BEFUDDLEMENT BETWIXT TWO FULCRUMS: CALIBRATING THE SCALES OF JUSTICE TO ASCERTAIN FRAUDULENT TRANSFERS IN LEVERAGED BUYOUTS

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> *Give me a lever long enough and a fulcrum on which to place it, and I shall move the world.*
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> Archimedes[1]

> *Archimedes, to move the entire globe, wanted only for a point firm and immovable; so also shall I be entitled to entertain the highest expectations, if I am fortunate enough to discover just one thing certain and indubitable.*
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> Descartes[2]

INTRODUCTION

In a leveraged buyout, a company goes deep into debt and grants liens on its assets to finance the purchase of itself. The company's risk of insolvency increases with its debt burden. Unsecured creditors of the company are exposed to this increased insolvency risk without compensation, unlike the parties to the leveraged

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None of the authors speaks herein on behalf of any other person or entity.

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[1] This quotation is apocryphal—a loose translation of words attributed to Archimedes by Pappus of Alexandria in his *Synagoge, Book VIII*, c. 340 A.D, over five hundred years after Archimedes' death. However dubious its provenance, the quote is traditional, widespread, and too apt not to use, illustrating as it does the power of leverage, and, if read literally, will-to-power ready to be loosed upon the world if sufficient leverage be available.

[2] RENÉ DESCARTES, THE METHOD, MEDITATIONS, AND SELECTIONS FROM THE PRINCIPLES OF DESCARTES 27 (John Veitch trans., William Blackwood & Sons ed., 6th ed. 1879) (1641).

buyout—buyer, seller and lender—all of whom expect good returns on the lesser risks to which they are exposed. When a leveraged buyout leaves the acquired company with "unreasonably small capital" such that insolvency is "reasonably foreseeable" upon consummation of the buyout, unsecured creditors may have recourse to constructive-fraudulent-transfer law. They need such recourse because: (1) they are not party to the leveraged buyout; (2) they have no good proxy among the parties; and (3) absent legal recourse, many have no ability to negotiate protection against uncompensated harm. Constructive-fraudulent-transfer law is defective in providing needed recourse. Proof of "unreasonably small capital" is exceedingly expensive. It requires hiring experts to conduct forensic financial analysis of whether insolvency was "reasonably foreseeable" when the buyout closed, considering: (a) the company's historical performance, (b) the terms of the buyout loans and (c) all foreseeable risks faced by the company. Trials tend to be lengthy. The "unreasonably small capital" standard is too indeterminate to enable aggrieved unsecured creditors to confidently predict the outcome of litigation. Typically, unsecured creditors—or, in bankruptcy, those charged with the duty to represent their interests—conclude that pursuing legal recourse is a high-stakes gamble with unpredictable odds, and they settle at a steep discount from the relief purportedly offered by constructive-fraudulent-transfer law. Harm goes unremedied and, therefore, doing harm is inadequately disincentivized. To correct these defects, we recommend carefully recalibrating the scales of justice through several clarifications of the standard for "unreasonably small capital." We recommend that the law specify:

- the probability at which cash-flow insolvency becomes "reasonably foreseeable;"
- the post-transaction period over which the probability of insolvency is to be projected;
- how margin-of-error is to be treated in determining whether insolvency is reasonably foreseeable; and
- whether a transfer is fraudulent if insolvency was reasonably foreseeable *ex ante* but the specific conditions ultimately precipitating insolvency were not.

I. BACKGROUND

On December 20, 2007, Tribune Co.—publisher of the *Chicago Tribune* and *L.A. Times* and owner of the Chicago Cubs—finished obligating itself on almost nine billion dollars in new debt, secured by liens on all its assets, to finance the purchase of . . . itself.[3] As is typical in a leveraged buyout ("LBO"), the buyers themselves were not liable for any of the debt.[4]

On the day of the closing, a financial analytics firm delivered a written opinion to Tribune's board—an opinion required by the lenders financing the buyout—that Tribune would be able to pay its debts as they came due, notwithstanding deteriorating revenues in the newspaper business and Tribune's vastly increased debt burden.[5] The markets thought differently. Ever since the public disclosure, eight months earlier, of approval of the LBO by Tribune's board, prices on Tribune's bonds had been trending downward, and prices of credit default swaps on Tribune's debt had been trending upward.[6] Securities analysts publically doubted Tribune's ability to bear the proposed debt-load.[7] The financial analytics firm initially retained to render an opinion that Tribune would be left solvent by the LBO refused to issue the opinion, forcing the parties to the deal to find another firm.[8] The substitute analysts' opinion proved mistaken. Less than one year after the buyout, despite extensive layoffs, Tribune found itself unable to cover its debts and filed for bankruptcy protection.[9]

In Tribune's bankruptcy, a group of unsecured creditors has sued for relief under fraudulent transfer law.[10] They argue that Tribune did not receive reasonably equivalent value in exchange for the debt it incurred in the LBO, that Tribune took on this debt for the benefit of the parties driving the deal (*i.e.*, the buyers, the former shareholders, and the lenders financing the LBO).[11] They argue that Tribune was rendered insolvent by the LBO or, if not, it was foreseeable Tribune would become insolvent if the LBO occurred.[12] They have asked the court to strip the lenders of

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[3] *See* Report of Kenneth N. Klee, As Examiner, Vol. 1, *In re* Tribune Co., No. 08-13141, at 170–78, 205–10, 460–62 (Bankr. D. Del. Aug. 3, 2010) [hereinafter Klee Report, Vol. 1] (describing $8.028 billion in loans made to Tribune in first stage of two-stage LBO, $3.705 billion in loans in second stage, and Tribune's use of $2.763 billion in loan proceeds to pay off pre-existing debts).

[4] *See* Erik Krusch, *Solvency Opinions, The Trib, and Leveraged Deals*, WESTLAW BUS. CURRENTS, Aug. 11, 2010, http://currents.westlawbusiness.com/Article.aspx?id=b64da7de-0c27-4915-93a6-f2c4b5b6f8b8.

[5] *See* Klee Report, Vol. 1, *supra* note 3, at 9–10 (noting closing conditioned on obtaining solvency opinion and procurement of solvency opinion regarding second stage of LBO "was marred by dishonesty and lack of candor . . . on the question of Tribune's solvency"), 236–37 (describing solvency opinion regarding first stage of two-stage LBO), 509–12 (describing solvency opinion regarding second stage of LBO).

[6] *See* Klee Report, Vol. 1, *supra* note 3, at 553–57.

[7] *See* Sarah Ellison, *How Will Tribune Pay Its Debts? Highly Leveraged Deal Leaves Little Room for Error, Despite Tax Breaks*, WALL ST. J., Apr. 4, 2007, at A10; Jon Fine, *Running Tribune—On Empty*, BUSINESSWEEK, Apr. 16, 2007, at 24.

[8] *See* Mike Spector & Shira Ovide, *Investment Bank Wouldn't Clear Tribune Ahead Of 2007 Buyout*, DOW JONES DAILY BANKR. REV., Aug. 3, 2010.

[9] *See* Affidavit of Chandler Bigelow III, Senior V.P. & CFO of Tribune Co. in Support of First Day Motions at 13–14, *In re* Tribune Co., No. 08-13141 (Bankr. D. Del. Dec. 8, 2008); Frank Ahrens, *Debt-Saddled Tribune Co. Files for Bankruptcy Protection*, WASH. POST, Dec. 9, 2008, at D1.

[10] *See* Complaint, Wilmington Trust Co. v. JPMorgan Chase Bank, N.A., No. 10-50732 (Bankr. D. Del. Mar. 4, 2010).

[11] *Id.* at ¶¶ 6, 82, 151.

[12] *Id.* at ¶¶ 5, 9, 78, 82, 147, 152–53.

their liens and subordinate their claims, denying them their position at the front of the line for distribution of the value remaining in Tribune.[13]

The court presiding over Tribune's bankruptcy appointed an examiner to investigate these allegations. The examiner delivered a report to the court concluding that Tribune did not receive reasonably equivalent value in exchange for the obligations it incurred to finance the LBO, that it was "highly likely" that Tribune was rendered insolvent and without adequate capital by the second stage of the two-stage LBO, and that a court would be "somewhat likely" to conclude that the transactions in that second phase constituted intentional fraudulent transfers.[14]

Assuming the examiner is correct about the Tribune buyout, how could a deal like this have happened? Why did the risk of fraudulent transfer liability not dissuade the deal parties from engaging in fraudulent transfers? Why would the buyer of a company put it at foreseeable risk of insolvency? Why would lenders finance an LBO if doing so would put the borrower at risk of insolvency? We will explore these questions. Along the way, we will identify defects in fraudulent transfer law that have resulted in harm being left unremedied and inadequately disincentivized. To assist in correcting these defects, we will recommend ways to recalibrate the scales of justice to better ascertain fraudulent transfers in leveraged buyouts.

A. Leveraged buyouts expose target-companies' unsecured creditors to uncompensated credit-risk, involuntarily and without compensation.

A leveraged buyout is an acquisition of a company in which the buyer (most often a private equity fund) pays only a fraction of the purchase price.[15] The buyer obtains purchasing power far greater than its investment using the leverage of borrowed money—money borrowed not by the buyer, but by the company acquired (the "target-company" or "target").[16] The target-company is solely responsible for repayment of the debt—typically a combination of secured and unsecured debt.[17]

The target's assets serve as collateral for the secured debt.[18] All of the debt is normally non-recourse to the buyer.[19] The targets of LBOs are well-capitalized

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[13] *Id.* at 51.

[14] Klee Report, Vol. 1, *supra* note 3, at 8–9, 19.

[15] *See* PETER A. HUNT, STRUCTURING MERGERS AND ACQUISITIONS 101, 293 (4th ed. 2009); Steven N. Kaplan & Per Strömberg, *Leveraged Buyouts and Private Equity*, 23(1) J. ECON. PERSP. 121, 121, 124 (2009) (stating LBOs are "typically financed with 60 to 90 percent debt"); Ulf Axelson, Tim Jenkinson, Per Strömberg & Michael Weisbach, *Borrow Cheap, Buy High? The Determinants of Leverage and Pricing in Buyouts* 32 (Nat'l Bureau of Econ. Research, Working Paper No. 15952, 2010), *available at* http://www.nber.org/papers/w15952 (noting debt financed averaged 70% of purchase price in worldwide sample of 1157 LBOs closing 1980–2008).

[16] *See* HUNT, *supra* note 15, at 101.

[17] *See id.* at 104–06, 302–04; *In re* Hechinger Inv. Co. of Del., Inc., 274 B.R. 71, 81 (D. Del. 2002).

[18] *See* HUNT, *supra* note 15, at 302; *see also* Mellon Bank, N.A. v. Metro Commc'ns Inc., 945 F.2d 635, 645 (3d Cir. 1991).

companies, with significant owners' equity that can be replaced by LBO-loan debt and ample cash-flow available for greatly increased debt service.[20] LBOs greatly increase target-company indebtedness,[21] and the need to service debt is an inflexible demand on the target's cash-flow, increasing risk of the target becoming insolvent.[22] As the Third Circuit put it, "[t]he problem universal to all LBOs—characterized by their high debt relative to equity interest—is that they are less able to weather temporary financial storms because debt demands are less flexible than equity interest."[23]

The target's unsecured creditors bear this increased risk of the target's insolvency. They are poorly positioned to limit such risk, not being party to the LBO and being unshielded by any good proxy among the parties. A good proxy for unsecured creditors would have an equivalent interest in the target's continuing solvency and the power to protect that interest. The target itself might be thought to have those characteristics; however, though the target is a party to an LBO and

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[19] *See* Viva Hammer, *Taxation of High-Yield Debt—Beware the End of the Reprieve*, *in* TAXATION OF FINANCIAL PRODUCTS AND TRANSACTIONS 2011, at 250 (PLI Tax Law & Practice, PLI Order No. 28310 2011) (noting debt is non-recourse); H. Peter Nesvold, *Going Private or Going for Gold: The Professional Responsibilities of the In-House Counsel During a Management Buyout*, 11 GEO. J. LEGAL ETHICS 689, 692 (1998) (explaining financial investors purchase companies on leveraged basis with nonrecourse buying and use target companies' cash flow to repay debt); Kathryn V. Smyser, *Going Private and Going Under: Leveraged Buyouts and the Fraudulent Conveyance Problem*, 63 IND. L.J. 781, 785 (1988) (stating lenders expect to be paid from future operating earnings of target company, not assets of purchasers).

[20] *See* HUNT, *supra* note 15, at 103–04, 299–300; Center for Private Equity and Entrepreneurship, Tuck School of Business at Dartmouth, *Note on Leveraged Buyouts*, (Sept. 30, 2003), at 4, http://mba.tuck.dartmouth.edu/pecenter/research/pdfs/LBO_Note.pdf.

[21] *See* Axelson et al., *supra* note 15, at 47 tbl.5, panel E (finding, in their broad sample of LBOs, ratio of debt to enterprise value increased from average of 0.38 pre-LBO to average of 0.70 post-LBO).

[22] *See* HUNT, *supra* note 15, at 300–02; *Default and Migration Rates for Private Equity-Sponsored Issuers*, MOODY'S INVESTORS SERVICE, Nov. 2006, at 3 [hereinafter MOODY'S *Default and Migration Rates*]; *Private Equity 2009: Nearly Half of Defaults, But Better-Than-Average Recovery Prospects*, MOODY'S INVESTORS SERVICE, Mar. 2010, at 1, 5 [hereinafter MOODY'S *Private Equity*]; Kaplan & Strömberg, *supra* note 15, at 129; Axelson et al., *supra* note 15, at 47 tbl.5, panel E. Moody's notes that LBO-loan "[i]ssuers almost always target [*i.e.*, aim for, post-LBO] a single-B-type capital structure"—that is, a structure wherein the debt is "speculative-grade" and the credit outlook "poor." MOODY'S *Private Equity*, *supra*, at 5. "Private-equity-sponsored companies are almost always rated B1 or lower at inception, and 70% of the defaulted issuers backed by private equity were initially rated B2 or lower." *Id.* at 1. For the period 1983–1999, 24.48% of corporate bonds rated B1 defaulted within five years, and 28.45% of those rated B2 defaulted within five years. *See Historical Default Rates of Corporate Bond Issuers*, MOODY'S INVESTORS SERVICE, Jan. 2000, at Ex. 31 [hereinafter MOODY'S *Historical Default Rates*]. Moody's found that, the higher the target's credit rating pre-LBO, the greater the increase in default risk. *See* MOODY'S *Default and Migration Rates*, *supra*, at 7–8.

In a superficially-contrasting study, Kaplan and Strömberg found, in a data-set of over 17,000 firms LBO'd worldwide since 1970, a reported rate of bankruptcy of 1.2% per annum—*less than* the 1.6% per annum average default rate reported by Moody's for all U.S. corporate bond issuers 1980–2002—but they warn that their data does not include all cases of distress and cite as "perhaps consistent" with this warning Kaplan's own earlier finding that the default-rate among larger public-to-private companies LBO'd in the 1980s was 23%, much higher than the 6–7% rate reflected in the Kaplan/Strömberg dataset for the same period. *See* Kaplan & Strömberg, *supra* note 15, at 129.

