULENT CONVEYANCE ACT § 5, 7A U.L.A. 504 (1985).

147. *Id.* UFCA § 5 provides:

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.

or encumbrance.”¹⁴⁸ Sections 4 and 6 of the UFCA, which govern transactions entered into by insolvents and by persons about to incur debts beyond their ability to repay them as they mature, apply to both conveyances and obligations.¹⁴⁹ The section 5 reference only to conveyances suggests that the intended scope of that section is narrower than the scope of sections 4 and 6. It may be argued, however, that the omission of the word “obligation” from section 5 was merely an oversight by the UFCA’s drafters.

There appears to be no decision in which a guarantee has been avoided solely because property remaining with the guarantor after it contracted the guarantee was “unreasonably small capital.” Since a guarantee has no immediate impact on the guarantor’s assets, this provision arguably has no application to guarantee contracts.

3. Inability to Pay Debts as They Mature

Section 548(a)(2)(B)(iii) of the Code provides that an obligation is subject to avoidance if it was incurred at a time when the debtor “intended to incur, or believed that [it] would incur, debts that would be beyond [its] ability to pay as such debts matured.”¹⁵⁰ Proof of insolvency or unreasonably small capitalization is unnecessary when the trustee is proceeding under this provision. Whether the debtor intended to incur debts beyond its ability to repay is a question of fact.¹⁵¹

Like Code section 548(a)(2)(B)(iii), section 67d(2)(c) of the Bankruptcy Act¹⁵² applied to all creditors, not just those in existence at the time of the challenged transaction.¹⁵³ Section 6 of the UFCA parallels section 548(a)(2)(B)(iii) in substance, if not in form.¹⁵⁴ Thus, decisions based on the corresponding provisions of the Bankruptcy Act and the UFCA are solid authority for interpreting section 548(a)(2)(B)(iii).

It appears that no court has avoided a guarantee under section 548(a)(2)(B)(iii) of the Code, section 67d(2)(c) of the Act, or section 6 of the UFCA. Given the contingent nature of the guarantee obligation, proof that a guarantee was contracted with the intent to incur debts beyond the debtor’s ability to repay them as they matured would be very difficult to establish.

148. *Id.* § 1, 7A U.L.A. 430.

149. *See id.* §§ 4, 6, 7A U.L.A. 474, 507 (1985) (text of § 4 quoted *supra* note 136; text of § 6 quoted *infra* note 154).

150. 11 U.S.C. § 548(a)(2)(B)(iii) (1982) (text quoted *supra* note 118).

151. *See Hartnett v. Doyle*, 16 Tenn. App. 302, 64 S.W.2d 227 (1932).

152. 11 U.S.C. § 67d(2)(c) (repealed 1978) provided that an obligation was subject to avoidance “as to then existing and future creditors, if made or incurred without fair consideration by a debtor who intends to incur or believes that he will incur debts beyond his ability to pay as they mature.”

153. *Id.*

154. UNIF. FRAUDULENT CONVEYANCE ACT § 6, 7A U.L.A. 507 (1985) states:

Every conveyance made and every 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.

4. Appraising a Prospective Guarantor's Financial Condition

Before deciding whether to enter into a guaranteed loan transaction, a lender may wish to obtain an appraisal of the guarantor's financial condition to determine whether the guarantor is insolvent or undercapitalized at the time of the loan or whether the guarantor would be rendered insolvent or left with unreasonably small capital by making the guarantee. The appraisal should measure the guarantor's financial condition under the Code definition of insolvency as well as under the applicable state fraudulent conveyance law definition of insolvency. The lender can be reasonably certain that a guarantee will not be avoidable as a constructively fraudulent obligation if the appraisal shows that the guarantor will not be rendered insolvent or undercapitalized by executing the guarantee. If more than one solvent and sufficiently capitalized guarantor is available to guarantee the loan, it may be possible for the lender to structure the transaction so that each guarantor guarantees only that portion of the loan that will not render it insolvent or undercapitalized. As additional protection against the possibility that the guarantee will be avoided as a constructively fraudulent obligation, the lender should consider requiring the guarantor's legal counsel to issue an opinion letter stating that the guarantor will not be rendered insolvent or undercapitalized by undertaking the guarantee.

