Improving Fraudulent Transfer Law in Leverage Buy-Outs through Judicial Certainty & Reliability

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Introduction

Leveraged buyouts (LBOs) allow acquirers to fund investments more easily because the acquirers can use a target’s assets to finance the acquisition. Having become more popular in the 1980s, LBOs have created a market for corporate control, which has increased pressure on existing management to focus on performance.\(^1\) Although changes in a firm’s capital structure and ownership can improve corporate governance and reduce taxes, thereby increasing the value of the firm, it also has the effect of transferring value from creditors to equity holders.\(^2\)

Over 5000 LBOs were completed from 2005 to 2007, creating a combined estimated firm value of over $1.6 trillion. They accounted for approximately 30% of the total number of LBO transaction that occurred from 1984 to 2007 and 43% of the total real dollar value of all leveraged buyouts during the same period.\(^3\) In 2006 alone, LBOs accounted for approximately 25% of the dollar value of all mergers and acquisitions in the United States.\(^4\) Although these figures are impressive, they are not surprising given the fact that when credit is inexpensive and the economy is expanding, highly leveraged LBOs can provide an optimal means of acquiring target companies.\(^5\)

The value of LBOs totaled more than $800 billion from 2004 to 2008, of which $400 billion occurred in 2007.\(^6\) However, the recent financial crisis, caused in part by the dysfunctional banking industry and irresponsible lending, caused credit markets to tighten.\(^7\) Risks that had accumulated on the balance sheets of major financial institutions during the credit and asset bubble became apparent and several financial institutions, such as Lehman Brothers, Bear Stearns and AIG, appeared to threaten the stability of the entire economy. As credit markets tightened rapidly, many companies acquired through LBOs were unable to refinance their debt in

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\(^1\) Michael Simkovic and Benjamin S. Kaminetzky. Leveraged Buyout Bankruptcies, the Problem of Hindsight Bias and the Credit Default Swap Solution, 2011 Colum. Bus. L. Rev. 118, 128.


the ensuing recession, such as Chrysler, LyondellBasell, Capmark Financial Group, Reader's Digest and Tribune Co. declared bankruptcy.

Despite the difficulty of predicting how many companies will file for bankruptcy, a study conducted by the Boston Consulting Group and IESE Business School suggests that approximately half of former LBO targets will probably be unable to service their debt within the next few years. Given that debt maturities are expected to peak in 2012-2014, there is a distinct possibility that many companies will file for bankruptcy in the coming years if they are unable to secure lending to refinance their long-term debt.

LBOs that file for bankruptcy are routinely challenged under fraudulent transfer law, where plaintiffs allege that the LBO unreasonably reduced the target’s liquidity and capital adequacy, saddled it with debt and was completed as a means of funneling company assets to both current and former shareholders. These cases will bestow upon bankruptcy courts the responsibility and power of efficiently allocating billions of dollars to classes of creditors and clawing back

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9 In re Lyondell Chem. Co., No. 09-10023 (REG) (Bankr. S.D.N.Y.). In 2007, Lyondell Chemical Company (“Lyondell”), formerly North America’s third-largest independent, publicly traded chemical company, was acquired by Basell AF S.C.A. in a LBO. Lyondell and certain affiliates incurred obligations in the approximate amount of $20.7 billion, with fees amounting to $574.6 million and payments to officers, employees and other insiders amounting to $337.3 million. When Lyondell filed for bankruptcy in 2009, unsecured creditors sought to avoid the transactions or claw back payments that totaled more than $20 billion.

10 In re Tribune Co., No. 08-13141 (KJC) (Bankr. D. Del.). In 2007 the Tribune Company was acquired through a LBO, in which the company incurred an additional $9 billion in debt as a direct result of the LBO. The LBO increased its total debt and contingent liabilities to approximately $14 billion, its assets being valued at $11 billion and the fees to lenders and other professionals totaling approximately $200 million. When the company declared bankruptcy in 2008, unsecured creditors attacked the LBO and sought to avoid the transactions or clawback payments that aggregate over $8 billion.


funds from shareholders.14 Since these cases will have a crucial impact on the overall economy, it is imperative that bankruptcy courts wield their authority and power in a predictable, fair, and consistent fashion.

In this paper, we will seek to understand (I) the nature of LBOs, (II) the fundamental mechanisms in place under fraudulent transfer laws and (III) the remedies available to creditors who have been harmed by a LBO. Once this has been achieved, we will explore (IV) the means by which Courts determine whether a firm is solvent pursuant to fraudulent transfer laws and (V) the potential shortfalls and issues inherent to this analysis before (VI) elaborating on a recommended method of analysis that can reduce uncertainty and return control of the analysis to the Court.