[23] *Mellon Bank*, 945 F.2d at 647.

though an LBO has profound—and potentially catastrophic—effects on the target's capital structure, the target's interests are poorly represented at the negotiating table. The terms of a leveraged buyout are negotiated among the selling shareholders, the buyer, the lender, and, in a "friendly" takeover, the target's management and board of directors. None of these is a good proxy for unsecured creditors:

- The selling shareholders receive their price at closing and have no continuing stake in the target, and thus no exposure to risk of leverage-induced insolvency.
- The investment banks arranging or underwriting the LBO-loan package receives its considerable fees at closing and typically does not keep the loans on their books.[24]
- The LBO lenders[25] (1) are protected by their security interests in target-company assets, and (2) voluntarily assume credit-risk in pursuit of commensurate interest rates providing a favorable risk-adjusted return. Participants in the LBO loan commonly securitize or sell their interests rather than hold the debt to maturity, which eliminates their interest in the target's long-term solvency.
- The buyer's leveraged investment is at risk of total loss in the event of insolvency, but private equity funds reduce this risk by:
  (1) recouping their investment early through "dividend recapitalizations"—that is, causing the LBO'd company to take out additional loans and to dividend loan proceeds to shareholders—a practice that sometimes enables private equity funds to enjoy net gains even from portfolio companies that go bankrupt;[26] and

[24] In the 1980s and 1990s, debt financing for LBOs was provided predominately through the junk-bonds underwritten by investment banks. *See* Viral V. Acharya, Julian Franks & Henri Servaes, *Private Equity: Boom and Bust?*, J. APPLIED CORP. FIN., Fall 2007, at 45–46. In the 2000s, investment banks instead provided loans that they pooled and securitized as "collateralized loan obligations" ("CLOs"), at least until the financial crisis tarnished the image of CLOs and other securitized debt. For an example of the investment-bank fees generated in an LBO, see Klee Report, Vol. 1, *supra* note 3, at 208–10, 461–62 (detailing $207 million in fees and expenses paid to investment banks arranging and participating in financing roughly $11.7 billion in loans for LBO of Tribune Co.). Some have suggested that arrangers' pursuit of fees, combined with their lack of continuing on-the-books exposure, led to a loosening of LBO lending standards during the LBO-boom of the mid-2000s. *See, e.g.*, Acharya et al., *supra*, at 46.

[25] For an overview of the market for LBO debt in the U.S., including syndication and securitization, see Glenn Yago & Donald McCarthy, Milken Institute, *The U.S. Leveraged Loan Market: A Primer* (2004), http://milkeninstitute.org/pdf/loan_primer_1004.pdf.

[26] *See* Kelly Holman, *Recaps Raise Red Flags*, MERGERS & ACQUISITIONS REP., Oct. 5, 2009, at 1, http://www.allbusiness.com/banking-finance/financial-markets-investing/13137273-1.html. Through dividend recapitalizations, private equity funds maintain high leverage on portfolio companies capable of paying down their debt, thereby maintaining risk of insolvency. For a case study of such risk eventually being realized, even as the private-equity sponsor enjoyed net gains, see Julie Creswell, *Profits for Buyout Firms as Company Debt Soared*, N.Y. TIMES, Oct. 5, 2009, at A1, which describes how private equity funds

(2) aggregating risk of leverage-induced insolvency across a portfolio of leveraged acquisitions, enjoying leveraged rewards on the bets that pay off.

- In a "friendly" takeover, pre-LBO upper management commonly receives equity in the post-LBO company, which gives them an interest in the LBO.[27]
- The members of the pre-LBO board have fiduciary duties to pre-LBO shareholders—the sellers in an LBO—who, in turn, have an interest in maximizing sale price and, therefore, in maximizing the total package of debt and equity funding the LBO. To the extent the LBO would put the target in the "zone of insolvency," the directors have a conflicting fiduciary duty to the target's creditors.[28] But it is difficult, and perhaps impossible, to serve as fiduciary to two groups with conflicting interests. The board may be incentivized to support a deal pleasing to shareholders by the threat of a "hostile takeover," in which the buyer puts a proxy vote to shareholders to install a new board that will support the LBO.[29]

In sum, unsecured creditors are alone in being exposed to the risk of leverage-induced insolvency involuntarily and without prospect of reward. They can only hope to be paid what they are owed, which is unchanged by the LBO, however great the insolvency risk generated.

Voluntary unsecured creditors who lent to a target before any hint of leveraged buyout will have done so based on evaluation of the target's then-creditworthiness. Leveraged buyout deleteriously affects that creditworthiness. While voluntary pre-LBO creditors might, *ex ante*, negotiate loan terms (such as leverage-triggered interest rate increases) to protect themselves against LBO-induced credit-risk, only a small subset of voluntary unsecured creditors: (1) are sufficiently sophisticated to be aware of their exposure to LBO-induced credit risk; (2) have sufficient bargaining power to negotiate protective terms; and (3) have sufficiently concentrated interests to make it economical to negotiate, police, and enforce such

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maintained high leverage on Simmons for years, cashing out accrued equity through dividend recapitalizations until risk of insolvency was finally realized.

This paper focuses on the application of fraudulent transfer law to LBOs, but the analysis and recommendations herein apply equally to application of fraudulent transfer law to dividend recapitalizations.

[27] *See* HUNT, *supra* note 15, at 110, 300; *see, also*, Klee Report, Vol. 1, *supra* note 3, at 208–10, 430–38 (detailing equity interests provided to Tribune managers in connection with LBO).

[28] *See* VFB LLC v. Campbell Soup Co., 482 F.3d 624, 635 (3d Cir. 2007); FDIC v. Sea Pines Co., 692 F.2d 973, 976–77 (4th Cir. 1982); 3 WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF CORPORATIONS § 1035.60 (perm. ed., rev. vol. 2011).

[29] *See* FLETCHER ET AL., *supra* note 28, at § 1041.30 (recognizing potential conflict of interest in hostile takeover scenario); Joseph S. Melchione & Timothy I. Oppelt, *Fiduciary Duties of Credit Union Directors in the Merger Context*, 7 DEPAUL BUS. & COM. L.J. 203, 231–38 (2009) (describing conflicts between directors' and shareholders' interests in hostile takeovers and fiduciary law designed to align those interests).

terms.[30] Trade creditors, constrained by competition in their markets, will tend to fall outside that subset.[31] Furthermore, involuntary creditors—including tort claimants, employee-benefits plans, and government agencies with claims for taxes, environmental liabilities, pension-benefit insurance, *et cetera*—have little or no ability to negotiate protection of their interests.[32]

Because all parties to LBOs enjoy greater returns on risk than unsecured creditors, they expose unsecured creditors to more risk than unsecured creditors would choose for themselves.[33] The risk to unsecured creditors is a cost of leveraged buyouts that is, in economics parlance, "externalized" onto unsecured creditors.[34]

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[30] *See* Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887, 1916 (1994) (positing most unsecured creditors are unaware of risks involved when extending credit).

[31] Steve Knippenberg, *The Unsecured Creditor's Bargain: An Essay in Reply, Reprisal, or Support?*, 80 VA. L. REV. 1967, 1970 (1994) (describing vulnerability among voluntary unsecured creditors, particularly trade creditors).

[32] *See* Moody v. Sec. Pac. Bus. Credit, Inc., 971 F.2d 1056, 1073 n.27 (3d Cir. 1992) ("We recognize that certain voluntary creditors may be able to protect themselves against leveraged buyouts through loan agreements. However, not all creditors have the bargaining power to obtain such contractual protection and most creditors are involuntary."); United States v. Tabor Court Realty Corp., 803 F.2d 1288, 1297 n.2 (3d Cir. 1986). If a voluntary creditor has no choice in the matter of leveraged buyout, it can at least anticipate the possibility of a leveraged buyout when deciding whether to become a creditor. An *involuntary* creditor—such as a tort victim or statutory creditor—has no choice. Professors Baird and Jackson, arguing against the application of constructive-fraudulent-transfer law to LBOs, downplayed the problems of both voluntary and involuntary creditors:

> If fraudulent conveyance law does not cover a certain kind of activity, yet creditors want to prohibit it, it can be prohibited contractually. Myriad restrictions in loan agreements, for example, perform this function. If certain activity is prohibited by a few large creditors, other creditors (including nonconsensual creditors) may be able to profit by the monitoring of the debtor undertaken by those whose contracts do prohibit such activity.

Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829, 835 (1985). Professors Baird and Jackson provide no support for the proposition that creditors "may be able to profit" from vicarious protection of a few large creditors. The "myriad restrictions" to which they refer are common in secured loans from banks. The secured lenders to LBO'd companies are typically those providing the secured portion of the LBO-loan package. As discussed in parts I.A and I.D of this paper, they are poor proxies for unsecured pre-LBO creditors. Bondholders may be able to negotiate change-in-control covenants, giving them the right to demand repayment upon a change in control of the bond-issuing company, which affects the likelihood of a company being LBO'd. *See generally* Matthew T. Billett, Zhan Jiang & Erik Lie, *The Role of Bondholder Wealth Expropriation in LBO Transactions* (Working Paper, Mar. 2008), *available at* http://ssrn.com/abstract=1107448 (discussing change-in-control covenants in bonds and their influence on likelihood of issuer being subject to LBO). *But see* Yedidia Z. Stern, *A General Model for Corporate Acquisition Law*, 26 J. CORP. L. 675, 709 (2001) (explaining why bondholders may be poorly positioned to negotiate bond terms). But involuntary creditors are without a choice as to whether such covenants are in place, and small trade creditors cannot be expected to investigate and act on the existence of such covenants.

[33] *See* Stern, *supra* note 32, at 705–08 (describing conflicts between shareholders and creditors in LBOs).

[34] *Cf. id.* at 707–08 ("[O]ne of the main incentives for leveraged buyout acquisitions is the purchasing shareholders' intention of transferring the creditors' wealth to themselves by altering the degree of leverage in the company.").

Economics teaches that any activity that externalizes costs (if it does not externalize offsetting benefits) enjoys a net subsidy, and society will be poorer for it. Producers will not cease production when total costs exceed total benefits, because they do not bear all costs. They will disregard externalized costs and keep producing. Total costs will therefore exceed total benefits. From a conventional economic perspective, this failure to maximize "utility" is inefficient.[35] From a utilitarian perspective, it is a deviation from the ideal.[36] From the unsecured creditors' perspective, it is a privately-forced subsidy—an injustice tantamount to theft. From a Rawlsian justice perspective, the unsecured creditors' perspective ought to guide policy.[37] From all four perspectives, the externality should be internalized.[38]

B. The risks to which unsecured creditors are exposed by LBOs have been realized dramatically with the crashing of the LBO-wave of the mid-2000s.

LBOs have tended to come in waves, during periods when credit is relatively cheap and available.[39] There was a large wave in the 1980s, and another in the mid-2000s, each followed by a wave of target-company insolvencies.[40]

In the LBO-wave of the mid-2000s, loans for financing LBOs were—like mortgage loans and other forms of securitizable debt—relatively cheap and available on borrower-friendly terms.[41]

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[35] For a brief explanation of externalities, see ECONOMIST, *Research Tools: Economics A-Z: Externality*, http://www.economist.com/research/Economics/alphabetic.cfm?letter=E#externality.

[36] For an explanation of utilitarianism, see STANFORD ENCYCLOPEDIA OF PHILOSOPHY, *The History of Utilitarianism*, Mar. 27, 2009, http://plato.stanford.edu/entries/utilitarianism-history/.

[37] For a brief explanation of Rawls' theory of justice, see John Rawls, STANFORD ENCYCLOPEDIA OF PHILOSOPHY, *§ 4.6 The Original Position*, Mar. 25, 2008, http://plato.stanford.edu/entries/rawls/#OriPos; Robert K. Rasmussen, *An Essay on Optimal Bankruptcy Rules and Social Justice*, 1994 U. ILL. L. REV. 1, 11–12 (1994). Under Rawls' theory, just policy decisions are those which would be made behind a notional "veil of ignorance," where the policymaker has no knowledge of their own place in society. *See* Rawls, *supra*. The policymaker contemplating an LBO would not be guided solely by the unsecured creditors' perspective, but they would have to take that perspective into account, as they might find themselves similarly situated.

[38] The law-and-economics perspective agrees, but would only support a law internalizing costs if purported beneficiaries cannot not protect themselves by contract, which, as discussed *supra*, is commonly the case for unsecured creditors. For a law-and-economics argument that unsecured creditors do not need fraudulent transfer law to protect them from leveraged buyouts, see Baird & Jackson, *supra* note 32, at 835.

[39] *See* Kaplan & Strömberg, *supra* note 15, at 121, 137–41. On the positive correlation between cheap, abundant credit and the number of leveraged buyouts, see Steven N. Kaplan & Jeremy C. Stein, *The Evolution of Buyout Pricing and the Financial Structure in the 1980s*, 108 Q.J. ECON. 313, 313–14 (1993). On the positive correlation between cheap, abundant credit and the degree of leverage in the capital structure of private-equity-owned companies, see Axelson et al., *supra* note 15, at 5–6.

[40] *See Refunding Risk and Needs for U.S. Speculative-Grade Corporate Issuers*, MOODY'S INVESTORS SERVICE, Feb. 2010, at 4 [hereinafter MOODY'S *Refunding Risk I*]; Acharya et al., *supra* note 24, at 44–50. Regarding the wave of insolvencies following the LBO-wave of the 1980s, see Kaplan & Stein, *supra* note 39, at 313-357.

In 2007 and 2008, risks that had accumulated on the balance sheets of major financial institutions during the credit and asset bubble (and that were sometimes hidden off those balance sheets) manifested at a few such institutions and appeared to threaten nearly all.[42] Credit markets tightened rapidly and dramatically.[43] In the ensuing recession, many companies acquired through leveraged buyout during the boom buckled under their debt burdens.[44] Many have gone bankrupt, including Chrysler, Hawaiian Telcom, Linens 'N Things, Simmons, LyondellBasell, Capmark Financial Group, Reader's Digest, Cooper-Standard Automotive, Aleris International, Extended Stay Hotels, and Tribune Co.[45] Many more have defaulted

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[41] *See* Anil Shivdasani & Yihui Wang, *Did Structured Credit Fuel the LBO Boom?* 21–22, 29–32 (Working Paper, Apr. 24, 2009), *available at* http://ssrn.com/abstract=1285058; *see also* MOODY'S *Refunding Risk I, supra* note 40, at 2. According to Moody's,

> [t]he leveraged loan market expanded for a number of reasons during the mid-2000s: abundant market liquidity, lender tolerance for high leverage, the emergence of hedge-fund and private-equity participation in the loan market, covenant-lite structures (especially in early 2007), and numerous new investors in collateralized loan obligations (CLOs). During 1999-2004, the total U.S. leveraged loan market grew from $669 billion to $920 billion. By early 2010 the leveraged loan market stood at $1,631 billion.

MOODY'S *Refunding Risk I, supra* note 40, at 4.

[42] *See generally The Financial Crisis: A Timeline of Events and Policy Actions*, FED. RES. BANK OF ST. LOUIS, http://timeline.stlouisfed.org/index.cfm?p=timeline.

[43] *See* Timothy Bianco & Mehmet Pasaogullari, *An Update on the High-Yield Corporate Bond Spread and Economic Activity*, FED. RES. BANK OF CLEV., Dec. 22, 2009, http://www.clevelandfed.org/research/trends/2010/0110/01monpol.cfm; Mary Beth Chosack, *The April 2010 Senior Loan Officer Opinion Survey on Bank Lending Practices*, BOARD OF GOVERNORS OF THE FED. RES. SYS., May 3, 2010, at tbls. 1 & 2, http://federalreserve.govf/boarddocs/SnLoanSurvey/201005; Michael B. Gordy & Søren Willemen, *Constant Proportion Debt Obligations: A Post-Mortem Analysis of Ratings Models*, FED. RES. BOARD FIN. & ECON. DISCUSSION SERIES, Sept. 23, 2009, at figs. 1, 7–8, http://www.federalreserve.gov/pubs/feds/2010/201005/index.html.

[44] *See $640 Billion & 640 Days Later: How Companies Sponsored by Big Private Equity Have Performed During the U.S. Recession*, MOODY'S GLOBAL CORPORATE FINANCE, Nov. 2009, at Report No. 121005 [hereinafter MOODY'S *$640 Billion*]. Moody's concluded that, over the study period (January 2008–September 2009): (1) the ten largest private-equity-owned leveraged buyouts performed significantly worse than similarly-rated public companies; (2) companies owned by the largest private equity firms defaulted at roughly the same rate as similarly rated companies, but suffered higher rates of distress; and (3) distress was "much more common" among LBO'd companies compared to similarly-rated companies. *See id.* at 4. The second and third of these three conclusions might be misread to mean that LBO'd companies fared nearly as well as other companies, defaulting at the same rate, although showing higher rates of distress—a misreading because Moody's compared the default rate on LBO-loan-backed debt to *speculative-grade* debt. *See id.* at 1–3 & nn.1 & 3. As discussed *supra* note 20 and accompanying text, LBOs are targeted at *well-capitalized* companies with ample equity that can be replaced by debt and ample cash-flow that can be redirected to debt service. Moody's report therefore indicates that, post-LBO, these formerly well-capitalized companies defaulted at about the same rate as distressed companies (except the largest LBO'd companies, which defaulted more often).