IV. SECTION 548(c)

Section 548(c), the "savings clause," provides that "except to the extent that an obligation is voidable under section 544, 545, or 547" of the Code, the obligee of an obligation deemed fraudulent under section 548(a)(1) or 548(a)(2) may enforce the obligation to the extent it gave value to the debtor, if two conditions are met.¹⁵⁵ The obligee must show that it gave value for the obligation and that it received the obligation in good faith.¹⁵⁶

The applicability of section 548(c) to guarantee transactions is uncertain. On its face, the provision appears to indicate that the lender in a guaranteed loan transaction may not enforce a fraudulently incurred guarantee to any extent under any circumstances. Section 548(c) allows an obligee to enforce an obligation "to the extent that such . . . obligee gave value to the debtor."¹⁵⁷ Typically, the lender gives no value to the guarantor in exchange for the guarantee. The guarantor benefits, if at all, from the borrower whose loan it has guaranteed.¹⁵⁸ In *Howco Leasing Corp. v. Alexander Dispos-Haul Systems, Inc. (In Re Alexander Dispos-Haul Systems)*, apparently the only case in which a court has

155. 11 U.S.C.A. § 548(c) (West Supp. 1985) states:

Except to the extent that a transfer or obligation voidable under this section is voidable under section 544, 545, or 547 of this title, a transferee or obligee of such a transfer or obligation that takes for value and in good faith has a lien on or may retain any interest transferred or may enforce any obligation incurred, as the case may be, to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation.

156. *Id.*

157. *Id.*

158. See *supra* notes 63-64 and accompanying text.

discussed section 548(c) in connection with a guarantee, the court favored a literal interpretation of the provision.¹⁵⁹ The court stated:

There is nothing in 11 U.S.C. § 548(a)(2)(A) which requires the value received by a bankrupt guarantor to flow from the beneficiary of the guarantee rather than the other parties to the transaction. The origin of any consideration received in exchange for a guarantee or a transfer only becomes important for purposes of 11 U.S.C. § 548(c) where the creditor claims a lien on the subject matter of transfer after voidability has been found.¹⁶⁰

An alternative to this reading of section 548(c) would interpret the provision as protecting the lender in a guaranteed loan transaction to the extent that the guarantor received value from any source as a result of incurring the guarantee. Such a reading of the savings clause is consistent with the conclusion that section 548(a) applies to three-party and guarantee transactions. No principled rationale appears for applying both sections 548(a) and 548(c) to two-party transactions, while applying only section 548(a) to three-party transactions in which no benefit flows directly to the debtor.

If section 548(c) applies when a guarantee is fraudulent under section 548(a), the lender then must show that it took the obligation for value and in good faith. Clearly, loan proceeds transferred by the lender to the borrower constitute "value."¹⁶¹ There is no requirement that the "value" presently referred to be passed to the debtor.¹⁶² The presence or absence of good faith is a question of fact to be resolved according to the specific circumstances of each case.¹⁶³ Knowledge that the obligor is in poor financial condition when it incurs its obligation may lead to a finding that the obligee did not receive the obligation in good faith.¹⁶⁴ "Indeed, the presence of any circumstances placing the [obligee] on inquiry as to the financial condition of the [obligor] may be a contributing factor in depriving the former of any claim to good faith unless investigation actually disclosed no reason to suspect financial embarrassment."¹⁶⁵ An appraisal or opinion letter obtained by the obligee at the time of the guarantee transaction which shows that the guarantee did not place the guarantor in a poor financial condition probably would be strong evidence that the obligee received the obligation in good faith.

Code section 548(c) was derived from section 67d(6) of the Bankruptcy Act. Section 67d(6) provided, in part, that an "obligee, who without actual fraudulent intent has given a consideration less than fair . . . for such . . . obli-

159. *Alexander*, 36 Bankr. at 616.

160. *Id.*

161. "Value" includes "property, or satisfaction or securing of a present or antecedent debt of the debtor, but does not include an unperformed promise to furnish support to the debtor or to a relative of the debtor." 11 U.S.C. § 548(d)(2)(A) (1982).