I. Understanding the Nature of LBOs

One of the most efficient means of taking a company private or acquiring a company for the Acquirer is through a Leveraged Buy-Out (LBO) because the Target ‘s assets usually finance the acquisition. Once acquired, the Acquirer usually seeks to increase the value of the Target rapidly through various strategies, such as lowering costs by improving efficiency or finding new profitable synergies, while decreasing its exposure to risk, before implementing a profitable exit strategy through an IPO. Although these strategies can increase the value of a company, they can also lead to bankruptcy. In order to understand the nature of LBOs, it is important to discuss (1) the structure of LBOs, (2) their purpose as a method of acquisition and (3) any potential shortfalls.

1. The Structure of LBOs

A leveraged buyout (LBO) is the acquisition of an asset or entity through one of three basic forms: (1) a direct sale to the buyer, (2) a cash merger with the buyer, or (3) a stock purchase by the buyer that may be followed by a merger.15 In an LBO, the acquisition price is financed through a combination of debt and equity, with the cash flows or assets of the target being used as collateral to secure and repay the debt used to finance the purchase.16 Since the debt usually

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has a lower cost of capital than the equity, the returns on the equity increase with increasing debt. Therefore, the debt essentially acts as a lever to increase a purchaser’s returns on the investment, with the buyer paying the selling stockholders for their shares in order to acquire the target. Although the target is encumbered by large amounts of debt, the buyer incurs no liability for the debts.\(^\text{17}\)

At its core, a LBO is the purchase of an entity with borrowed funds secured by the entity’s assets.\(^\text{18}\) In most LBOs, the shareholders of a target company are interested in divesting their interests in the company, whereas the buyer, usually a private equity firm or a consortium of companies, seeks to purchase the target because it believes the target is underperforming or is undervalued.\(^\text{19}\) For public companies, the buyer will need to make a tender offer for the target’s outstanding shares, while the target retains an investment bank to conduct an auction in order to maximize shareholder value.

In order to complete the buyout, the acquirer follows several steps: (1) the acquirer creates a shell company strictly for the purpose of the acquisition, (2) then seeks a variety of financing sources, borrowing an amount that represents approximately 60-90% of the acquisition price and infusing 40-10% of its own equity, the loans being transferred to the target upon closing of the transaction. (3) The equity and the borrowed funds are used to purchase the shares of the target from the shareholders and (4) once the transaction closes; the lenders receive repayment obligations from the target and first priority liens on all the target’s assets.

(see diagram hereunder for typical structure of an LBO transaction)\(^\text{20}\)

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\(^\text{20}\) http://privateequityblogger.com/2008/10/leveraged-buyouts.html
More complicated structures involve multiple tranches of debt, including variations within each tranche, with the Target issuing junk bonds to provide additional subordinated financing. Senior debt is often used to finance the bulk of the purchase price, with senior lenders receiving first priority liens on all of the target’s assets to secure the target’s obligation to pay. Within the senior debt tranche, there may be loans of varying terms, maturities, payment schedules, seniorities, and amortization. The capital structure may also include mezzanine lenders, which rely on junior liens or unsecured repayment obligations from the target at higher interest rates, and subordinated unsecured debt in multiple tranches.

After the LBO, the target receives no direct benefit from the transaction but bears a sizeable debt load on collateralize assets that were previously unemcumbered. Moreover, a LBO significantly and negatively affects a company’s capital structure by increasing the company’s debt burden, which impacts the rights of the company’s existing creditors if the company becomes insolvent. Therefore unsecured creditors of the target are exposed to the increased insolvency risk without receiving any compensation for the increase in risk, while the acquirer, lenders and shareholders of the target receive the benefits of the LBO without sharing in the risk.

2. The Purpose of LBOs

The appeal of LBO transactions is that they give the acquirer the possibility to acquire a target for virtually nothing. If the LBO is entirely funded by debt, or if the acquirer is able to extract its

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24 See, e.g., Mellon Bank, N.A. v. Metro Comm’ns, Inc., 945 F.2d 635, 645-46 (3d Cir. 1991) (where the court found that: “The effect of an LBO is that a corporation’s shareholders are replaced by secured creditors. Put simply, stockholders’ equity is supplanted by corporate debt. 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.”).
cash shortly after the close of the transaction through dividends, management fees, or some other device, the acquirer benefits substantially from the transaction while incurring very little downside risk of loss. Consequently, the acquirer has strong incentive to pursue risky strategies, such as mergers, divestitures or drastic cost cutting, which have a high probability of succeeding spectacularly or failing miserably. By contrast, normal corporate managers, who are generally not significant equity owners, might pursue overly conservative strategies to preserve their jobs or to protect the interests of stakeholders rather than just shareholders.

Acquirers typically decide to complete LBOs through a highly leveraged financing option because they: (i) lack the resources necessary to purchase the target; (ii) do not want to commit significant resources to the acquisition and/or (iii) lack the borrowing capacity to finance the acquisition. In return for the loans necessary to finance the transaction, the lenders receive a direct claim against the target company and a lien on the target company’s assets.

From the perspective of the acquirer, the acquirer benefits from being able to acquire the target while only supplying about 10-40% of the purchase price. Moreover, the fact that the company was acquired through the use of debt results in significant tax savings because the interest payments are deductible from the company’s income. Therefore, the LBO is effectively subsidized by the cash flows paying down the debt because they would ordinarily have been taxed at either the corporate or shareholder level.