[45] *See In re* Chrysler LLC, No. 09 B 50002(AJG) (Bankr. S.D.N.Y.); *In re* Hawaiian Telcom Commc'ns Inc., No. 08–02005 (Bankr. D. Haw.); *In re* Linens Holding Co., No. 08-10832(CSS) (Bankr. D. Del.); *In re* Simmons Bedding Co., No. 09-14037 (MFW) (Bankr. D. Del.); *In re* Lyondell Chem. Co., No. 09–10023 (REG) (Bankr. S.D.N.Y.); *In re* Capmark Fin. Grp. Inc., No. 09–13684 (CSS) (Bankr. D. Del.); *In re*

on their LBO debt, including Clear Channel Communications, Harrah's Entertainment, and TXU.[46] Unsecured creditors have suffered enormous losses.

There may be more fallout to come. The LBO-wave of the mid-2000s left LBO'd companies with a great deal of speculative-grade debt scheduled to mature between 2011 and 2014, and, in the first half of 2010, rating agencies issued grave warnings about refunding risk and consequent default risk faced by speculative-grade borrowers during that period.[47] Since then, the rate of defaults among speculative-grade borrowers has significantly decreased.[48] Speculative-grade borrowing has become cheaper and more available, and many speculative-grade borrowers have taken advantage of these conditions to extend maturities on their debts.[49] Rating agencies' warnings have become less dire, lately focusing on continued refunding and default risk among weaker speculative-grade borrowers.[50]

C. Fraudulent transfer law offers remedy and disincentives for excessive risk-externalization in leveraged buyouts.

Fraudulent transfer law—an ancient body of law[51] incorporated into state statutes and into the Bankruptcy Code[52]—offers a potential remedy to unsecured

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Reader's Digest Ass'n, Inc., No. 09-23529 (RDD) (Bankr. S.D.N.Y.); *In re* Cooper-Standard Holdings Inc., No. 09-12743 (PJW) (Bankr. D. Del.); *In re* Aleris Int'l, Inc., No. 09-10478 (BLS) (Bankr. D. Del.); *In re* Extended Stay Inc., No. 09–13764 (JMP) (Bankr. S.D.N.Y.); *In re* Tribune Co., No. 08–13141 (KJC) (Bankr. D. Del.).

[46] *See* Jenny Andersen & Julie Creswell, *Power Players, Unplugged*, N.Y. TIMES, Feb. 28, 2010, at BU1 (examining disastrous leveraged buyout of Texas energy conglomerate TXU, funded by high risk loans and bonds); Michael S. Derby, *Economic-Strength Data, Stock Gains Damp Treasurys*, WALL ST. J., Jan. 30, 2008, at C2 (discussing Harrah's inability to offload its debt from leveraged buyout by trading in secondary markets); Geraldine Fabrikant, *Radio Giant Faces Crisis in Cash Flow*, N.Y. TIMES, Apr. 29, 2009, at B1 (discussing Clear Channel's LBO and problems company will face in trying to meet debt obligations). LBO'd companies comprised nearly half of non-financial American companies that defaulted on Moody's-rated debt in 2009. *See* MOODY'S *Private Equity, supra* note 22, at 1–3 (analyzing level of defaults of leveraged buyouts in 2009). Moody's notes that, "[f]or some companies, covenant-lite loan agreements have helped forestall default. Covenant-lite structures have also facilitated some distressed-exchange opportunities." *Id.* at 5.

[47] *Leveraged Finance: Wave of Debt Coming Due May Wash Away Some U.S. Speculative-Grade Borrowers*, STANDARD & POOR'S, June 16, 2010, at 2; MOODY'S *Refunding Risk I*, *supra* note 40, at 1–5.

[48] *See* William H. Chew, *For U.S. Leveraged Finance, How Much Credit Risk Remains?*, STANDARD & POOR'S, Feb., 2011, at 3–4 [hereinafter S&P *Risk Remains*]; *Refunding Risk & Needs US Speculative-Grade Corporate Issuers 2011-2015*, MOODY'S INVESTORS SERVICE, Jan., 2011, at 18 [hereinafter MOODY'S *Refunding Risk II*].

[49] *See* S&P *Risk Remains*, *supra* note 48, at 5; *Leveraged Finance: How Far Can Leveraged Loan Borrowers Kick Maturities Down The Road*, STANDARD & POOR'S, June 16, 2010, at 2–3; MOODY'S *Refunding Risk II*, *supra* note 48, at 3–4; *U.S. Non-Financial Corporate Bond Issuers' Maturities: Manageable through 2012, But Expected to Soar Thereafter*, MOODY'S INVESTORS SERVICE, Sept. 2010, at 11.

[50] *See* S&P *Risk Remains*, *supra* note 48, at 4–5; MOODY'S *Refunding Risk II*, *supra* note 48, at 14–15.

[51] American fraudulent transfer law has its origins in ancient Roman law, via England's Statute of 13 Elizabeth, passed by Parliament 1571, which made illegal and void any transfer for the purpose of hindering, delaying or defrauding creditors. *See* 13 Eliz., ch. 5 (1571), *superseded by* The Law of Property Act, 15 Geo.

creditors harmed by excessive risk-externalization in leveraged buyouts. Fraudulent transfer law, in its most basic form, says that a debtor may not transfer assets intending to place them beyond reach of creditors.[53] The law was developed to address the problem of debtors seeking to avoid repaying creditors by transferring assets to a friend, relative or affiliate.[54] A court that finds a transfer to be fraudulent orders the transfer avoided (that is, the transferred assets returned) to the extent necessary to satisfy creditors' claims.[55] A court may also enjoin transfer by the debtor or transferee, or appoint a receiver, subject to applicable principles of equity.[56]

Fraudulent transfer law provides the same remedies, irrespective of proven intent, for "constructively fraudulent transfers"—transfers bearing certain indicia of fraud or that are inherently harmful to creditors.[57] These include transfers made (and liabilities incurred)[58] in exchange for less than "reasonably equivalent value" by a transferor in one of several financially precarious positions—either:

1. insolvent at the time of transfer;
2. rendered insolvent by the transfer;

5, ch. 20, § 172 (1925); Max Radin, *Fraudulent Conveyances at Roman Law*, 18 VA. L. REV. 109, 109 (1931).

[52] In the United States, there are both federal and state fraudulent transfer laws. All fifty states have fraudulent transfer statutes, all but six modeled on the Uniform Fraudulent Transfer Act ("UFTA"), successor to the Uniform Fraudulent Conveyance Act ("UFCA"). *See* UNIF. FRAUDULENT TRANSFER ACT: Refs. & Annots., 7A U.L.A. 2 (2006). Federal law includes the fraudulent-transfer provisions in section 548 of the Bankruptcy Code. *See* 11 U.S.C. § 548 (2006). The law of fraudulent transfers varies somewhat among jurisdictions; however, UFTA § 4 and Bankruptcy Code § 548(a)(1) are similar by design, and cases applying one are persuasive authority regarding application of the other. *See* COLLIER ON BANKRUPTCY, ¶¶ 548.01[1][b] & 548.01[2][a] (Alan N. Resnick & Henry J. Sommer eds., 16 ed. 2010). This paper includes direct citations to the UFTA as a proxy for citations to statutes of each state incorporating the UFTA.

[53] *See* United States v. Green, 201 F.3d 251, 254 (3d Cir. 2000) (noting historically, fraudulent transfer law attacked transactions where transferor had specific intent to keep assets away from creditors); *see also* Henry v. Lehman Commercial Paper, Inc. (*In re* First Alliance Mortg. Co.), 471 F.3d 977, 1008 (9th Cir. 2006) ("The purpose of fraudulent transfer law is 'to protect creditors from last-minute diminutions in the pool of assets in which they have interests.'" (quoting Pioneer Liquidating Corp. v. San Diego Trust & Sav. Bank (*In re* Consol. Pioneer Mortg. Entities), 211 B.R. 704, 717 (S.D. Cal. 1997))); Jack F. Williams, *Revisiting the Proper Limits of Fraudulent Transfer Law*, 8 BANKR. DEV. J. 55, 63 (1991).

[54] *See* Baird & Jackson, *supra* note 32, at 829.

[55] *See* 11 U.S.C. §§ 548(a)(1)(A), 550; UFTA § 7 (2006); *see also* Damazo v. Wahby, 305 A.2d 138, 142 (Md. 1973) ("[T]he underlying objective of the uniform act . . . is to enhance and not impair the remedies of the creditor.").

[56] *See* UFTA § 7(a)(3) & cmt. 3; Ritchie Grocer Co. v. Sanders, 294 S.W.2d 54, 55 (Ark. 1956) (affirming appointment of receiver of assets fraudulently transferred). Regarding injunctive relief, see *infra* note 148.

[57] *See* UFTA § 4(b).

[58] Fraudulent-transfer law applies not only to transfers of interests in specific property for less than reasonably equivalent value, but also to obligations incurred for less than reasonably equivalent value. The Bankruptcy Code speaks of these in the alternative. *See* 11 U.S.C. § 548 (a)(1). For simplicity, in this paper, the term "transfer" includes the incurring of obligations.

3. left, following the transfer, with "unreasonably small capital" for the business in which it is engaged or is about to engage; or
4. intending to incur, or believing it would incur, debts it would be unable to pay as they matured.[59]

It is said that courts developed constructive-fraudulent-transfer law in recognition of the difficulty of obtaining proof that a debtor transferred assets *intending* to keep them from creditors.[60] In this conception, constructive-fraudulent-transfer law describes circumstantial evidence of intent. The more precarious a debtor's financial condition, the greater the likelihood its creditors will be harmed by an asset-giveaway, and the greater the debtor's motive to divert assets to those it prefers over its creditors. For example, the owner of a closely-held company that is drowning in debt has incentive to cause the company to transfer assets to his alter-ego instead of preserving assets for the company's creditors.

While the origins of constructive-fraudulent-transfer law may lie in courts' efforts to remedy fraud otherwise irremediable due to the difficulty of obtaining proof of fraudulent intent,[61] that purpose fails to explain constructive-fraudulent-transfer law as it exists. If divining intentional fraud from circumstantial evidence were courts' and lawmakers' sole purpose, they created a body of law grossly over-inclusive in assigning liability. Not every asset-giveaway that leaves the transferor in peril of insolvency is *intended* to deprive creditors of the transferred assets. The transferor (or those controlling it) might instead be negligent of insolvency risk.

A better explanation of constructive-fraudulent-transfer law is that a creditor unable to collect its due suffers the same harm whether the debtor has given away assets *intending* to thwart collection or *negligent* of creditors' ability to collect.[62] In this conception, constructive fraudulent transfer is not just a means of divining fraud, but a related unintentional tort whereunder: (1) the would-be transferor in, or approaching, a precarious financial condition owes its creditors a duty to obtain reasonably equivalent value in exchange for transfers; and (2) the would-be transferor contemplating an asset-giveaway owes its creditors a duty to proceed

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[59] *See* 11 U.S.C. § 548(a)(1)(B); UFTA § 4(a)(2); UFCA §§ 4–6. UFCA's test for constructive fraudulent transfer turns on "fair consideration" instead of "reasonably equivalent value." UFCA § 3.

[60] *See, e.g.*, Baird & Jackson, *supra* note 32, at 830–31; Barry L. Zaretsky, *Fraudulent Transfer Law as the Arbiter of Unreasonable Risk*, 46 S.C. L. REV. 1165, 1166 (1995).

[61] *See* Twyne's Case, 76 Eng. Rep. 809, 810–11 (K.B. 1601) (setting forth six "badges of fraud"); Bruce A. Markell, *Toward True and Plain Dealing: A Theory of Fraudulent Transfers Involving Unreasonably Small Capital*, 21 IND. L. REV. 469, 473–74 (1988).

[62] Some courts have recognized this. *See In re* Moody v. Sec. Pac. Bus. Credit Inc., 971 F.2d 1056, 1073 (3rd Cir. 1992); MFS/Sun Life Trust—High Yield Series v. Van Dusen Airport Servs. Co., 910 F. Supp. 913, 933 (S.D.N.Y. 1995) ("[C]ourts now uniformly hold that fraudulent conveyance laws apply to LBOs. They recognize that even if the collusive aspects of the Elizabethan paradigm may not be present in an arm's-length LBO, creditors will suffer the same type of harm the laws were designed to remedy if the target is rendered insolvent."); *In re* Healthco Int'l, Inc., 208 B.R. 288, 302 (Bankr. D. Mass. 1997) (describing "unreasonably small capital" element of constructive fraudulent transfer as "similar to the concept of negligence, which is conduct that creates an unreasonable risk of harm to another's person or property").

only if it is not in, and will not end up in, a precarious financial condition.[63] Breaching either duty, whether intentionally or negligently, harms unsecured creditors.

In a leveraged buyout, the target engages in three major transfers:

1. incurring obligations to repay the loan;
2. granting the lender liens; and
3. transferring loan proceeds to the sellers in exchange for stock in itself.

The third of these transfers is covered by a "safe-harbor" provision of the Bankruptcy Code whereunder payment in settlement of a securities transaction cannot be avoided unless "actual" fraudulent transfer is proven—meaning that the plaintiff must prove that the transferor actually intended to impede creditors' collection.[64] We will examine courts' application of fraudulent transfer law to the other two transfers (both of which are to LBO lenders), looking first at the reasonably equivalent value element, then at the financially-precarious-position element.

Where an LBO is found to have been a fraudulent transfer, the court's order that the transfer is avoided may include: (1) stripping secured LBO-lenders of their liens; (2) recovery of loan payments; (3) subordination or disallowance of LBO-lenders' claims; and (4) recovery of fees paid to professionals in connection with a

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[63] Professors Baird and Jackson articulated a different view of constructive-fraudulent-transfer law—that it is aimed at reaching actual fraud via "badges of fraud" but is over-inclusive, sweeping in "legitimate transfers," including LBOs. *See* Baird & Jackson, *supra* note 32, at 830–35, 850–54. Judge Queenan, who wrote the Third Circuit's seminal decision in *Moody* (see *infra* notes 105 *et seq.* and accompanying text) wrote an opinion when he was a bankruptcy judge highly-critical of the professors' view:

> Although conceding that gifts by insolvents should be actionable without regard to intent, [Professors Baird and Jackson] would leave fraudulent transfer law in Elizabethan times and claim exemption for leveraged buyouts because of their modern business context and an assumed absence of actual fraudulent intent on the part of their participants. But a transaction which at the outset gives the debtor no value and leaves it insolvent or with unreasonably small capital is quite different from one which merely turns out poorly in the end. The Baird and Jackson arguments are unconvincing in both their logic and their inconsistency with the express wording of the fraudulent transfer statutes.

In re Vadnais Lumber Supply, Inc., 100 B.R. 127, 134 (Bankr. D. Mass. 1989) (internal citations omitted).

[64] *See* 11 U.S.C. § 546(e); Brandt v. B.A. Capital Co. LP (*In re* Plassein Int'l Corp.), 590 F.3d 252, 258 (3d Cir. 2009); QSI Holdings, Inc. v. Alford (*In re* QSI Holdings, Inc.), 571 F.3d 545, 549–51 (6th Cir. 2009); Contemporary Indus. Corp. v. Frost, 564 F.3d 981, 985–86 (8th Cir. 2009). Congress legislated the safe harbor out of concern that securities and commodities markets could be disrupted by avoidance of settled transactions. *See* H.R. REP. NO. 97-420, at 1 (1982), *reprinted in* 1982 U.S.C.C.A.N. 583, 583; Kaiser Steel Corp. v. Charles Schwab & Co., 913 F.2d 846, 848–50 (10th Cir. 1990); George V. Utlik & Schuyler G. Carroll, *The Safe Harbor Provided for "Settlement Payments" by Section 546(e)*, 19 NORTON J. BANKR. L. & PRAC. 321, 323 (2010).

leveraged buyout.[65] In a target-company's bankruptcy (which is where fraudulent transfer actions regarding LBOs have historically been brought) these remedies increase unsecured creditors' recovery on their claims.