162. See 11 U.S.C.A. § 548(c) (West Supp. 1985) (text quoted *supra* note 155).

163. See, e.g., *Seligson v. New York Produce Exch.*, 394 F. Supp. 125 (S.D.N.Y. 1975) (good faith should be determined on a case by case basis).

164. 4 COLLIER ON BANKRUPTCY ¶ 548.07[2], at 548-63 (15th ed. 1979).

165. *Id.* at 548-63 to -64.

gation may retain the . . . obligation as security for repayment."¹⁶⁶ Thus, the Act did not require an obligee to show affirmative good faith as a prerequisite to enforcing its obligation. In addition, section 67d(6) did not state that an obligee could enforce its obligation only to the extent of consideration passed by the obligee directly to the obligor.

Sections 9 and 10 of the UFCA¹⁶⁷ correspond to section 548(c) of the Code. The UFCA and Code provisions differ substantially. UFCA sections 9 and 10 entitle an obligor's creditors to have a fraudulent obligation set aside;¹⁶⁸ Code section 548(c) is merely a savings clause that permits the obligee to enforce its obligation to the extent of value given. Like section 67d(6) of the Bankruptcy Act, UFCA section 9 permits an obligee "who without actual fraudulent intent has given less than a fair consideration for the obligation [to] retain the obligation as security for repayment."¹⁶⁹

V. SECTION 544(b)

Section 544(b) of the Code permits the trustee to avoid "any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under section 502 . . . or that is not allowable only under section 502(c)."¹⁷⁰ The provision contains no original substantive law for determining whether an obligation is avoidable; rather, it allows the trustee to assert certain state law claims on behalf of the bankruptcy estate.¹⁷¹

Section 544(b) permits the trustee to assert only those state law avoidance

166. 11 U.S.C. § 107d(6) (repealed 1978).

167. UNIF. FRAUDULENT CONVEYANCE ACT §§ 9, 10, 7A U.L.A. 577, 630 (1985) provide:

Section 9. Rights of Creditors Whose Claims Have Matured

(1) Where a conveyance or obligation is fraudulent as to a creditor, such creditor, when his claim has matured, may, as against any person except a purchaser for fair consideration without knowledge of the fraud at the time of the purchase, or one who has derived title immediately or mediately from such a purchaser,

(a) Have the conveyance set aside or obligation annulled to the extent necessary to satisfy his claim, or

(b) Disregard the conveyance and attach or levy execution upon the property conveyed.

(2) A purchaser who without actual fraudulent intent has given less than a fair consideration for the conveyance or obligation, may retain the property or obligation as security for repayment.

Section 10. Rights of creditors whose Claims Have not Matured

Where a conveyance made or obligation incurred is fraudulent as to a creditor whose claim has not matured he may proceed in a court of competent jurisdiction against any person against whom he could have proceeded had his claim matured, and the court may,

(a) Restrain the defendant from disposing of his property,

(b) Appoint a receiver to take charge of the property,

(c) Set aside the conveyance or annul the obligation, or

(d) Make any order which the circumstances of the case may require.

168. See *id.* § 9(1)(a).

169. *Id.* § 9.

170. 11 U.S.C. § 544(b) (1982).

171. 4 COLLIER ON BANKRUPTCY ¶ 544.03[1], at 544-15 (15th ed. 1979).

claims that could be asserted by an actual unsecured creditor. One commentator has written:

Like Prometheus bound, the trustee is chained to the rights of creditors in the case under title 11. If there are not creditors within the terms of section 544(b) against whom the transfer is voidable under the applicable law, the trustee is powerless to act so far as section 544(b) is concerned.¹⁷²

If, at the time the debtor filed its petition, the creditor is not entitled to bring a claim, the trustee also has no right of action under section 544(b).¹⁷³ Such an eventuality may result, for example, by the running of the statute of limitations. Code section 546 states that an action under section 544 must be commenced within two years of the time the trustee was appointed but in no event after the case is closed or dismissed.¹⁷⁴

Section 544(b) is based on section 70e of the Bankruptcy Act.¹⁷⁵ Section 70e permitted the trustee to avoid obligations avoidable by an actual creditor under applicable state law. Significantly, section 70e did not limit the trustee's avoidance power to claims held by an unsecured creditor. The provision allowed the trustee to avoid any obligation avoidable by an actual creditor, whether secured or unsecured.¹⁷⁶