Other indirect benefits of the LBO are: (1) the target receives savings from going private, such as operational synergies and the costs caused by compliance with federal and state securities laws, (2) the target may benefit from new ownership and management’s experience in cutting costs and improving cash flows and performance, (3) the remaining shareholders benefit more from any appreciation in the company’s equity because benefits will be distributed among fewer parties, and (4) the new company is arguably more flexible at adjusting to yield short-term gains and may be able raise funds with greater ease than the target.

Provided that the company is able to continue to remain solvent and generate profits, the cash-flows serve to repay the debt, reducing the acquirer’s leverage. The acquirer may also receive fees that can make the transaction profitable, such as (1) transaction fees for putting together the acquisition, (2) annual management fees, (3) dividend distributions, and (4) fees when the target is sold, regardless of whether or not the target becomes insolvent following the acquisition.

Finally, the selling shareholders receive funds once the deal is closed. Since the shareholders no longer have a stake in the target, they are not exposed to the risk of insolvency caused by the leverage. The investment banks arranging or underwriting the LBO receive their fees when closing and while the entities providing financing protect their loans through their security

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29 Annual management fees for the HCA buyout was $ 15 million per year. The management contract was for ten years, and the fee would increase proportionately to the yearly increase in EBITDA. For HCA, this fee was 1 percent of the sale price. HCA was acquired for $ 33 billion. If the corporation was sold for the exact same price, the buying group would receive $ 330 million even though their efforts had not led to an appreciation in the market value of the corporation. Samir D. Parikh. Saving Fraudulent Transfer Law, 86 Am. Bankr. L.J. 305, 313 (2012).
interests in the target-company assets, which is securitized and sold to other investors rather than held by the entity.\textsuperscript{31} Therefore, once an LBO has closed, most entities have limited interest in the target’s long-term solvency since they no longer bear any risk.

Although there is a risk that the buyer’s leveraged investment will be lost in the event of insolvency, buyers, such as private equity funds, can reduce their risk by: (1) recouping their investment by taking out additional loans and distribute the proceeds to shareholder (dividend recapitalization) and (2) diversifying their risk of an aggregate leverage-induced insolvency across a portfolio of leveraged acquisitions and profiting off the successful LBOs.\textsuperscript{32} Therefore, the acquirer effectively bares little risk in the transaction while benefiting from substantial gains.

\section{3. The Potential Shortfalls of LBOs}

Unfortunately, LBOs do not benefit all stakeholders equally, with the target’s employees, unsecured creditors and future prospects bear most of the downside risks associated with the Target.\textsuperscript{33} Due to the considerable debt burden that the target must service following the LBO, the target must invariably undertake a variety of cost-cutting measures, usually at the expense of employees, focusing on short-term prospects, with equity holders favoring high risk operational and financing decisions, as opposed to debt holders, whose upside is capped by the amount of their debt, tend to favor more conservative decisions.\textsuperscript{34}

However, there are disadvantages to cost cutting measures as one of the primary means of paying down the debt. This can hinder the overall prosperity of a community that depends on the Target for jobs and incite the Target’s talented workers to seek offers from competitors that offer more job security. Moreover, since the Target’s cash flows must be affected to servicing the debt, the new management is unlikely to replace operating assets or expend funds on repairs and maintenance. This will lead the Target’s property and equipment to become outdated and remain in poor condition. Moreover, curtailing research and development expenditures will likely decrease future growth prospects and increase the likelihood that the Target loses market share and becomes more inefficient.

\textsuperscript{31} In the 1980s and 1990s, debt financing for LBOs was provided predominately through the junk-bonds underwritten by investment banks. 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, (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. For an overview of the market for LBO debt in the U.S., including syndication and securitization, see Glenn Yago & Donald McCarthy, Milken Institute, \textit{The U.S. Leveraged Loan Market: A Primer} (2004), \texttt{http://milkeninstitute.org/pdf/loan_primer_1004.pdf}. See, John H. Ginsberg, M. Katie Burgess, Daniel R. Czerwonka & Zachary R. Caldwell. Befuddlement Betwixt Two Fulcrums: Calibrating the Scales of Justice to Ascertain Fraudulent Transfers in Leveraged Buyouts 19 Am. Bankr. Inst. L. Rev. 76.