While aggrieved creditors[66] sometimes claim that an LBO involved intentional fraudulent transfer, and, in rare instances, they have succeeded in that cause of action,[67] most fraudulent transfer litigation regarding LBOs centers on constructive fraudulent transfer. This paper focuses on fixing the analytical framework of constructive-fraudulent-transfer law as applied to LBOs.

1. Courts have generally concluded that LBOs do not provide the target-company with "reasonably equivalent value."

Though the target-company receives loan proceeds in exchange for incurring loan obligations, courts view this exchange as but one in a series of successive transactions comprising the LBO, the whole of which is conceived, executed and construed as a single transaction and which, taken as a whole, leaves the target with less than reasonably equivalent value.[68] In evaluating the reasonable equivalence of value exchanged, courts look to the net effects of the whole transaction.[69] There is variation among LBOs in the particular series of step-transactions, but the net effect is the same: (1) the loan proceeds go from the lenders to the sellers, and (2) the target company obligates itself for the LBO debt and grants security interests in its assets to secure that debt, for the acquisition shares in itself.[70]

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[65] *See In re* Best Prods. Co., Inc., 168 B.R. 35, 47–56, 60–61 (Bankr. S.D.N.Y. 1994) (contemplating each of listed remedies). Regarding equitable subordination, see 11 U.S.C. § 510(c) (empowering bankruptcy court to equitably subordinate); *In re* Pajaro Dunes Rental Agency, Inc., 174 B.R. 557, 597–98 (Bankr. N.D. Ca. 1994) (discussing equitable subordination); *In re* O'Day Corp., 126 B.R. 370, 412–13 (Bankr. D. Mass. 1991) (finding equitable subordination proper).

[66] In this paper, we sometimes treat creditors as being in the plaintiff position in fraudulent transfer cases. It is creditors whom fraudulent transfer law exists to protect. In bankruptcy, however, fraudulent transfer actions belong first to the trustee of the bankruptcy estate (in a liquidation under chapter 7) or to the debtor in possession (under chapter 11), each of whom manages the estate as fiduciary to creditors. *See* 11 U.S.C. § 544 (listing avoidance powers of trustee); 11 U.S.C. § 1107 (granting debtor in possession in chapter 11 powers of trustee); *see also In re* Nat'l Forge Co., 326 B.R. 532, 542 (W.D. Pa. 2005) (noting Bankruptcy Code confers power and responsibility on trustees and debtors in possession to bring fraudulent transfer actions).

[67] *See, e.g.*, United States v. Gleneagles Inv. Co., 565 F. Supp. 556, 580–81 (M.D. Pa. 1983), *aff'd in relevant part sub nom.* United States v. Tabor Court Realty Corp., 803 F.2d 1288 (3d Cir. 1986); *see also* Report of Kenneth N. Klee, As Examiner, Vol. 2, *In re* Tribune Co., No. 08-13141, at 32–77 (Bankr. D. Del. Aug. 3, 2010) [hereinafter Klee Report, Vol. 2] (concluding it to be "somewhat likely" court would find intentional fraud in second phase of Tribune LBO).

[68] *See In re* Nat'l Forge Co., 344 B.R. 340, 347–48 (W.D. Pa. 2006); Randall D. Crocker & Shay A. Agsten, *Seventh Circuit Addresses Reasonably Equivalent Value in LBOs*, AM. BANKR. INST. J., Feb. 2010, at 23.

[69] *See, e.g., Tabor Court Realty Corp.*, 803 F.2d at 1302–03; *In re* Joy Recovery Tech. Corp., 286 B.R. 54, 75 (Bankr. N.D. Ill. 2002).

[70] *See* JOSEPH W. BARTLETT, EQUITY FINANCE: VENTURE CAPITAL, BUYOUTS, RESTRUCTURINGS & REORGANIZATIONS § 16.1 (2010); Jack F. Williams, *Revisiting the Proper Limits of Fraudulent Transfer Law*, 8 BANKR. DEV. J. 55, 75 (1991).

The net effect is that the target incurs loan obligations to acquire shares in itself.[71] This stock-buyback is the practical means by which leverage is effected. In the target's capital structure, equity is replaced by debt.

The shares acquired by the target are "treasury stock." Acquiring treasury stock can be useful to a company in altering its capital structure, but treasury stock itself is worthless to the company.[72] Treasury shares provide no voting rights, no rights to receive dividends, and no rights to receive assets upon liquidation.[73] Treasury shares are not assets on a GAAP-compliant balance sheet.[74] They are effectively extinguished for purposes of determining ownership, irrespective of whether the target retires the shares or holds them for reissue.

Courts have concluded that: (1) treasury stock is of no value to the target,[75] (2) the target receives reasonably equivalent value for obligations incurred on that portion of the LBO debt used to pay off the target's antecedent debt (except to insiders),[76] and (3) the target may receive reasonably equivalent value *indirectly*—not in exchange for its transfers, but as a consequence of the LBO.[77] Defendants have proposed several indirect benefits, including superior new management and "synergies."[78] Courts have seldom found indirect benefits to amount to reasonably

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[71] There are variations on the exact steps through which LBOs are accomplished, but the net effect is the same.

[72] On the utility of treasury-stock-acquisition in capital restructuring, see generally Joseph R. Oliver & Katherine S. Moffeit, *Corporate Share Buybacks*, CPA J., Aug. 2000, http://www.nysscpa.org/cpajournal/2000/0800/dept/d85600a.htm (discussing reasons behind increase in stock-buybacks).

[73] *See* Comm'r of Internal Revenue v. Fink, 483 U.S. 89, 96 (1987).

[74] U.S. GAAP Codification of Accounting Standards, Codification Topic 505–30: Treasury Stock.

[75] *See* Robinson v. Wangemann, 75 F.2d 756, 757 (5th Cir. 1935); *In re* Roco Corp., 21 B.R. 429, 434 (B.A.P. 1st Cir. 1982); *In re* Corp. Jet Aviation, Inc., 45 B.R. 629, 634 (Bankr. N.D. Ga. 1985).

[76] 11 U.S.C. § 548(d)(2)(A) (2006) (defining "value" to include "satisfaction or securing of present or antecedent debt of debtor"); *see* Atlanta Shipping Corp. v. Chem. Bank, 818 F.2d 240, 249 (2d Cir. 1987); *In re* Aphton Corp., 423 B.R. 76, 89 (Bankr. D. Del. 2010).

[77] *See In re* Fruehauf Trailer Corp., 444 F.3d 203, 212–13 (3d Cir. 2006); Mellon Bank, N.A. v. Metro Commc'ns., Inc., 945 F.2d 635, 646 (3d Cir. 1991); Rubin v. Mfrs. Hanover Trust Co., 661 F.2d 979, 991 (2d Cir. 1981).

[78] On superior new management as value received by the target, see, for example, C-T of VA, Inc. v. Euroshoe Assocs. L.P., 762 F. Supp. 675, 678 (W.D. Va. 1991). *But see In re* Structurlite Plastics Corp., 224 B.R. 27, 31 (B.A.P. 6th Cir. 1998) (holding new management and opportunity to obtain additional credit not reasonably equivalent value); United States v. Gleneagles Inv. Co., Inc., 565 F. Supp. 556, 576 (M.D. Pa. 1983) (noting new management not fair consideration). "Superior new management" seems a rich assertion to make in an ensuing bankruptcy. On "synergies" as value received by the target, see *Mellon Bank*, 945 F.2d at 647–48.

A target may also derive indirect value in the form of lowered average cost of capital as a result of replacing equity with debt financing; however, in estimating that value, the relative cost of capital should be adjusted for insolvency risk. While debt financing is sometimes cheaper than equity, it is also less flexible in its demands on cash-flow. A company may choose not to pay dividends in lean times, but a company that cannot timely pay its debts is at the mercy of its creditors. Moreover, if the target that cannot pay down its debt by the time the debt matures bears risk of being unable to refinance at a rate that enables it to stay in business.

equivalent value.[79] Still, plaintiffs are in a difficult position if allocated the burden of proving *absence* of reasonably equivalent from purported indirect benefits. Defendants will find indirect benefits to assert, inexpensively burdening plaintiffs with the expense of marshalling refutatory evidence.

Some courts have seen the difficulty of plaintiffs' position and placed on defendants the burden of initially producing evidence of the value of purported indirect benefits.[80] Other courts have recognized indirect benefits only to the extent they might properly be included on the target's balance sheet.[81] This may make sense. Assets having no value on a GAAP-compliant balance sheet are unlikely to return value in a liquidation. Unsecured creditors have an interest in transfers that risk insolvency returning value that can be monetized in an asset sale if insolvency occurs. On the other hand, it is arguably unfair to only consider indirect benefits with liquidation value. Reasonably equivalent value is calculated as of the transaction date, when the target is a going concern.[82] The GAAP-compliant-balance-sheet test may ignore indirect benefits of significant value to the target on a going-concern basis.

2. Whether an LBO is a fraudulent transfer turns on whether the target was left with "unreasonably small capital."

Fraudulent transfer cases arising out of LBOs generally turn not on the issue of reasonably equivalent value, but on whether, upon consummation of the transaction, the target was in one of the financially precarious states triggering liability[83]—and most often on whether the target was left with "unreasonably small capital."[84]

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[79] *But see Mellon Bank*, 945 F.2d at 646–48 (noting creditors of bankrupt LBO'd company failed to prove synergies and increased availability of credit constituted less than reasonably equivalent value); *C-T of VA, Inc.*, 762 F. Supp. 675, 678–79 (finding reasonably equivalent-value in acquirer's investment of new capital plus indirect benefits attributable to new management, and refusing to consider creditors' argument that investment was not reasonably equivalent value given increase in debt/asset ratio).

[80] *See* MFS/Sun Life Trust—High Yield Series v. Van Dusen Airport Servs. Co., 910 F. Supp. 913, 937 (S.D.N.Y. 1995); *In re* Cambridge Capital, LLC, 331 B.R. 47, 62 (Bankr. E.D.N.Y. 2005).

[81] *See In re* Consol. Capital Equities Corp., 143 B.R. 80, 87, 92 (Bankr. N.D. Tex. 1992); *see also In re* Bay Plastics, Inc., 187 B.R. 315, 331 (Bankr. C.D. Cal. 1995) (finding target insolvent at time of LBO after deducting $2.26 million of goodwill booked to target's balance sheet immediately following LBO but unavailable to pay creditors in this liquidation case).

[82] *See, e.g.*, *In re* Robinson, 80 B.R. 455, 460 (Bankr. N.D. Ill. 1987); *In re* Morton Shoe Cos., 24 B.R. 1003, 1011 (Bankr. D. Mass. 1982); Jack F. Williams, *Revisiting the Proper Limits of Fraudulent Transfer Law*, 8 BANKR. DEV. J. 55, 86 (1991).

[83] For a recitation of the financially-precarious states that, in combination with transfer for less than reasonably equivalent value, may trigger liability, see 11 U.S.C. § 548(a)(1)(B) (2006); UFCA §§ 4–6 (1999); UFTA § 4(a)(2) (2006).

[84] The other solvency tests rarely apply to LBOs. Private equity funds and LBO-lenders have ample incentive not to arrange leveraged buyouts of companies that are already insolvent, or that immediately render the target immediately insolvent. An exception is described in *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288, 1295–96 (3d Cir. 1986), wherein the Third Circuit affirmed the district court's judgment that the LBO-lender knew or should have known that the target would be rendered insolvent by the LBO.

A transferor is left with "unreasonably small capital" if it was "reasonably foreseeable" at the time of the transfer that the transferor would be left with insufficient cash-flow to sustain operations,[85] considering all sources of operating capital, including loans[86] and sales of assets unnecessary to operations.[87] Courts have approached this issue by examining the reasonableness of target-company projections prepared in connection with the LBO,[88] while recognizing that such projections "tend to be optimistic."[89] Projections of cash-flow solvency are reasonable if they are well-founded on the target's historical performance and "account for difficulties that are likely to arise, including interest rate fluctuations and general economic downturns, and otherwise incorporate some margin for error."[90] If the target's projections are unreasonable, the question impliedly becomes whether reasonable projections would have shown insolvency to be reasonably foreseeable,[91] but in practice the two steps are one—proving that the target's projections are unreasonable means proving that reasonable projections would have shown insolvency to be reasonably foreseeable.[92]

D. Unsecured creditors need effective constructive-fraudulent-transfer law to remedy and regulate excessive risk-externalization in LBOs.

Unsecured creditors of LBO-targets need effective constructive-fraudulent-transfer law to remedy, and thereby regulate, excessive risk-externalization in LBOs because, as described above:[93]

(1) they are not party to the LBO;
(2) they have no good proxy among the parties; and

[85] *See* Moody v. Sec. Pac. Bus. Credit, Inc., 971 F.2d 1056, 1073 (3d Cir. 1992); *see also* Boyer v. Crown Stock Distrib., Inc., 587 F.3d 787, 794 (7th Cir. 2009); MFS/Sun Life Trust-High Yield Series v. Van Dusen Airport Servs. Co., 910 F. Supp. 913, 944 (S.D.N.Y. 1995); *In re* Bergman, 293 B.R. 580, 584 (Bankr. W.D.N.Y. 2003); *In re* Healthco Int'l, Inc., 208 B.R. 288, 302 (Bankr. D. Mass. 1997).

[86] *See Moody*, 971 F.2d at 1072–74; Lee B. Shepard, *Beyond Moody: A Re-Examination of Unreasonably Small Capital*, 57 HASTINGS L.J. 891, 910 (2006).

[87] *In re* Vadnais Lumber Supply, Inc., 100 B.R. 127, 137 (Bankr. D. Mass. 1989); *In re* Jacobson, 48 B.R. 497, 501 (Bankr. D. Minn. 1985); Shepard, *supra* note 86, at 911.

[88] *See Moody*, 971 F.2d at 1073; ASARCO LLC v. Ams. Mining Corp., 396 B.R. 278, 397 (S.D. Tex. 2008); Credit Managers Ass'n. of S. Cal. v. Fed. Co., 629 F. Supp. 175, 184–88 (C.D. Cal. 1985); *In re* Iridium Operating LLC, 373 B.R. 283, 345 (Bankr. S.D.N.Y. 2007); *In re* Pajaro Dunes Rental Agency, Inc., 174 B.R. 557, 593 (Bankr. N.D. Cal., 1994).

[89] *Moody*, 971 F.2d at 1073.

[90] *Id.*

[91] *Cf.* Klee Report, Vol. 2, *supra* note 67, at 230–31 (adjusting projections on which solvency-opinion-provider based its opinion before using them to assess reasonable foreseeability of insolvency).

[92] *Cf. Moody*, 971 F.2d at 1072 ("If projections are unreasonable . . . it will follow that the debtor was left with an unreasonably small capital.").

[93] *See supra* Part I.A.

(3) absent constructive-fraudulent-transfer law, voluntary unsecured creditors commonly have little leverage to negotiate protection of their interests, and involuntary unsecured creditors commonly have none.