The option to proceed under section 544(b) rather than under section 548 has several advantages for the trustee. Section 548 limits avoidance of obligations to those incurred on or within a year of filing of the bankruptcy petition.¹⁷⁷ State fraudulent conveyance laws typically have a limitations period of three or more years.¹⁷⁸

The laws of some states may make it easier to prove that an obligation was fraudulently incurred than does section 548. Under the Pennsylvania Uniform Fraudulent Conveyance Act, for example, once the plaintiff proves that an obligation was incurred without fair consideration, the burden shifts to the obligee to prove that the obligor was solvent.¹⁷⁹ Further, applicable state law may permit the trustee to recover attorney's fees in a successful fraudulent conveyance action.¹⁸⁰ New York law, for example, specifically permits a bankruptcy trustee to recover attorney's fees in a successful action to avoid a transfer or obligation incurred with the actual intent to defraud creditors.¹⁸¹

172. *Id.* ¶ 544.03[1], at 544-16.

173. *Id.* ¶ 544.03[2], at 544-21.

174. 11 U.S.C. § 546 (1982).

175. 11 U.S.C. § 110e (repealed 1978).

176. *See id.*

177. 11 U.S.C.A. § 548(a) (West Supp. 1979).

178. *See, e.g.,* N.Y. DEBT. & CRED. LAW §§ 276 (McKinney 1945) (providing a six-year statute of limitations for fraudulent conveyance actions).

179. *Baker v. Geist*, 457 Pa. 73, 321 A.2d 634 (1974).

180. *Gleneagles*, 565 F. Supp. at 577.

181. N.Y. DEBT. & CRED. LAW §§ 276-a (McKinney 1945). Section 276-a is applied in federal bankruptcy proceedings. *See, e.g.,* *Bartle v. Markson*, 299 F. Supp. 958 (N.D.N.Y. 1969), *aff'd*, 423 F.2d 637 (2d Cir. 1970); *Glenmore Distilleries Co. v. Seideman*, 267 F. Supp. 915 (E.D.N.Y. 1967); *Reiber v. Baker (In Re Baker)*, 17 Bankr. 392 (Bankr. W.D.N.Y. 1982).

VI. CONCLUSION

Sections 548 and 544(b) of the Code permit the trustee in bankruptcy to avoid a debtor's obligations that deplete the debtor's assets to the detriment of its creditors. A guarantee is an obligation that may decrease the obligor's net worth and harm its creditors. As such, it is subject to the Code's fraudulent conveyance provisions.¹⁸² In contemplating a guaranteed loan transaction, a lender must be aware of this reality. To guard against the risk that a guarantor will avoid its obligation in bankruptcy, counsel for the lender should consider the following precautions:

1. The guarantor's assets should be appraised. The appraisal should document the guarantor's assets according to the "fair valuation" standard stated by the Code. It should also establish the value of the guarantor's assets under the applicable state law valuation standard, for example, the "present fair salable value" standard of the UFCA.

2. The guarantor's liabilities also should be appraised. This appraisal should include the guarantor's contingent, unmatured, disputed and unliquidated debts.

3. Appraisals of the guarantor's assets should be reviewed with an awareness of whether the guarantor is insolvent or undercapitalized at the time of the loan, or whether it would be rendered insolvent or undercapitalized as a result of incurring the guarantee.

4. When more than one guarantor is involved in the transaction, counsel should consider structuring the guarantee agreements so that each guarantor guarantees only as much of the debt as it can reasonably afford.

5. Counsel for lender should obtain an opinion letter from counsel for guarantor certifying that the guarantor is solvent and possessed of sufficient capital and that the guarantee is valid and enforceable according to its terms.

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182. UNIF. FRAUDULENT CONVEYANCE ACT, 7A U.L.A. 427 (1985). Twenty-six states have adopted the UFCA. *See id.* In 1984 the National Conference of Commissioners on Uniform Laws approved a new fraudulent conveyance law, the Uniform Fraudulent Transfer Act, 7A U.L.A. 639 (1985). No state has yet adopted this Act. *See id.*