\textsuperscript{34} Samir D. Parikh. Saving Fraudulent Transfer Law, 86 Am. Bankr. L.J. 305, 314 (2012) (finding that in the first two years after a LBO, private equity firms cut 17.7% of jobs, compared to the 10.9% job force reduction conducted by non-private equity firms after an acquisition); Michael Simkovic and Benjamin S. Kaminetzky. Leveraged Buyout Bankruptcies, the Problem of Hindsight Bias and the Credit Default Swap Solution, 2011 Colum. Bus. L. Rev. 118, 217 (2011).
For this reason, the LBO is an attractive acquisition method for the buyers, sellers and lenders alike, since they bear very little risk, but not for creditors. Entities such as employee pension plans, retirement plans, mutual funds, and other entities that manage funds belonging to millions of individuals may have purchased the target company’s debt securities before the leveraged buyout. They can only hope to be paid what they are owed, which is unchanged by the LBO, regardless of the inherent risk of insolvency. As a result of these conflicting interests, debt holders try to constrain equity holders’ and prevent them from undertaking too much risk through covenants, change-of-control provisions, and other mechanisms designed to protect them from a risky shift in management strategy.

LBOs greatly increase target-company indebtedness, and the need to service debt is an inflexible demand on the target’s cash-flow, increasing risk of the target becoming insolvent. Since the lender nearly always assumes a senior lien position, the lender is limited in so far as it is under-secured. The target’s unsecured creditors are exposed to the increased risk of the target’s insolvency involuntarily and without prospect of reward.

Essentially, unsecured creditors (1) are not party to the LBO, (2) have no good proxy among the parties and (3) absent legal recourse, they may be unable to negotiate protection against uncompensated harm. The target’s management may have made a series of failed decisions that were aggressive, risky and short-term oriented, including firing employees and reducing investment in research and development, repairs and maintenance. These decisions were detrimental to the company’s business and operations because, though cash flow was increased, these funds were not reinvested in the company. In the event that revenues stop growing and cash flow contract, companies acquired through a LBO may be unable to service their debt.

Once in bankruptcy, the company’s assets are usually encumbered by liens, which were given to secure the financing for the LBO. The only viable option for unsecured creditors who refuse to accept an overwhelming loss on their investment is to invoke fraudulent transfer law and attack the LBO that precipitated the company’s collapse.

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37 Michael Simkovic and Benjamin S. Kaminetzky. Leveraged Buyout Bankruptcies, the Problem of Hindsight Bias and the Credit Default Swap Solution, 2011 Colum. Bus. L. Rev. 118, 217 (2011); Samir D. Parikh. Saving Fraudulent Transfer Law, 86 Am. Bankr. L.J. 305, 314 (2012) (finding that in 51% of the over 17,000 worldwide LBOs that occurred between 1970 and 2007 and had a financial sponsor in the CapitalIQ database, the acquirer exited from management of the target within 6 years of the acquisition. Usually, exit strategies involve (1) the sale of the company, (2) an initial public offering of the stock or (3) bankruptcy).
incorporated into state statutes and into the Bankruptcy Code, offers a potential remedy to unsecured creditors harmed by excessive risk-externalization in leveraged buyouts. If the LBO directly caused the bankruptcy, then the LBO will be considered as a fraudulent transfer, in so far as the Target gave assets of value but did not receive anything of equivalent value in exchange.

A fundamental principle of corporate and bankruptcy law is that creditors should be paid before Ownership. Since an LBO can effectively short-circuit that principle fraudulent transfer law protects creditors by giving them a way to avoid the LBO. Creditors will argue that the leveraged buyout represented a fraudulent transfer because management essentially authorized the company to overpay for its outstanding shares. This overpayment left the company insolvent or with unreasonably small capital to operate; the only equitable result being to unwind the leveraged buyout and recover the fraudulently transferred funds. Therefore, unsecured creditors need effective fraudulent transfer law to deter and remedy excessive risk-externalization in LBOs.

II. Fraudulent Transfer Law

Many states have enacted the Uniform Fraudulent Transfer Act (UFTA), which provides that: “(a) (1) the trustee may avoid any transfer […] incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily (A) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted, or (B) (i) received less than a


44 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, PP 548.01[1][b] & 548.01[2][a] (Alan N. Resnick & Henry J. Sommers eds., 16 ed. 2010).


50 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").


52 This allows a trustee to avoid transfers that were made within two years of the petition date with the intent to “hinder, delay or defraud” creditors, regardless of whether the recipient had knowledge of that bad faith. See, e.g.,
reasonably equivalent value in exchange for such transfer or obligation; and (ii) (I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation; (II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; (III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured; or (IV) made such transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.”

Therefore, a plaintiff may avoid a transfer if there was (1) actual intent to hinder delay or defraud or (2) the target received less than reasonably equivalent value and the Target (i) was or would become insolvent as a result of the transfer, (ii) was left with unreasonably small capital, (iii) incurred debts that the target would be unable to service or (iv) made the transfer with the intention to benefit an insider.