The Third Circuit has recognized that, absent fraudulent transfer law, the parties to the LBO—buyer, sellers and lenders—are incentivized to, as the court put it, "abuse" unsecured creditors, by imposing on them high and uncompensated risk of target-company insolvency:

> [A] thorough understanding of the typical leveraged buyout transaction reveals that there is a potential for abuse of the debtor's creditors, particularly those who are unsecured, when a company is purchased through a leveraged buyout.
>
> . . . .
>
> Commonly, the acquirer invests little or no equity [sic[94]].
>
> . . . .
>
> The level of risk facing the newly structured corporation rises significantly due to the increased debt to equity ratio. This added risk is borne primarily by the unsecured creditors, those who will most likely not be paid in the event of bankruptcy. The lender, which normally assumes a senior, secured position vis-à-vis other creditors, is at risk only to the extent that the loan is under-collateralized. An LBO may be attractive to the buyer, seller, and lender because the structure of the transaction could allow all parties to the buyout to shift most of the risk of loss to other creditors of the corporation if the provisions of section 548(a)(2) [fraudulent transfer law] were not applied.
>
> The selling shareholders receive direct benefit in the LBO transaction as they are cashed out, usually at a price above the price the shares were trading shortly before the acquisition is announced. The new purchaser also benefits from the transaction by thereby achieving ownership of the corporation. The lender is attracted by the higher interest rates and fees usually associated with LBOs. The target corporation, however, receives no direct benefit to offset the greater risk of now operating as a highly leveraged corporation.[95]

Therefore, the Third Circuit has concluded, "failed leveraged buyouts merit close scrutiny under the fraudulent conveyance laws."[96] Judicial scrutiny is not an

[94] Regarding leverage ratios in LBOs, see *supra* notes 15 & 21.
[95] Mellon Bank, N.A. v. Metro Commc'ns. Inc., 945 F.2d 635, 645–46 (3d Cir. 1991).
[96] *Moody*, 971 F.2d at 1073.

end in itself, but a means to the end of constructive-fraudulent-transfer law—determining, remedying, and thereby disincentivizing excessive externalization of insolvency-risk in asset-giveaways. To effectively serve that end, adjudication needs to be efficient and predictable. Presently it is neither. Ambiguities in constructive-fraudulent-transfer law make the pursuit of relief unnecessarily expensive, the outcome unpredictable and the risk-adjusted return on litigation low, even in strong cases. Aggrieved creditors—or their fiduciaries in the LBO'd company's bankruptcy proceedings—therefore tend to settle at a steep discount.

They have done just that in the current wave of post-LBO bankruptcies. They settled before filing threatened suit in the bankruptcies of Reader's Digest and Station Casinos, Inc. and after filing suit in the bankruptcy of LyondellBasell.[97] It remains to be seen what will happen in the bankruptcy of Tribune Co., in which unsecured creditors have alleged that Tribune's LBO involved fraudulent transfers, and a court-appointed examiner has issued a report containing conclusions consistent with those allegations.[98]

The tendency of constructive-fraudulent-transfer law to produce steeply-discounted settlements leaves harm unremedied and leveraged buyouts involuntarily subsidized by unsecured creditors. In this paper, we offer recommendations to make the law clearer and its outcomes more predictable, and to thereby raise the risk-adjusted return on the prosecution of strong cases. Our recommendations regard constructive-fraudulent-transfer law generally, not merely as it applies to leveraged buyouts. But leveraged buyouts—and subsequent dividend recapitalizations[99]—make it critical to get the law right, given the vast capital at stake in private equity and the strong tendency of parties to private-equity-sponsored LBOs to externalize risks.

Our recommended clarifications of constructive-fraudulent-transfer law do not call for the standard of what constitutes a constructive fraudulent transfer to be lowered in favor of aggrieved creditors. Rather, the recommended clarifications would make relief more available *in practice*.

II. RECOMMENDED CLARIFICATIONS OF THE MEANING OF "UNREASONABLY SMALL CAPITAL"

A transferor is left with "unreasonably small capital" if it was "reasonably foreseeable" at the time of transfer that the transferor would be left with insufficient

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[97] See Joint Amended and Revised Motion of the Debtors and the Official Comm. of Unsecured Creditors to Approve Revised Settlement Agreement with Fin. Party Defendants in Comm. Litig. at 2–5, *In re* Lyondell Chem. Co., No. 09-10023, (Bankr. S.D.N.Y. Mar. 6, 2010), ECF No. 3891, wherein unsecured creditors alleged that lenders and buyer knew, when they approved the leveraged acquisition, that the $22 billion in acquisition-debt would leave the company undercapitalized. The unsecured creditors settled in exchange for lenders relinquishing $450 million and assigning certain rights of action. *Id.* at 8–10 (listing terms of settlement agreement).

[98] *See supra* Part I (discussing Tribune case).

[99] For a description of dividend recapitalizations, see *supra* note 26 and accompanying text.

cash-flow to sustain operations.[100] This test is too vague to guide the decision-making of parties to LBOs, of litigants, or of courts.[101] The test also necessitates exceedingly expensive proof of what was foreseeable at the time of the LBO, peering into the then-future of the target. There is great and inherent uncertainty in projecting the future of a business operating in the marketplace, a complex system involving interactions among a great many variables, many of which can themselves be projected only with a high degree of uncertainty. That uncertainty, combined with ambiguity in the law, makes the question before the court exceedingly difficult to resolve, even with the benefit of expert witnesses' analyses. Trials in these cases are long and expensive.[102] The expense and unpredictability of these trials makes litigation a high-stakes gamble.[103] Even strong cases tend to

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[100] *See supra* notes 85–92 and accompanying text.

[101] In *Lyondell*, the debtors and LBO-lenders agreed on terms of settlement of the fraudulent transfer action and moved for approval of the settlement under Bankruptcy Rule 9019, which requires that settlement be within the range of reasonableness given the likelihood of the bankruptcy estate's success on the merits (to prevent debtors' collusion with insiders or subsets of creditors over the interest of its creditor body). *In re* Lyondell Chem. Co., No. 09-10023 (REG), 2011 WL 11413, at *1 (Bankr. S.D.N.Y. Jan. 4, 2011). Even after exchange among the debtors, the LBO lenders, and the Official Committee of Unsecured Creditors of factual allegations, extensive discovery, legal arguments, and expert reports and rebuttals thereto, no one agreed on the likelihood of success on the merits. The LBO lenders declared it "highly unlikely" that creditors would have succeeded on the merits in a fraudulent transfer action. The debtors declared "neither side is a clear winner" because "the parties have strong and weak points across the multitude of issues." The unsecured creditors committee, even upon joining in support of the settlement as reasonable, reasserted its belief that it "would have prevailed." And the court, declining to step into the breach and utterly without elaboration, declared the settlement reasonable. *See* Financing Party Defendants' Reply Memorandum of Law Joining the Debtors' Motion for Approval of Settlement Under Rule 9019 at 32–34, *In re Lyondell*, ECF No. 362; Debtors' Omnibus Reply to Objections to the Debtors' Motion to Approve Settlement With Financing Party Defendants in Committee Litigation at 46–49, *In re Lyondell*, ECF No. 345; Joint Amended and Revised Motion of the Debtors and the Official Committee of Unsecured Creditors to Approve Revised Settlement Agreement With Financing Party Defendants in Committee Litigation at 14, *In re Lyondell*, ECF No. 365; Order Approving Revised Settlement With Financing Party Defendants in Committee Litigation Pursuant to Bankruptcy Rule 9019 at 3, *In re Lyondell*, ECF No. 371. Peter Friedman of Cadwalader, Wickersham & Taft, who represented Lyondell, stated, in a telephone interview on September 15, 2010, that the difficulty of predicting outcomes in these cases extends beyond the indeterminacy of the standard, that the difficulty is compounded by the paucity of judicial opinions and the extremely fact-intensive nature of the inquiry.

[102] It is notable how frequently courts mention the duration of trial regarding fraudulent transfers in leveraged buyouts. *See, e.g.*, Brandt v. Wand Partners, 242 F.3d 6, 12 (1st Cir. 2001) (noting 27-day trial); Moody v. Sec. Pac. Bus. Credit, Inc., 971 F.2d 1056, 963 (3d Cir. 1992) (noting five-week bench trial); United States v. Tabor Court Realty Corp., 803 F.2d 1288, 1290 (3d Cir. 1986) (noting trial extended over 120 days and recorded approximately 20,000 pages of transcript); ASARCO LLC v. Ams. Mining Corp., 396 B.R. 278, 298 (S.D. Tex. 2008) (noting four-week bench trial); *In re* CNB Int'l, Inc., 393 B.R. 306, 312 (Bankr. W.D.N.Y. 2008) (noting three-week trial).

[103] In approving settlement of fraudulent transfer actions regarding LBOs, courts have noted the expense and uncertainty of fraudulent transfer litigation. *See In re* Best Prods. Co., 168 B.R. 35, 62 (Bankr. S.D.N.Y. 1994) (noting indeterminacy of financial projections and expert opinions thereon, and prospect of protracted, expensive litigation); *see also In re* Dreier LLP, 429 B.R. 112, 127 (Bankr. S.D.N.Y. 2010) (indicating bankruptcy courts consider increased costs as one factor in approving settlements); *In re* Resorts Int'l, Inc., 145 B.R. 412, 454 (Bankr. D.N.J. 1990) (noting parties' assertion that litigating case would be "speculative, protracted, and extremely costly").

settle at a steep discount. The law thus fails to remedy and disincentivize harm as it should, resulting in continued high risk of insolvency among LBO'd companies. To serve as a clearer guide to decision-making, the law needs to answer the following questions:

A. What percentage likelihood of insolvency triggers liability?

Courts have provided no clear guidance on the probability at which insolvency becomes "reasonably foreseeable" such that the transferor is left with "unreasonably small capital." Courts *have* clearly signaled that the issue turns on probability. Judge Posner recently opined for the Seventh Circuit in *Boyer* that:

> A corporate transfer is "fraudulent" . . . if the corporation didn't receive "reasonably equivalent value" in return for the transfer and as a result was left with insufficient assets to have *a reasonable chance* of surviving indefinitely.
>
> . . . .
>
> The difference between insolvency and "unreasonably small" assets in the LBO context is the difference between being bankrupt on the day the LBO is consummated and having at that moment such meager assets that bankruptcy is a consequence *both likely and foreseeable*.[104]

Judge Queenan, who wrote the Third Circuit's decision in *Moody*[105]—perhaps the most-cited opinion regarding the reasonable-foreseeability test—wrote, in an opinion when he was a bankruptcy judge, that "a transaction leaves a company with unreasonably small capital when it creates an 'unreasonable risk' of insolvency, *not necessarily a likelihood* of insolvency."[106]

The opinions of Judges Posner and Queenan both indicate that "unreasonably small capital" turns on *some* probability of insolvency—either "likely" (per Judge Posner) or not necessarily likely but giving rise to "unreasonable risk" (per Judge Queenan). Neither decision—nor any of which we are aware—translates these probabilistic terms into a specific threshold probability of insolvency that triggers liability. Without such a standard, it is all but impossible to predict whether a court would decide that an LBO involves constructive fraudulent transfers, unless the LBO *doomed* the target to certain insolvency. A certain-doom standard is not in keeping with the risk-based standard for "unreasonably small capital" that courts have partially articulated.[107]

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[104] Boyer v. Crown Stock Distrib., Inc., 587 F.3d 787, 792, 794 (7th Cir. 2009) (emphases added).

[105] Moody v. Sec. Pac. Bus. Credit Inc., 971 F.2d 1056 (3rd Cir. 1992).

[106] *In re* Healthco Int'l, Inc., 208 B.R. 288, 302 (Bankr. D. Mass. 1997) (emphasis added).

[107] Unreasonably small capital is supposed to be a financial condition "short of equitable insolvency." *Moody*, 971 F.2d at 1070; *accord In re* Fid. Bond & Mortg. Co., 340 B.R. 266, 294 (Bankr. E.D. Pa. 2006);

It makes sense for constructive fraudulent transfer liability to turn on some probability of insolvency less than 100%. Unsecured creditors are harmed not only by a transfer for less than reasonably equivalent value that is *certain* to cause insolvency, but also by one that creates substantial *risk* of insolvency. As risk of insolvency increases, unsecured claims against the transferor become less likely to be paid and therefore decrease in value. A probability-based test for unreasonably small capital sets a limit on the risk that can be imposed. The law should make the limit clear by providing a specific threshold probability of insolvency.

Though courts have not specified the foreseeable post-transfer risk of insolvency that triggers liability, they have made clear that they will approach the issue of whether insolvency was reasonably foreseeable by evaluating the reasonableness of target-company projections prepared in connection with the LBO.[108] Courts have not said that they *defer* to such projections; rather, the projections seem to provide an analytical point of departure for evaluating the foreseeable likelihood of insolvency. This approach makes sense. The projections accompanying an LBO may be overly optimistic,[109] but they contain a wealth of relevant data and analysis. There is no need to toss the baby with the bathwater. It is more efficient to adjust the projections as necessary to make them reasonable and then examine the risk of insolvency projected.

In *Moody*, the Third Circuit instructs that reason requires that projections be well-founded on the target's historical performance and "account for difficulties that

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In re O'Day Corp., 126 B.R. 370, 407 (Bankr. D. Mass. 1991). Equitable insolvency is the general inability of the corporate debtor to meet its pecuniary liabilities as they mature, by means of either available assets or an honest use of credit. *See* VFB LLC v. Campbell Soup Co., 482 F.3d 624, 636 (3d Cir. 2007); MFS/Sun Life Trust-High Yield Series v. Van Dusen Airport Servs. Co., 910 F. Supp. 913, 943 (S.D.N.Y. 1995). That is, equitable insolvency is certain doom to cash-flow insolvency. Short of that is the realm of risk described by Judges Queenan and Posner.

[108] *See supra* notes 88–92 and accompanying text.

[109] The Third Circuit noted in *Moody* that target-company projections prepared in connection with LBOs "tend to be optimistic." *Moody*, 971 F.2d at 1073. That tendency stems from the interests of various parties involved in LBO transactions. *See supra* Part I.A. LBO lenders require a solvency opinion provided (for a fee) by an independent valuation firm. If the LBO is to go forward, the solvency opinion must conclude that the target *will* be adequately capitalized, and that it *will* be able to pay its debts as they come due. Such opinions are based on financial projections of solvency provided by the target's management and reviewed by the investment bank arranging the LBO loans. *See* Jeffrey R. Greene & Lori M. Price, *Solvency Analysis in Leveraged Transactions, in* FINANCIAL VALUATION: BUSINESSES AND BUSINESS INTERESTS 13-7 (James H. Zukin and John G. Mavredakis, 1990) (listing sources of information examined in solvency opinion); Richard Lieb & Robert J. Feinstein, *LBO Litigation, Financial Projections and the Chapter 11 Plan Process*, 21 SETON HALL L. REV. 598, 606–07 (1991) (discussing role outside financial advisors take in creating financial projections for LBO target companies). The target's projections of solvency are, like all projections, based on assumptions. The opining firm conducts some due diligence on the projections—including comparing growth projections to growth rates for comparable companies, posing questions to the CFO and bank and projecting less favorable "downside case" scenarios—but, in the end, valuation firms assume, rather than opine, that the target's projections are "reasonable." *See* Steven J. Cleveland, *An Economic and Behavioral Analysis of Investment Bankers When Delivering Fairness Opinions*, 58 ALA. L. REV. 299, 322 (2006) (asserting banks give deference to management's projections as accurate rather than investigate inputs into those projections).

are likely to arise, including interest rate fluctuations and general economic downturns, and otherwise incorporate some margin for error."[110] A more rigorous standard of reasonableness might require accounting not only for "difficulties that are *likely* to arise" but also foreseeable the full set of solvency-inducing scenarios that have a non-negligible, estimable chance of occurring.[111]

Under the *Moody* standard, rigorously applied, projections should include: (1) a realistic set of "downside-case" scenarios and (2) an estimated probability of insolvency. To promote reasonableness in solvency projections and opinions, courts should deem projections and opinions unreasonable *per se* to the extent that they indicate that a highly-leveraged company *will* remain solvent but include no estimate of the likelihood that the underlying assumptions are mistaken.

While probability-based projections might require analysis beyond that currently performed in connection with LBOs, projecting a probability of insolvency is clearly feasible. Rating agencies do it when they rate debt issuing from an LBO.[112] Their ratings belie the reasonableness of assumption-bound opinions that the target *will be solvent*. The investment bank arranging the LBO debt seeks these inconsistent opinions simultaneously. As the bank awaits opinion from a putatively-independent expert-for-hire that the target will remain solvent—on which opinion the bank conditions closing—it communicates with the rating agencies about prospective ratings for the forthcoming LBO loan debt. Lead LBO lenders typically structure LBO leverage to achieve particular speculative-grade debt ratings,[113] with a view toward maximizing profits from the sale of debt. The targeted ratings have corresponding historical average default rates that are well over 20% during the five years following issuance.[114] The high default rates associated with the ratings that the banks target are inconsistent with the projections and opinions of solvency that the banks require. Requiring honest assessment of the probability of insolvency concurrently with the structuring of LBO debt (which the aforementioned *per se* rule would accomplish) would resolve this disconnect.