Although most courts have found that leveraged buyouts are not fraudulent transfers, at least some courts have been willing to evaluate these transactions as potentially fraudulent. These cases and others have led some writers to conclude that an animating purpose of fraudulent transfer law is to "regulate the permissible degree of risk" that debtors can take with funds they

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53 This allows a trustee to avoid a transfer made by an insolvent debtor that is not supported by consideration; see Wyle v. C.H. Rider & Family, (In re United Energy Corp.), 944 F.2d 589, 597 (9th Cir. 1991) (construing federal fraudulent transfer provision to direct courts to determine whether debtor received reasonably equivalent value); see also In re M & L Bus. Mach. Co., 164 B.R. 657, 667 (D. Colo. 1994) (rejecting trustee’s argument suggesting transferee did not give value because transferee lacked good faith). Craig T. Lutterbein “Fraud and deceit abound, but do the bankruptcy courts really believe everyone s crooked: the bayou decision and the narrowing of good faith. 8 Am. Bankr. Inst. L. Rev. 405, 407 (2010).

54 See 11 U.S.C. §§ 548 (a)(1)(A)-(B) (2006) (allowing trustee to pursue both actual fraud and constructive fraud actions against transferee within two years of transfer); Unif. Fraudulent Transfer Act§4, 5. The Bankruptcy Code’s provisions on fraudulent transfers were greatly influenced by the UFCA, containing both actual and constructive fraud provisions John H. Ginsberg, M. Katie Burgess, Daniel R. Czerwonka & Zachary R. Caldwell. Befuddled Betwixt Two Fulcrums: Calibrating the Scales of Justice to Ascertain Fraudulent Transfers in Leveraged Buyouts 19 Am. Bankr. Inst. L. Rev. 81. (2011) .See, e.g., Mullins v. TestAmerica Inc., 564 F.3d 386, 400 (5th Cir. 2009); Elway Co., LLP v. Miller (In re Elrod Holdings Corp.), 421 B.R. 700, 709 (Bankr. D. Del. 2010). However, the transferee’s objective good faith will be a defense to a actual fraudulent transfer if, and only to the extent that, the transferee gave value. Code § 548(c); see Slone v. Lassiter (In re Grove-Merritt), 406 B.R. 778, 809–10 (Bankr. S.D. Ohio 2009) (an absolute defense is available if the transferee was in objective good faith and gave reasonably equivalent value to the debtor). James M. Lawniczak. 2-16 Asset Based Financing: A Transactional Guide § 16.12; Craig T. Lutterbein “Fraud and deceit abound, but do the bankruptcy courts really believe everyone s crooked: the bayou decision and the narrowing of good faith. 8 Am. Bankr. Inst. L. Rev. 405, 407 (2010).

obtain from creditors. In order to fully understand the impact of the UFTA, we will discuss how the UFTA considers (1) intentional fraud, (2) equivalent value and (3) constructive fraud.

1. Intentional / Actual Fraud

Section 548(a)(1) of the Bankruptcy Code permits avoidance if the transferor "made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became indebted." Pursuant to the Bankruptcy Code provisions, it is the debtor’s intent, actions or knowledge that are play a crucial role in determining whether there was actual fraud. As such, a Trustee need only show evidence of the debtor’s intentions for actual fraud to avoid the transfer. For example, in a Ponzi scheme bankruptcy, a trustee should be able to easily prove that nearly every transfer was made with the intent to commit fraud since it is inherent in the very nature of a Ponzi scheme, in so far as the investments from later investors are used to pay earlier investors in order to attract new investors. Therefore, in Ponzi scheme bankruptcies, the trustee’s avoidance actions are usually brought as actual fraud actions, rather than constructive fraud actions.

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59 See In re Cahillane, 408 B.R. 175, 191 (Bankr. N.D. Ind. 2009) (noting that focus is on state of mind of debtor, and culpability of transferee is not essential); In re National Audit Defense Network, 367 B.R. 207, 221 (Bankr. D. Nev. 2007) (“It is key in this analysis that the required intent to hinder, delay or defraud is the debtor’s; no collusion with the transferee is necessary.”); Craig T. Lutterbein “Fraud and deceit abound, but do the bankruptcy courts really believe everyone s crooked: the bayou decision and the narrowing of good faith. 8 Am. Bankr. Inst. L. Rev. 405, 434 (2010).
60 Craig T. Lutterbein “Fraud and deceit abound, but do the bankruptcy courts really believe everyone s crooked: the bayou decision and the narrowing of good faith. 8 Am. Bankr. Inst. L. Rev. 405, 434 & 436 (2010) (citing Conroy v. Shott, 363 F.2d 90, 91-92 (6th Cir. 1966) (noting “the question of intent to defraud is not debatable” because debtor was conducting Ponzi scheme); see also In re Indep. Clearing House Co., 77 B.R. 843, 860 (D. Utah 1987) (“Knowledge to a substantial certainty constitutes intent in the eyes of the law . . . and a debtor’s knowledge that future investors will not be paid is sufficient to establish his actual intent to defraud them.”); SeeTerry v. June, 432 F. Supp. 2d 635, 639 (W.D. Va. 2006) (“One can infer intent to defraud future undertakers from the mere fact that the debtor was running a Ponzi scheme.”); see also Peter S. Kim, Navigating the Safe Harbors: Two Bright Line Rules to Assist Courts in Applying The Stockbroker Defense and The Good Faith Defense,2008 COLUM. BUS. L. REV. 657, 674-75).
61 James Butler Cash, Jr., Note, When is an Equity Participant Actually a Creditor? The Effect of In re AFI Holding on Ponzi Scheme Victims and the Good Faith Defense,98 KY. L.J. 329, 336, 339-340 (2009) (noting actual fraud gives substantial advantage to trustee in being able to recover all amounts transferred to investor, not just fictitious profits trustee can obtain under constructive fraud); Arthur J. Steinberg & John F. Isbell, The Need to Revisit the 'Value in Good Faith' Defense to Fraudulent Transfer Claims, 18 NORTON J. BANKR. L. & PRAC., 393, 394 (2009) (arguing in actual intent cases, trustee’s burden of proof for prima facie case if there is a Ponzi scheme is easier to satisfy than constructive intent cases). However, an investor’s profits will be avoided under constructive fraud theories. See In re Bayou Group, LLC, 396 B.R. 810, 827-28 (Bankr. S.D.N.Y. 2008) (holding plaintiffs constructive fraud claims are limited to fictitious profits). An investor will not be able to assert the section 548(c)
However, not all bankruptcies are as straightforward as Ponzi schemes and determining the extent of the knowledge and intent of directors, officers and other agents is a daunting task. It can be very difficult to prove beyond reasonable doubt that there was an actual intent to defraud, therefore intent must ultimately be deduced or inferred from actions taken by the individuals involved. For example, a general strategy which involves stripping a debtor of its assets without regard to the position of creditors can be sufficient for a court to determine that there was an intentional fraud. As a result of the inherent difficulty of determining intent, bankruptcy courts have, on occasion, determined that an intentional fraudulent transfer occurred despite finding that there was a genuine fraud.

In evaluating the transferor’s actions, courts will consider the existence of any elements of fraud, such as (1) the value of the consideration received by the debtor; (2) the nature of the relationship between the debtor and the transferee; (3) whether the debtor was insolvent at the time of the transfer or became insolvent shortly after the transfer was made or the obligation was incurred; (4) whether the debtor retained possession or control of the property transferred once the transfer occurred; (5) whether the transfer encompassed substantially all the debtor’s assets; and (6) whether the transfer or obligation was disclosed or concealed.

Although the Bankruptcy Code’s provisions on fraudulent transfers are similar to those of the UFCA, they contain some significant functional differences. These changes are especially significant when dealing with Ponzi scheme bankruptcies and the good faith defense under defense for his profits because the investor will not have given value for the profits. See In re Randy, 189 B.R. 425, 442 (Bankr. N.D. Ill. 1995) (stating courts have denied transferees trying to protect profits from Ponzi scheme shelter of section 548(c) because they did not give any value for transfer); see also In re Indep. Clearing House, 77 B.R. at 859 (“[T]he use of investors’ money to perpetuate a Ponzi scheme is not the type of ‘property’ and hence ‘value’ Congress had in mind when it passed section 548(a)(2).”); Craig T. Lutterbein “Fraud and deceit abound, but do the bankruptcy courts really believe everyone s crooked: the bayou decision and the narrowing of good faith. 8 Am. Bankr. Inst. L. Rev. 405, 434-5 (2010) and UNIF. FRAUDULENT CONVEYANCE ACT § 3 (1918) (defining fair consideration as requiring “fair equivalent therefore” and exchange is done in “good faith”) with UNIF. FRAUDULENT CONVEYANCE ACT § 9 (allowing transferee to keep any value given if transfer gave fair consideration--requiring value and good faith--and is without knowledge of the debtor’s fraudulent purpose).

62 Samir D. Parikh. Saving Fraudulent Transfer Law, 86 Am. Bankr. L.J. 305, 318 (2012) (noting that the fraud of an officer of a corporation is imputed to the corporation when the officer’s fraudulent conduct was (1) in the course of his employment, and (2) for the benefit of the corporation. This is true even if the officer’s conduct was unauthorized, effected for his own benefit but clothed with apparent authority of the corporation, or contrary to instructions. McNamara v. PFS (In re Pers. & Bus. Ins. Agency), 334 F.3d 239, 242-43 (3d Cir. 2003)).


§548(c) of the Bankruptcy Code. Section 548(c) protects a transferee who receives a fraudulent transfer by allowing the transferee to retain value equivalent to the value the transferee exchanged for the transfer as long the exchange was made in “good faith.” As such, the Bankruptcy Code’s fraudulent transfer provisions protects a transferee up to the amount of value it gave in good faith, regardless of whether the transfer occurred under constructive and actual fraud. In such circumstances, the trustee will need to prevent the transferee from demonstrating that the transferee gave value to the debtor in good faith in order to avoid the transfer. Consequently, the analysis for determining whether a trustee can avoid a transfer is similar to the analysis for recovering under constructive fraud pursuant to the UFCA.