The question remains: at what probability is the foreseeable risk of insolvency great enough to make insolvency reasonably foreseeable (or to make projections of solvency unreasonable)? Suppose there is a foreseeable 40% chance of target-company insolvency if an LBO closes—is such insolvency reasonably foreseeable? What if the probability is 30%? 10%? Published decisions provide no clear guidance. One commentator proposes a 50% probability of insolvency as a reasonable starting point.[115] Whether or not that is the right threshold, it has the needed virtue of clarity.

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[110] *Moody*, 971 F.2d at 1073.

[111] *Id.* (emphasis added).

[112] The rating agencies publish historical average default rates for corporate debt at each rating. *See, e.g.*, MOODY'S *Historical Default Rates*, *supra* note 22, at 28.

[113] *See supra* note 22.

[114] *See id.*

[115] *See* J.B. Heaton, *Solvency Tests*, 62 BUS. LAW. 983, 990 (2007).

While there are reasons not to set too permissive a limit on the risk of insolvency that LBO parties may externalize onto creditors, there are also reasons not to set too restrictive a limit. An LBO inherently involves the target engaging in transfers for less than reasonably equivalent value. Substantial increases in leverage increase risk of target-company insolvency. Unsecured creditors bear that risk—not solely, but heavily. The risk decreases the value of their claims, and it does so immediately, not just when the risk is realized.[116] So why not have a constructive-fraudulent-transfer law that remedies *any* transfer for less than reasonably equivalent value that substantially increases risk of insolvency? Two potential reasons:

First, LBOs might externalize benefits that offset externalized costs, making some subsidy through externalized costs reasonable from society's perspective (if not from the perspective of unsecured creditors).

Second, many businesses operate much of the time in or near the zone of insolvency. Not all transactions return as much value as the transferor might reasonably expect. All transfers for less than reasonably equivalent value increase risk of insolvency. If the law deemed fraudulent every such transfer that substantially increased insolvency risk, commerce would be impaired by the threat of fraudulent transfer litigation.

B. What is the period of time over which the likelihood of insolvency is to be determined?

Even with "unreasonably small capital" defined as a specific threshold probability of cash-flow insolvency, the test remains impracticably vague unless it specifies the period of time over which the probability of insolvency is to be determined. The test period may be outcome-determinative. For example, a 10% per year chance of cash-flow insolvency amounts to a 40% chance over four years, but a 50% chance over five years.

Published decisions provide but slight guidance on the applicable test period—instructing, for example, that "the adequacy of capital need only be tested within a reasonable period of the transfer at issue."[117]

"The longer the interval [between an LBO and insolvency], the less likely that the collapse was fated at the formation of the new company."[118] In *Boyer*, the Seventh Circuit expressed skepticism of judicial decisions indicating that a "reasonable period" may be but a year, and upheld a decision finding fraudulent

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[116] *See* Matthew T. Billett, Zhan Jiang & Erik Lie, *The Role of Bondholder Wealth Expropriation in LBO Transactions* (Soc. Sci. Research Network, Working Paper Mar. 27, 2008), *available at* http://ssrn.com/abstract=1107448.

[117] MFS/Sun Life Trust-High Yield Series v. Van Dusen Airport Servs. Co., 910 F. Supp. 913, 944 (S.D.N.Y. 1995).

[118] Boyer v. Crown Stock Distrib., Inc., 587 F.3d 787, 795 (7th Cir. 2009).

transfer in an LBO that led to bankruptcy after three-and-a-half years.[119] The court noted that the debtor:

> staved off bankruptcy for several years and might have staved it off longer . . . . But to assess the significance of this point one must distinguish between insolvency and the acknowledgement of insolvency and between insolvency and a lack of adequate capital. A firm might be insolvent in the bankruptcy sense of negative net worth . . . yet it might continue operating as long as it was able to raise enough money to pay its debts as they became due, or even longer if its creditors were forbearing.[120]

LBO'd companies at risk of insolvency have, in fact, been nursed along by LBO lenders seeking to avoid bad debt (or recognition thereof).[121] LBO lenders concerned about facing a fraudulent transfer action in the event of bankruptcy have motive to nurse the LBO'd company along until after the period at which courts look in determining unreasonable risk of insolvency, or after running of statutory limitations periods—four years under UFTA and most state statutes based thereon—whichever is first.[122] It so happens that default rates on LBO-debt initially assigned the single-B ratings targeted by LBO-loan arrangers[123] actually peak just over four years after closing.[124]

Extending the test period, as the Seventh Circuit did in *Boyer*, makes the test more creditor-protective. Unsecured creditors would be better protected by a test period that fully contemplates refinance risk by extending through the longest LBO-loan term.[125]

Many LBO'd companies are set up for refinance risk by non-amortizing, interest-only LBO loans with "bullet" principal payments at the end of the loan term.[126] A target might have good prospects for surviving the interest-only phase

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[119] *Id.*

[120] *Id.* at 794.

[121] *See* Erik Krusch, *Lose the Leverage!: Restructuring LBOs*, WESTLAW BUS. CURRENTS, Apr. 5, 2010, *available at* http://currents.westlawbusiness.com/Article.aspx?id=e5c2b50d-a590-4e12-9142-48bb7b676e0f; Lauren Silva, *Hope Isn't a Strategy*, BREAKINGVIEWS, July 17, 2009; Vyvyan Tenorio, *Sponsors Throw Lifelines*, DAILY DEAL, Dec. 22, 2008.

[122] Claims for relief under UFTA are extinguished unless an action is brought within four years after the transfer was made, or within one year after an intentional fraudulent transfer reasonably could have been discovered. *See* UFTA § 9 (2006).

[123] *See supra* note 22.

[124] *See* Edward Altman, *Current Conditions & Outlook in Credit Markets: A Tale of Three Periods*, slide presentation at the University of Toronto Distressed Assets Symposium (Mar. 3, 2010), at 18, *available at* http://www.investmentreview.com/files/2010/03/CreditMeltdown10_altman-slides.pdf.

[125] Under current practice, projections do not always take account of such risk. For example, in the Tribune LBO, the financial analytics firm opining that Tribune would be able to pay its debts simply assumed Tribune's ability to refinance. *See* Klee Report, Vol. 1, *supra* note 3, at 558–93.

[126] Regarding such LBO loan structures, see Axelson et al., *supra* note 15, at 8, 14–15, 32; see also Acharya et al., *supra* note 24, at 49.

but be at risk of insolvency when the principal comes due if refinancing is available only at a significantly higher rate. That is not an unlikely scenario given that waves of LBOs crest during periods of historically low interest rates. The companies LBO'd during a wave will need to refinance in a market in which interest rates will likely have regressed toward the mean.

Unsecured creditors would enjoy the fullest protection if the test period extended further, through the term of the target-company's respective liabilities to them. But some unsecured liabilities, particularly to involuntary creditors, can be very long-term, such as pension liabilities, liabilities for not-yet-manifested toxic torts and liabilities for environmental cleanup under CERCLA. Reliable financial projections cannot possibly reach such distant time horizons. The inherent uncertainty of financial projections is amplified as one projects further into the future. The test calls for assessing the *reasonably foreseeable* risk of cash-flow insolvency.[127] Beyond a certain point, financial projections offer no meaningful foresight, becoming no more predictive than a coin-toss. *Ex post*, courts won't be able to make heads or tails of them. *Ex ante*, margin of error becomes so wide that deal parties won't be able to steer clear of the margin and still do a leveraged deal.

Fraudulent transfer liability, if it is to turn on whether insolvency was reasonably foreseeable on the threshold of the deal, will only be practicable and predictable if the projection period is limited to a period over which projections are reasonably reliable. Balancing the protection of long-term creditors against the limited period over which projections are reasonably reliable, the law might require that the probability of insolvency be considered over a test period that contemplates a complete business cycle—the average period of time between the beginnings of successive recessions. Or the proper balance might be struck with a test period that extends through the year of the transaction and five years thereafter.[128] Either of these proposals would extend the test period to encompass the four-year peak default period of LBO-debt.[129] Either would likely encompass the maturity date of at least part of the LBO-debt package and thus require a solvency opinion giver to assess the company's ability to manage maturing debt while contemplating refinance risk.[130] (Either would also extend beyond the four-year period during which a constructive fraudulent transfer action may be brought under UFTA.)

To truly strike a wise and just balance would require answers to empirical questions, such as: what is the inherent margin of error in the cash-flow solvency

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[127] *See supra* note 85 and accompanying text.

[128] For a discussion of solvency opinion best practices by a practitioner, see Greene & Price, *supra* note 109, at 13-1. Greene's discussion of solvency opinion best practices includes a case study. *Id.* at 13-10 to -25. This case study extends balance sheet, income statement and cash flow projections, ratio analysis, and sensitivity testing of projections over a period encompassing the year of the transaction and five years post-transaction.

[129] *See supra* note 124.

[130] *See* Greene & Price, *supra* note 128, at 13-10, 13-25. Greene notes the need to examine both the amount of flexibility allowed by the financial covenants of the company's credit agreements and the maturity structure of the company's fixed obligations.

projections of highly-leveraged companies? It would require complex cost-benefit analysis and answers to difficult questions about distributive justice. The full analysis is probably susceptible to book-length treatment. And at the end of that tome, courts and legislators might still be left with a judgment call and room for the sway of bias. We therefore punt, after one final note: the period through which reasonable foresight is available via financial projection is not necessarily a long enough test period to adequately protect unsecured creditors. If it is not, the law may need more fundamental revision than we contemplate in this paper.

C. What to do about margin of error?

Uncertainty is inherent in financial projection. A business operating in the market is a complex, multi-variable system. Even the best model of such system, well-grounded in historical data, cannot provide projections without some margin of error. Judicial decisions say that, to be reasonable, cash-flow projections must "incorporate some margin for error,"[131] but do not say how margin-of-error should bear on whether cash-flow insolvency was reasonably foreseeable. Suppose the law were to deem an LBO to leave the target with unreasonably small capital if reasonable contemporaneous projections would have indicated a 50% probability of cash-flow insolvency within five years. Suppose further that the target's reasonable projections indicated a 40% probability of cash-flow insolvency within five years, with a +/-15% margin of error. Such margin of error means that the actual probability could be anywhere between 25% and 55%, which means that the projection offers no indication of whether the probability of insolvency is above or below the threshold of liability. Decisions indicating that solvency projections must "incorporate some margin for error" would seem to mean that aggrieved creditors get the benefit of uncertainty. The law can be improved by requiring statistically-rigorous assessment of margin of error. The margin of error in financial projections is high.[132]

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[131] Moody v. Sec. Pac. Bus. Credit, Inc., 971 F.2d 1056, 1073 (3d Cir. 1992); *accord* Boyer v. Crown Stock Distrib., Inc., 587 F.3d 787, 795 (7th Cir. 2009).

[132] It has been argued that financial projections are so inherently uncertain and manipulable that using projections to evaluate insolvency risk from an LBO cannot but lead to an expensive and unenlightening battle of the experts, and that courts should perhaps instead look to the market's assessment of that risk, as reflected in changes in credit spreads on target-company debt or in the price of credit default swaps. *See* Michael Simkovic & Benjamin Kaminetzky, *Leveraged Buyout Bankruptcies, the Problem of Hindsight Bias, and the Credit Default Swap Solution* 30–1 (Seton Hall Pub. Law, Working Paper No. 1632084, 2010), *available at* http://ssrn.com/abstract=1632084. Such a test could be used as either an alternative or adjunct to the current approach. The opinions of market participants reflected in market prices are subjective and hearsay, but market participants' pursuit of gains and risk of loss may make their collective assessment more reliable than that of rating agencies or solvency opinion givers pursuing fees from deal-party clients. On the other hand, the accuracy of market assessments can be confounded by securities fraud or by momentum investors.

D. If cash-flow insolvency was reasonably foreseeable at the time of transfer, there should be no defense that specific conditions precipitating insolvency were unforeseeable.

Suppose an LBO involved transfers for less than reasonably equivalent value, that insolvency was reasonably foreseeable when the transaction closed, that target-company insolvency ensued, but that insolvency was precipitated by unforeseeable events—are the transfers avoidable as constructively fraudulent? As we shall see, published opinions are divided. That division needs to be resolved. If unforeseeable precipitating conditions are a defense, the defense will be raised, and the wavilinear pattern of the LBO market will provide factual predicates. The LBO-wave of the mid-2000s, like that of the late-1980s, rose on ready credit and broke with the onset of recession. Though recessions are a recurring phase of the business cycle, the onset of significant recession is arguably difficult to foresee in boom-times. Therein lies the defense.

The law's treatment of unforeseeable-conditions defenses should satisfy two criteria: *First*, it should be consistent with the design of constructive-fraudulent-transfer law—leaving debtors free to transfer assets for less than reasonably equivalent value unless doing so foreseeably harms creditors. *Second*, it should add no litigable issues unnecessary to such design.

There are three ways courts might address unforeseeable-conditions defenses:

1. cease liability-analysis if insolvency was reasonably foreseeable at the time of transfer, hearing no argument that specific conditions precipitating insolvency were unforeseeable;
2. address unforeseeable-conditions defenses under a specific-proximate-cause test; or
3. address unforeseeable-conditions defenses under an actual-cause test.

Only the first way satisfies our criteria. Either of the latter two would lead to fraudulent-transfer law that fails to remedy serious harm, and each would add a litigable issue unnecessary to the law's design.

In *Boyer*, the Seventh Circuit took the first approach, expressly disregarding whether the particular circumstances precipitating insolvency were foreseeable and limiting inquiry to whether insolvency was reasonably foreseeable at the time of transfer given *all* foreseeable circumstances.[133] The buyer's post-LBO management errors were no defense.

> The fact that mistakes by the buyer hastened the company's demise is not a defense. Whether a transfer was fraudulent when made depends on conditions that existed when it was made, not on what

[133] *Boyer*, 587 F.3d at 794.

> happened later to affect the timing of the company's collapse . . . . Everyone makes mistakes. That's one reason why businesses need adequate capital to have a good chance of surviving in the Darwinian jungle that we call the market.[134]

1. If insolvency was reasonably foreseeable at the time of transfer, it should be irrelevant that unforeseeable conditions precipitated insolvency.

The Seventh Circuit was correct in *Boyer*. If there has been a transfer for less than reasonably equivalent value and insolvency was reasonably foreseeable, the transfer should be held constructively fraudulent even if conditions precipitating insolvency were unforeseeable, for two reasons:

a. First, *immediately upon such a transfer, creditors suffer material harm, irrespective of why, or even whether, insolvency ensues.*

An asset-giveaway that leaves the transferor undercapitalized harms creditors by generating two kinds of credit-risk:

(1) risk of the transferor becoming insolvent; and
(2) risk of deepened insolvency—that the transferor, in the event of insolvency, will have less assets to distribute to unsecured creditors.

The harm is immediate and does not depend on whether or why insolvency ensues. Unsecured claims against the transferor immediately decrease in value, as the unsecured creditor will find if it seeks to sell its claim or use it as collateral for a loan. The higher the likelihood of insolvency at the time of transfer, the more surely and entirely the value transferred is taken from unsecured creditors.

Where a transferor faces foreseeable likelihood of cash-flow insolvency, there will be *many* scenarios under which the transferor's cash-flow depletes to the point of insolvency—some likely, others unlikely. It is the *overall* likelihood of the debtor's insolvency that makes an asset-giveaway harmful. The probability of the particular chain of events actually leading to insolvency is irrelevant.

b. Second, *if insolvency was reasonably foreseeable, parties to the transfer should bear the risk of unforeseeably bad conditions, since they, not unsecured creditors, stood to reap any gains.*

The law's default position is that debtors are free to give away assets.[135] Fraudulent-transfer law limits this freedom only where creditors are harmed by an

[134] *Id.* at 795.
[135] *See* Bay View Estates Corp. v. Southerland, 154 So. 894, 900 (Fla. 1934) ("The mere fact that a person may be indebted to another does not render a conveyance of his property a fraud in law upon his creditors.

asset-giveaway that creates a reasonably foreseeable risk of insolvency. If the law were to instead deem fraudulent all transfers for less than reasonably equivalent value made when there was merely *some* foreseeable risk of insolvency, transactions posing slight risk to creditors would be squelched.