2. Related Entity Loan & Equivalent Value

A transfer must be for less than “reasonably equivalent value” to be a constructive fraudulent transfer under Code § 548(a)(1)(B) and under uniform state fraudulent transfer laws. The Code does not define the term “reasonably equivalent value” and courts have generally employed a case by case approach to its determination, moving away from a mathematical or percentage test. “Reasonably equivalent value is typically considered to be the value of the asset on the date of the transfer from the perspective of the creditors.”

The proper valuation of an asset for purposes of determining reasonably equivalent value is the amount which can be realized from the assets within a reasonable time and not upon immediate

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68 Craig T. Lutterbein “Fraud and deceit abound, but do the bankruptcy courts really believe everyone’s crooked: the bayou decision and the narrowing of good faith. 8 Am. Bankr. Inst. L. Rev. 405, 435 (2010) (citing In re Hill, 342 B.R. 183, 203 (Bankr. D.N.J. 2006) (stating use of section 548(c) defense “requires proof of two elements: ’first, innocence on the part of the transferee, and second, an exchange of value‘”); In re Lakes States Commodities, 253 B.R. 866, 877-78 (Bankr. N.D. Ill. 2000) (“[A] trustee may recover the full amount paid a Ponzi scheme investor unless the investor can establish . . . that it received payments from the scheme “for value and in good faith.”)).

69 See UNIF. FRAUDULENT CONVEYANCE ACT § 3. As mentioned, under the UFCA, a transferee would have to prove lack of knowledge as well as fair consideration to keep the value it exchange for an actual fraudulent transfer. See id. at § 9. Craig T. Lutterbein “Fraud and deceit abound, but do the bankruptcy courts really believe everyone’s crooked: the bayou decision and the narrowing of good faith. 8 Am. Bankr. Inst. L. Rev. 405, 435 (2010).

70 See Brown v. Third Nat’l Bank (In re Sherman), 67 F.3d 1348, 1355 (8th Cir. 1995) (“When a transfer is avoided under [section] 548(a), a transferee who takes for value and in good faith is given a lien to the extent of the value given to the debtor in exchange for the transfer under [section] 548(c).”); see also In re Practical Inv. Corp., 95 B.R. 935, 941 (Bankr. E.D. Va. 1989) (retaining deed of trust permitted if deed of trust taken for value and in good faith); Craig T. Lutterbein “Fraud and deceit abound, but do the bankruptcy courts really believe everyone’s crooked: the bayou decision and the narrowing of good faith. 8 Am. Bankr. Inst. L. Rev. 405, 436. (2010).

71 At least one of the financial condition tests, insolvency, capitalization and ability to pay debts, must also be present. James M. Lwniczak. 2-16 Asset Based Financing: A Transactional Guide § 16.12


73 James M. Lwniczak. 2-16 Asset Based Financing: A Transactional Guide § 16.12 (citing Decker v. Tramiel (In re JTS Corp.), 617 F.3d 1102, 1109 (9th Cir. 2010) (applying California UFTA and, accepting the original valuation of the property transferred as determined by the bankruptcy court based on a reduction due to the fact that the transferor needed to sell quickly, rather than the higher “fair market value” determined by the district court based on exposure to the market for a year); EBC I, Inc. v. Am. Online, Inc. (In re EBC I, Inc.), 380 B.R. 348, 362 (Bankr. D. Del. 2008), aff’d, 400 B.R. 13 (D. Del. 2009) and 382 Fed. Appx. 135 (3d Cir. 2010)).
liquidation or forced sale, unless the company is on its “deathbed.” Factors to be considered include (1) good faith of the parties, (2) the difference between the amount paid and the fair market value, (3) the percentage of the fair market value paid, and (4) whether the transaction was arm’s length.

Fraudulent transfers may occur in related loans, such as “upstream” loans and “cross stream” loans because the borrower may not have received fair equivalent value for the obligation to repay the secured debt that it incurred. In “upstream transactions, the loan proceeds are disbursed to the parent corporation of the borrower or the lender, and in “cross-stream” transactions, the loan proceeds are distributed to a “sister” entity. These loans may fall under the scope of fraudulent transfer laws because the borrower incurs a debt and has likely used its assets as collateral for the debt despite not retaining any the proceeds from the loan.

The same concern is present in “upstream”, “downstream” or “cross-stream” guarantees, where a company guarantees a loan taken by its parent corporation, a subsidiary or a sister entity, by pledging its assets without retaining the proceeds. Although these intercorporate guarantees are common because of the benefits they create for both the borrower and lender, they may be challenged as fraudulent transfers because the guarantor is not directly benefiting from the loan proceeds. In the event that the guarantee results in the guarantor’s insolvency, the transaction may be subject to attack as a fraudulent transfer.

Courts have recognized that these guarantees are usually legitimate business transactions and are not intended to frustrate creditors. Accordingly, even when the guarantor has not received a direct economic benefit, Courts performing a fraudulent transfer analysis have sought to uncover whether the guarantor received indirect benefits from the guarantee because it was part of a properly functioning corporate entity. However, courts will not recognize an indirect benefit unless it is “fairly concrete.”