Where the probability of insolvency is sufficient to make insolvency reasonably foreseeable, it is fair that a court order the transfer avoided to the extent necessary to satisfy claims, even if the transferor's insolvency is actually precipitated by unforeseeable circumstances, for two reasons: *First*, transfer-parties—not unsecured creditors—choose to participate in the asset-giveaway and stand to reap any gains, so it is fair they bear the risk of unforeseeable conditions. *Second*, unsecured creditors bear the risk of harm from all asset-giveaways made where the probability of insolvency is *less than* foreseeably likely, for which risk they are uncompensated—a symmetrical unfairness, which is a fairness of sorts.

2. A Flawed Response to the Unforeseeable Conditions Defense: Require Specific Proximate Causation

Courts might address arguments that conditions leading to a transferor's insolvency were unforeseeable by asking *whether the circumstances precipitating insolvency were reasonably foreseeable*. If not, the transfer would not be actionable. Such inquiry would add to the law of constructive fraudulent transfer an element that we might call "specific proximate causation."

There are judicial opinions implying that specific proximate causation is an element of constructive fraudulent transfer. The Third Circuit in *Moody* wrote:

> . . . [U]nreasonably small capital . . . furnish[es] a standard of causation which looks for a link between the challenged conveyance and the debtor's insolvency. . . .
>
> . . . .
>
> The district court properly found that [the target's] failure was caused by a dramatic drop in sales due to increased foreign and domestic competition, rather than a lack of capital. Plaintiff plausibly contends that defendants should have anticipated some of these problems and incorporated a margin for error. But we cannot say the district court erred in finding that the drastic decline in sales was unforeseeable as of the date of the leveraged buyout.

The owner of property, whether real or personal, possesses the absolute right to dispose of all or any part of his property as he sees fit. The only restriction imposed by law is that no transfer shall be made which will interfere with the existing rights of other persons. If the right of disposition is exercised to the injury or prejudice of other persons, the courts will then interfere, and the question arises whether the circumstances constituted ipso facto a fraud upon the complaining creditors or whether the alleged facts raise a presumption of fraud."), *overruled on other grounds by* B.A. Lott, Inc., v. Padgett, 14 So. 2d 667 (Fla. 1943).

> Therefore, we conclude that the district court properly determined that the leveraged buyout did not leave [the target] with an unreasonably small capital.[136]

Thus the transferor was not left with "unreasonably small capital" unless the specific factors precipitating insolvency—a "dramatic drop in sales due to increased foreign and domestic competition"—were foreseeable.[137]

Similarly, In *In re O'Day Corp.*, the district court wrote that:

> [T]he projections employed . . . were imprudent. Although Meritor [the defendant bank] points to a variety of unpredictable, internal and external problems, such as poor management, bad marketing decisions, decline in the number of dealers and sales people, and the stock market crash of October 1987 as the causes of O'Day's dismal performance following the LBO . . . the Court finds that labor problems, cost variances and cylicality in the industry were the major contributors to O'Day's fiscal woes and were manifest and readily predictable prior to the LBO. Thus . . . the Court concludes that O'Day was left with unreasonably small capital.[138]

Whether O'Day was left with unreasonably small capital turned on whether the particular "major contributors to O'Day's fiscal woes" were foreseeable, not on whether O'Day's insolvency was reasonably foreseeable as a general matter, considering all foreseeable circumstances.[139]

Including a specific-proximate-cause element in the law of constructive fraudulent transfer would be detrimental, for two reasons: *First*, the law would fail to remedy harms at which it is (and should be) aimed. *Second*, the test is impracticable.

a. If specific-proximate-cause were required, constructive-fraudulent-transfer law would fail to remedy harms at which it is aimed.

In the law of negligence, proximate-cause limits liability for harms caused by one's actions to those a reasonable person would have foreseen.[140] Thus, in the classic case *Palsgraf v. Long Island Railroad Co.*, the defendant railroad was not liable because a reasonable person would not have foreseen that railroad employees' helping a passenger to board a moving train risked causing a scale hanging some

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[136] *Moody*, 971 F.2d at 1071, 1074–75.
[137] *Id.* at 1074–75.
[138] 126 B.R. 370, 407 (Bankr. D. Mass. 1991).
[139] *See id.*
[140] *See* David G. Owen, *The Five Elements of Negligence*, 35 HOFSTRA L. REV. 1671, 1681–82 (2007).

distance down the platform to fall on Mrs. Palsgraf.[141] A reasonable person would not have foreseen that a package carried by the passenger contained fireworks that might explode if the package fell, and that the explosion would dislodge the scale.[142] The chain of events was too improbable to foresee, and thus to avoid. In negligence, "[t]he risk reasonably to be perceived defines the duty to be obeyed."[143]

In constructive-fraudulent-transfer, the risk reasonably to be perceived is creation of credit-risk through an asset-giveaway by a transferor already insolvent, or that is rendered insolvent, or that is left foreseeably likely to become insolvent. When insolvency is foreseeably likely, the foreseeable risk is *not* of the transferor becoming insolvent through any *particular* post-transfer chain of events, but the *aggregate* likelihood of it becoming insolvent under reasonably foreseeable conditions. Where such risk is present, asset-giveaways are so harmful to creditors that constructive-fraudulent-transfer law deems them actionable.

A specific-proximate-cause test makes no sense because creditors are immediately harmed by the creation of credit-risk itself, regardless of whether that risk has been realized in insolvency, and irrespective of the particular chain of precipitating events. The value of unsecured creditors' claims against the transferor is *immediately* discountable by the increase in credit-risk upon the transfer.

Even if constructive-fraudulent-transfer law were meant to regulate not the *creation* of credit-risk, but the *realization* of that risk in insolvency, a proximate cause test would still cause the law to fail to remedy harms it should. Were a specific-proximate-cause element added to the law, recovery would be limited to those cases where the particular post-transfer chain of events that happens to precipitate insolvency is *itself* likely. The law would leave unremedied all the many cases where the foreseeable aggregate risk of insolvency is high but the particular set of circumstances precipitating insolvency was not sufficiently likely, considered in isolation, to be foreseeable.

If a transferor is at high risk of cash-flow insolvency, there will be many factors capable of reducing cash-flow enough to precipitate insolvency. Some insolvency scenarios will be more likely than others. Only a subset of scenarios may be sufficiently likely to be foreseeable. If the foreseeably-high overall risk of insolvency is realized, liability should not turn on which of the scenarios happened to come about first.

Where circumstances that happen to precipitate insolvency are not themselves foreseeably likely, the chain-of-events through which creditors are harmed is unlike that which led to scales falling on Mrs. Palsgraf. Insolvency was foreseeably likely, and insolvency has in fact materialized. Unsecured creditors of a company overleveraged in an LBO are more like dependents of someone who died after

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[141] 248 N.Y. 339, 340–41 (1928).

[142] *Id.* at 341 ("Nothing in the situation gave notice that the falling package had in it the potency of peril to persons thus removed.").

[143] *Id.* at 344.

being negligently exposed to an immunosuppressive toxin. Liability should not turn on the rarity of the pathogen that happened to first overrun the deceased's weakened defenses.

b. A proximate-cause test would be impracticable.

A proximate-cause test would be impracticable. To determine whether the specific precipitants of insolvency were foreseeable, a court will have to identify precipitating events and conditions. Enumerable factors can reduce cash-flow. It will often be difficult to identify which proximately caused insolvency. Defendants will attribute insolvency to specific, unlikely factors or combinations of factors. Plaintiffs will seek to describe factors at a higher level of generality (for example, decreased revenues, increased expenses), the genus being inherently more common than the species. From the trial of identifying precipitating factors would ensue the tribulation of determining the reasonable foreseeability of each. None of this elaborate inquiry will be relevant to the law's purpose.

3. Another Flawed Response to the Unforeseeable Conditions Defense: Require Actual Causation

Courts might address the defense that circumstances precipitating a transferor's insolvency were unforeseeable by asking *whether the transferor would have become insolvent even without the transfer* and, if so, deeming the transfer *not* actionable despite reasonably-foreseeable insolvency. Such an *actual-cause* test might be easier to apply than a *specific-proximate-cause* test, though it would make a rougher cut. An actual-cause test would not relieve defendants of liability where *any* unlikely chain-of-events precipitated insolvency, only where the precipitating conditions were so severe that the transferor would have gone insolvent even without the transfer.

Courts in at least two cases have implied that *actual cause* is an element of constructive-fraudulent transfer.[144] In *In re Dakota Drilling,* the court concluded that the plaintiff had not proven that the transferor was left with unreasonably small capital, "since many outside factors, such as the general depression of the oil drilling industry, unrelated to . . . [the allegedly fraudulent transfers] could have played into Dakota Drilling's inability to pay creditors and its decision to file for bankruptcy."[145]

An actual causation test is a bad idea. Creditors are harmed by a transfer that leaves the transferor foreseeably likely to become insolvent, *irrespective of whether*

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[144] *See In re* Pioneer Home Builders, Inc., 147 B.R. 889, 894 (Bankr. W.D. Tex. 1992) ("Where a debtor already has unreasonably small capital, that the debtor subsequently engaged in transfers which worsened, but did not cause, its financial infirmities, will not subject those transfers to avoidance as fraudulent conveyances."); *In re* Dakota Drilling, Inc., 135 B.R. 878, 887 (Bankr. D.N.D. 1991).

[145] 135 B.R. at 887.

the transferor would have become insolvent anyway. That is why fraudulent-transfer law makes actionable asset-giveaways when the transferor is *already insolvent*. When the transferor is already insolvent or is doomed to insolvency irrespective of the challenged transfer, an asset-giveaway harms creditors by leaving the transferor with *even less* assets to distribute among creditors. Fraudulent-transfer law does not stand indifferent to deepened insolvency.[146]

Constructive fraudulent-transfer law *does* contemplate actual causation—it defines the financially-precarious conditions under which creditors are *actually caused* to be worse off by an asset-giveaway. Under those conditions, creditors are immediately worse-off *even if insolvency does not ensue*. Accordingly, state fraudulent-transfer laws do not require, as a precondition for avoidance, that the transferor be in bankruptcy or any other insolvency proceeding.[147] Indeed, courts have enjoined prospective fraudulent transfers.[148] That the fraudulent-transfer provisions of the Bankruptcy Code inherently apply only in bankruptcy does not mean that a fraudulent transfer is only actionable in the event of bankruptcy, much less only if bankruptcy is caused by the challenged asset-giveaway. To add such an actual-cause element to fraudulent-transfer law would leave unremedied extensive harm that the law is meant to, and should, internalize.

III. HOW INDETERMINACY AFFECTS OUTCOMES

In this section, we address how the indeterminacy of the test for unreasonable small capital combines with the expense of litigating the issue to produce steeply discounted settlements, both within and outside of bankruptcy.

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[146] In a decision to the contrary which we believe to be in error, a district court held that debtor's execution of a mortgage and note to a real estate lender were not constructively-fraudulent transfers because the debtor:

> was having difficulty paying its debts as they came due *before* the transfers . . . For avoidance purposes, both the Bankruptcy Code and TUFTA [the Texas Uniform Fraudulent Transfer Act] require that the disputed transfers *cause* the unreasonably small capital condition. . . . Where a debtor already has unreasonably small capital, that the debtor subsequently engaged in transfers which worsened, but did not cause, its financial infirmities, will not subject those transfers to avoidance as fraudulent conveyances.

In re Pioneer Home Builders, Inc., 147 B.R. at 894.

[147] *See, e.g., In re* Old CarCo LLC, 435 B.R. 169, 189, 193 (Bankr. S.D.N.Y. 2010) (stating insolvency is not element of intentional fraudulent conveyance claim, and fact that claim is being brought in context of bankruptcy proceeding would not alter state law). Similarly, the fraudulent transfer provisions of the Federal Debt Collection Procedure Act, which regards obligations to the U.S. government, do not require that the obligor be in bankruptcy. *See* 28 U.S.C. §§ 3301–08 (2006).

[148] *See* Bowman v. Dixon Theatre Renovation, Inc., 581 N.E.2d 804, 809 (Ill. App. Ct. 1991) (upholding preliminary injunction against prospective fraudulent transfer); Mitsubishi Power Sys. Ams., Inc. v. Babcock & Brown Infrastructure Group U.S., LLC, C.A., No. 4499-VCL, 2009 WL 1199588, at *6 (Del. Ch. Apr. 24, 2009) (granting temporary restraining order against prospective fraudulent transfer).

A. Outside of Bankruptcy

Unsecured creditors jeopardized by a leveraged buyout or dividend recapitalization are not bound to wait for bankruptcy to pursue legal recourse. All fifty states have codified constructive-fraudulent-transfer law,[149] and, unlike the fraudulent transfer provisions of the Bankruptcy Code, the state statutes are not contingent on bankruptcy.[150] The Uniform Fraudulent Transfer Act, on which most states' statutes are based, expressly provides for injunction.[151] There is no reason in law or equity why unsecured creditors could not seek to enjoin an announced deal before it closes,[152] and they have every right to pursue avoidance after closing but before the risk created by the deal causes the target's bankruptcy.

Even though a post-closing, pre-bankruptcy action would avert the great expense of bankruptcy, and a pre-closing injunctive action would avoid the costs of unwinding a large and complicated deal, powerful economic incentives are arrayed against any pre-bankruptcy action being brought. The benefits of a successful avoidance action will be shared among all unsecured creditors, but the high costs will be borne by whatever creditor or creditors prosecute the action. The chapter 11 bankruptcy process brings unsecured creditors together and arranges for them a representative assembly (the unsecured creditors committee) with counsel whose fees are paid from the bankruptcy estate,[153] but *outside* of bankruptcy, the unsecured creditors have to organize themselves to pursue litigation as a group. Organizing and negotiating the terms of such an effort would involve considerable transaction costs. Trade creditors would likely decline to participate for fear of losing a customer. The uncertainty of success on the merits further reduces the incentive for unsecured creditors to organize a group of willing creditors to bear the high costs of an avoidance action, whether injunctive or remedial. In the case of an injunctive action, creditors pursuing preliminary injunction will be faced with the daunting prospect of proving the likelihood of their success on the merits in an action whose outcome is all but impossible to predict.

B. In Bankruptcy

In bankruptcy, the indeterminacy of the test for unreasonable small capital and the expense of litigating the issue influence the decisions of: (1) the debtor, (2) the

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[149] *See supra* note 52.

[150] *See supra* note 147 and accompanying text.

[151] UFTA § 7(a)(i) (2006).

[152] Fraudulent transfers have been enjoined. *See supra* note 148. We are unaware of any leveraged buyout or dividend recapitalization yet having been enjoined as a fraudulent transfer.

[153] *See* 11 U.S.C. § 1102(a)(1) (2006) (providing for creation of creditors committee); *id.* § 1103(a) (empowering creditors committee to hire attorneys and other professionals); *see also id.* § 330(a)(1)(A)–(B) (authorizing court to award compensation to attorneys and other professionals serving creditors committee).

unsecured creditors committee, and (3) the court, in each case in favor of discounted settlement of fraudulent transfer claims.

1. The Debtor

Fraudulent transfer law exists to protect creditors, but bankruptcy law assigns the right to sue for avoidance of fraudulent transfers to the trustee of the bankruptcy estate (in chapter 7 liquidations)[154] or to the debtor in possession of the bankruptcy estate (under chapter 11, the chapter of the Bankruptcy Code under which LBO'd companies typically file),[155] each of whom has a fiduciary duty to creditors to maximize the value of the estate.[156] Where the bankruptcy estate of an LBO'd company has a strong case that the LBO involved fraudulent transfers, executives making decisions on behalf of the debtor-in-possession may have interests that conflict with the debtor-in-possession's fiduciary duty to maximize the value of the estate. They may: (1) have been (or may be allied with) pre-LBO executives or directors, who are exposed to claims that they breached fiduciary duties to pre-LBO creditors by approving a leveraged buyout creating unreasonable risk of insolvency, or (2) be influenced by the debtor-in-possession lender financing the operations of the debtor-in-possession during bankruptcy—which may be the very bank that arranged the LBO loans. Such interests may disincline executives to decide that the debtor-in-possession should vigorously pursue a fraudulent transfer action. The indeterminacy of constructive-fraudulent-transfer law, and the attendant expense of litigation, offers them a rational basis on which to assert that a meager settlement is reasonable and that pursuing an avoidance action is inconsistent with the debtor-in-possession's fiduciary duty to maximize the value of the estate.

2. The Unsecured Creditors Committee

Chapter 11 might be seen as providing a check on this risk, in the form of the official committee of unsecured creditors—a representative assembly of unsecured creditors with a fiduciary duty to represent the interests of all unsecured creditors.[157] The unsecured creditors' committee can move the court to transfer to the committee the right to bring a fraudulent transfer action, including on grounds that the debtor-in-possession is too conflicted to reliably evaluate the merits of a fraudulent transfer action and to diligently pursue such action if meritorious.[158]

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[154] *See* 11 U.S.C. § 544 (providing avoidance powers to trustee of bankruptcy estate).

[155] *See* 11 U.S.C. § 1107 (providing debtor in possession powers of trustee).

[156] *See* Commodity Futures Trading Comm'n v. Weintraub, 471 U.S. 343, 352 (1985).

[157] *See* 11 U.S.C. § 1102(a)(1) (providing for appointment of committee); *In re* Kensington Int'l Ltd., 368 F.3d 289, 315 (3d Cir. 2004) (discussing fiduciary duty of committee to unsecured creditors as whole).

[158] *See, e.g.*, Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery, 330 F.3d 548, 564 (3d Cir. 2003); Commodore Int'l v. Gould (*In re* Commodore Int'l Ltd.), 262 F.3d 96, 100 (2d Cir. 2001); Official Comm. of Unsecured Creditors of W. Pac. Airlines, Inc. v. W. Pac. Airlines, Inc. (*In re* Pac. Airlines, Inc.), 219 B.R. 575, 577–78 (D. Colo. 1998). In *Tribune*, the creditors' committee requested, and

The unsecured creditors' committee might seem to have ample incentive to vigorously pursue a fraudulent transfer action regarding an overleveraging LBO:

- in the absence of an avoidance action, secured LBO lenders may be entitled to nearly the entire bankruptcy estate (net of bankruptcy expenses), leaving unsecured creditors slight recovery on their claims;
- a successful, meritorious avoidance action that strips LBO lenders of their security interests and returns loan payments and fees to the estate can have an enormous effect on the value of the estate and its distribution among creditors, dramatically improving unsecured creditors' recoveries; and
- even a fraudulent transfer action of dubious merit may yield significant settlement in favor of unsecured creditors, especially because summary judgment for the defense is unlikely given the ambiguity of the test for unreasonably small capital and the complexity of the proof, which the test requires of the parties.

Moreover, the committee's attorneys and other professionals are paid out of the bankruptcy estate.[159] That might seem the *coup de grâce* in an argument for the proposition that the unsecured creditors committee is well-incentivized to vigorously pursue a fraudulent transfer action—indeed, the committee might seem dangerously incentivized to go for broke. But that is incorrect. The estate does pay the committee's legal fees and costs, but all bankruptcy professionals and (absent avoidance of liens) secured creditors are entitled to 100% payment on their claims before the unsecured creditors are entitled to *any* payment, so unsecured creditors pay for the cost of litigation, and they also pay for any fees and costs incurred by the debtor-in-possession.[160] The unsecured creditors' recovery is thus on the line in the high-stakes, uncertain-odds gamble of fraudulent transfer litigation.

To the extent unsecured creditors *are* willing to take their chances, courts have made the bet even more unattractive by allowing the debtors-in-possession to settle

was granted, standing to bring fraudulent transfer actions and has filed suit. *See* Order Granting Unsecured Creditors Committee's Standing Motions, *In re* Tribune Co., No. 08-13141 (Bankr. D. Del. Oct. 26, 2010), ECF No. 6150.

[159] *See* 11 U.S.C. § 330 (providing payment to trustee, examiner, or other professional person); *id.* § 1103 (codifying attorney hiring procedure by committee); Brenda Hacker Osborne, *Attorney's Fees in Chapter 11 Reorganizations: A Case for Modified Procedures*, 69 IND. L.J. 581, 591 (1994) (discussing how courts grant reasonable compensation for actual and necessary services and expenses).

[160] *See* Ted Janger, *Crystals and Mud in Bankruptcy Law: Judicial Competence and Statutory Design*, 43 ARIZ. L. REV. 559, 607 n.182 (2001) (asserting payment for litigation by unsecured committee comes out of unsecured creditors' recovery); *see also* 11 U.S.C. § 330 (permitting for compensation of professionals with bankruptcy estate); *id.* § 507 (creating priorities for payment in bankruptcy, where unsecured creditors are behind both secured creditors and administrative expenses); *id.* § 1129(b)(2)(B)(ii) (codifying absolute priority rule where no junior unsecured creditor may receive payment before all senior creditors have been paid in full).

a fraudulent transfer case that the court previously authorized the unsecured creditors committee to bring.[161]

3. The Bankruptcy Court

Before any settlement regarding the assets and liabilities of the estate can be finalized, the bankruptcy court must approve it as "fair and equitable."[162] This should theoretically prevent debtors-in-possession from settling cheap in collusion with insiders (who may still control the debtor) or in favor of their LBO lender over the interests of unsecured creditors. In practice, the requirement of court approval is a weak check on lowball settlements. The court determines whether the settlement is "fair and equitable" according to a four-factor test consisting mostly of basic litigation-risk analysis: "(1) the probability of success in litigation; (2) the likely difficulties in collection; (3) the complexity of the litigation involved, and the expense, inconvenience and delay necessarily attending it; and (4) the paramount interest of the creditors."[163] The test for constructive fraudulent transfer makes the expense of litigation great and the probability of success far less than certain, so the range of settlements a court can construe as fair and equitable will encompass low settlements. And courts are likely to view nearly any settlement with favor, faced with the prospect of possibly having to order the unwinding of a large and complicated transaction, and with the certainty of having to apply ambiguous legal standard following a lengthy trial involving an unelucidating battle of experts.

V. BENEFITS OF CLARIFYING THE LAW AS RECOMMENDED

Clarifying constructive-fraudulent-transfer law as we have recommended offers several benefits:

- Parties to fraudulent transfer litigation would have a clearer standard for what they need to prove, which would make preparing proof a more focused, less expensive exercise. Trials would tend not to be as

[161] In the Lyondell bankruptcy, the court granted the committee derivative standing to prosecute fraudulent transfer actions against parties to the LBO that drove the company to bankruptcy. *See* Order Granting Motion of the official Committee of Unsecured Creditors for an Order (I) Authorizing the Committee to Pursue Lender Claims and Other Claims and Causes of Action of the Debtors' Estates and (II) Granting Related Relief, *In re* Lyondell Chem. Co., No. 09-10023 (Bankr. S.D.N.Y. 2009), ECF No. 2345. After the committee filed a complaint, the debtor-in-possession negotiated a settlement with the LBO lenders regarding the fraudulent transfer claims. The committee was not a party to the negotiations and, indeed, opposed the settlement. The debtor filed a Rule 9019 motion and, before the hearing, reached a settlement with the committee that increased the unsecured creditors' cash recovery by $150 million. The court approved the settlement and the company emerged from bankruptcy in April, 2010. *See supra* note 101.

[162] *See* Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414, 425 (1968); Motorola, Inc. v. Official Comm. of Unsecured Creditors (*In re* Iridium Operating LLC), 478 F.3d 452, 463 (2d Cir. 2007).

[163] Myers v. Martin (*In re* Martin), 91 F.3d 389, 393 (3d Cir. 1996).

astonishingly long as they have been.[164] Litigation would waste less resources. Reducing the cost of obtaining remedy would make remedy more available.

- Litigation outcomes would be more predictable, which would: (1) induce settlement, because providing the parties a clearer picture of how each is likely to fare in the absence of settlement promotes agreement on how much it is worth to each side to avoid the fight, and (2) promote enforcement, because creditors with strong cases (or their fiduciary in a bankruptcy of the LBO'd company) could be confident of favorable outcomes and would therefore invest in prosecution—something they are much less likely to do when litigation is a high-stakes gamble.
- By more predictably remedying harm, the law would more effectively disincentivize risk-externalization in LBOs. Unsecured creditors would be less often forced to subsidize LBOs. Parties contemplating LBOs would take fuller account of the law and the interests of unsecured creditors. Deals that ought never to happen—those economically attractive only because they are subsidized by externalized risk—would not happen.
- Constructive-fraudulent-transfer law that effectively internalizes externalized risks would provide economic benefits generally. Businesses would be able to extend unsecured credit assured of being at low risk of unremedied fraudulent transfers. They would be able to assess the creditworthiness of a would-be borrower with greater assurance that the borrower will not give its assets away so as to leave itself at foreseeable risk of insolvency. Credit would be cheaper because lenders would need less compensation for risk of unremedied fraudulent transfer. Cheaper credit (all else being equal) fosters economic growth. Also, by restraining excessive leverage, constructive-fraudulent-transfer law restrains not only insolvency-risk, but also systemic risks arising from too much capital being exposed to risk of overleverage-induced insolvency.
- Parties to LBOs will have a clear legal standard they can use in setting deal terms that will not run afoul of the heretofore-hazy line.

VI. WHY HAVE AMBIGUITIES PERSISTED?

If the recommended clarifications of law would have the benefits we have described, why, after decades of fraudulent transfer actions regarding LBOs, has the law not been so clarified? Two possibilities:

First, the ambiguities may self-perpetuate. Courts can only decide cases that come before them (though they can provide guidance beyond precedent by modeling reasoning, by issuing non-fact-specific holdings of law, and through

[164] *See, e.g.*, *In re* Best Prods. Co., 168 B.R. 35, 60–61 (Bankr. S.D.N.Y. 1994) (noting indeterminacy of financial projections and expert opinions thereon, and prospect of protracted, expensive litigation).

dicta). Fraudulent-transfer claims regarding LBOs tend to settle at a steep discount, their merits notwithstanding, because of the law's opacity and unpredictability, combined with the expense of litigation. Because of the pattern of litigation being preempted by settlement, courts have only occasional opportunity to refine the law. Hence the law's ambiguity may self-perpetuate.

Second, cases may be too few and too factually complex for a court hearing any one case to confidently articulate general rules.

The state of the law may also result from reluctance by some courts to find fraudulent transfers in LBOs.[165] Judge Posner recently described such reluctance:

> Some courts have been reluctant to apply the [Uniform Fraudulent Transfer] Act as written to leveraged buyouts . . . . They sympathize with minority shareholders who have no power to prevent such a deal. They may also agree with the scholars who have argued that many LBOs are welfare-enhancing transactions because by making the managers owners (managers are often the buyers in an LBO) and thus fusing ownership with control, an LBO increases the managers' incentive to operate the corporation with a view to maximizing its value rather than their salaries and perks. These scholars also argue that devices that facilitate transfers of corporate control increase the mobility of capital. . . . The reluctance . . . is not easy to square with the language of the Uniform Fraudulent Transfer Act.[166]

If courts are reluctant to conclude that LBOs involve fraudulent transfers, there may be reasons beyond those identified by Judge Posner. Courts are ordinarily in the business of enforcing contracts between private parties, not voiding them. The enforceability of contracts is at the heart of the free-enterprise system. A vigorous capitalist economy requires that businesses be able to both obtain debt financing and take risks, and an overbroad delineation of constructive fraudulent transfer would impede them from doing so. Judges may be trepidatious about voiding a transfer comprising part of a large, complex, multi-step, multi-party transaction like an LBO. LBOs are big business on Wall Street, in London, and in other financial centers.

Another reason for possible judicial reluctance may be the notion that the parties to LBOs have keen interests in avoiding insolvency of the target-company, and that these interests will protect the parallel interests of unsecured creditors. To

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[165] For example, in cases arising out of the LBO boom of the 1980s, courts expressed unease about finding fraudulent conveyance in an LBO in the absence of proof of bad faith. *See, e.g.*, Kupetz v. Wolf, 845 F.2d 842, 847 (9th Cir. 1988); Credit Managers Ass'n of S. Cal. v. Fed. Co., 629 F. Supp. 175, 181 (C.D. Cal. 1986); *In re* Ohio Corrugating Co., 91 B.R. 430, 439 (Bankr. N.D. Ohio 1988).

[166] Boyer v. Crown Stock Distrib., Inc., 587 F.3d 787, 794 (7th Cir. 2009) (internal citations omitted).

the contrary,[167] unsecured creditors actually have no good proxy among the parties to an LBO.

CONCLUSION

The clarifications we recommend may be best accomplished through revision of fraudulent-transfer statutes—because they are several, because the law's ambiguity may self-perpetuate and because courts may be reluctant to interfere in leveraged buyouts. In the indefinite meantime, until legislators act, courts should take every opportunity to clarify the law, following the lead of Judge Posner in his recent opinion for the Seventh Circuit in *Boyer*.[168] As of this writing, the opportunities are dwindling in the fraudulent transfer litigation arising from the massive LBO-wave of the mid-2000s.[169] If the courts fail to take such opportunities as remain, the LBO market will provide another, but not without more collateral damage. The LBO market is already resurgent, notwithstanding the wrack of defaults and insolvencies left behind by the tsunami just receded.[170]

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[167] *See supra* Part I.A (discussing exposure of unsecured creditors in LBO deals).

[168] *See Boyer*, 587 F.3d at 794 (discussing ambiguity in application of legal term "unreasonably small").

[169] Insolvencies resulting from those LBOs are likely to continue beyond the period when fraudulent-transfer actions can be brought. Moody's has projected that many companies LBO'd during 2004 through 2007 are going to need refinancing in 2012 through 2014, when credit markets are going to be overwhelmed by demand because of the volume of high-yield debt needing refinancing, and because interest rates are likely to be higher due to governments' demand for credit. *See* MOODY'S *Private Equity*, *supra* note 22, at 4. The creditors of companies becoming insolvent because they are unable to refinance at a rate that enables them to remain solvent will have limited recourse under fraudulent transfer law. Claims for relief under UFTA are extinguished unless an action is brought within four years after the transfer was made, or within one year after an intentional fraudulent transfer reasonably could have been discovered. *See* UFTA § 9 (2006). And some courts have refused to declare LBOs to be constructively-fraudulent transfers more than a couple years after the buyout—although Judge Posner's opinion in *Boyer* casts such reasoning in doubt. *See Boyer*, 587 F.3d at 795.

[170] *See A Rebound In Private Equity Re-Energizes The LBO Market*, STANDARD & POOR'S, July 23, 2010, at 1; *Business: Waiting for a Wave; Mergers and Acquisitions*; ECONOMIST, Aug. 28, 2010, at 53; *Finance and Economics: Crazy Little Thing Called Leverage; Private Equity*, ECONOMIST, May 22, 2010, at 77; Mark Gongloff, *Leveraged-Loan Market Surges As Investors Seek Alternatives*, DOW JONES DAILY BANKR. REV., Sept. 17, 2010; Peter Lattman & Anupreeta Das, *Bankers Expect Megabuyout*, WALL ST. J., May 6, 2010. Even "covenant-lite" loans have come back. *See The Leveraging of America: Covenant-Lite Loan Structures Diminish Recovery Prospects*, STANDARD & POOR'S, July 18, 2007, at 5; Nicole Bullock, *Hungry Investors Return to 'Covenant-lite' Deals*, FIN. TIMES, Feb. 4, 2011; Katherine Greene, *Cov-Lite Loans Make a Return—High Demand as Lyondell Pares Yield; Skittish no More?*, WALL ST. J., Mar. 26, 2010, at C8.