74 See, e.g., Coated Sales, Inc. v. First E. Bank, N.A., 144 B.R. 663, 667 (Bankr. S.D.N.Y. 1992) (“Fair value is not synonymous with a forced sale or the value of a continuing unhampered business”; rather it is what can be realized for the assets over a reasonable period of time). James M. Lawniczak. 2-16 Asset Based Financing: A Transactional Guide § 16.12.
80 See, e.g., Leibowitz v. Parkway Bank & Trust Co. (In re Image Worldwide, Ltd.), 139 F.3d 574, 578–79 (7th Cir. 1998); Smith v. Am. Founders Fin., Corp., 365 B.R. 647, 667 (S.D. Tex. 2007); Heritage Bank Tinley Park v. Steinberg (In re Grabill Corp.), 121 B.R. 983, 995 (Bankr. N.D. Ill. 1990); Mellon Bank, N.A. v. Metro Commc’ns, Inc., 945 F.2d 635, 646–48 (3d Cir. 1991), where the Court concluded that the guarantor received reasonably equivalent value for a loan made to an affiliate’s debt because the loan strengthened the corporate group and would
Debts and guarantees incurred by the borrower solely for the benefit of third parties are presumed to not be supported by a reasonably equivalent value. Therefore, constructive fraudulent transfer law essentially recognizes that an unpaid creditor suffers the same harm regardless of whether the debtor has intentionally given away its assets in an attempt to inhibit collection or the debtor is unable to pay its debts as they mature due to the debtor’s negligence.

3. Constructive Fraud

Instead of attempting to determine the intent of the parties, constructive fraud focuses on the economics of the transaction. Section 548(a)(1)(B) of the Bankruptcy Code states that a plaintiff can demonstrate constructive fraud when the debtor received "less than a reasonably equivalent value in exchange for such transfer or obligation," while the debtor was either: (1) insolvent or about to become insolvent; (2) engaged in a business with unreasonably small capital; or (3) incurring debts that the debtor did not believe it could pay. It should be noted that only the third element involves knowledge or intent of fraud with regard to the financial condition of the debtor. Although the code suggests a standard based on subjective intent, courts have held that intent can be inferred where the facts and circumstances surrounding the transaction show that the debtor could not reasonably have believed that it could pay its debts as they matured.

In evaluating the fair value of a company’s assets for purposes of determining solvency, the court must first determine if the assets should be valued on a “going concern” basis or a liquidation basis. In the context of a LBO, the going concern basis will be appropriate. To allow the guarantor to benefit from “synergy” within the corporate group; Drewes v. FM Da-Sota Elevator Co. (In re Da-Sota Elevator Co.), 939 F.2d 654, 656 (8th Cir. 1991), where the Court concluded that indirect benefits included intangibles such as goodwill, and an increased ability to borrow working capital.

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86 See UFTA §4-6.
90 Courts will consider a variety of factors to determine if, at the time of the transaction or shortly thereafter, the company was conducted with the intention that it would be a going concern. See In re EBC I, Inc., 380 B.R. at 355
determine going concern value, courts rely on the debtor’s balance sheet at the time of the transaction and then adjust the book value of the debtor’s assets to reflect the assets’ market value. Many courts also take into account intangible assets not carried on the debtor’s balance sheet, including good will.

Assuming that the court finds that the debtor had sufficient capital to fund operations, the court will then consider how long the debtor was able to do so. The amount of time between consummation of the leveraged buyout and the debtor’s bankruptcy filing is relevant, in so far as courts are less likely to collapse a LBO the longer the interval. An insolvency occurring shortly after the LBO will tend to comfort the view that, even if the debtor was not insolvent at the time of the transaction, the debtor was left with unreasonably small capital. Although there is not clear definition of what constitutes a short interval, courts have considered intervals as long as three and a half years to be short because “an inadequately capitalized company may be able to stagger along for quite some time, concealing its parlous state or persuading creditors to avoid forcing it into a bankruptcy proceeding …”

Courts will generally conduct a cash flow analysis of the debtor at the time of the LBO and compare the results with an evaluation of the debtor’s debts that existed when the LBO was completed and those that the debtor intended or was reasonably likely to incur in the foreseeable future. Furthermore, courts will consider the market pricing of the debtor’s debt (to evaluate the market’s view of the debtor’s risk of default) in an assessment of whether the debtor had more difficulties in meeting its financial obligations after the leveraged buyout.

III. Remedies & Shareholder Defenses

If the lenders and borrowers do not carefully plan the LBO, the target of an LBO may be unable to bear the debt burden and will be forced to declare bankruptcy. Once in bankruptcy, the debtor’s assets are subject to clear distribution priorities in which secured creditors are paid

(explaining that in almost all leveraged buyout cases, these factors will invariably lead a court to adopt the “going concern” basis for valuation).

before shareholders.100 However, it is possible that, by the time the Target has declared bankruptcy, the shareholders have received most of the Target’s assets and secured creditors have secured liens on the remaining assets while unsecured creditors are left with nothing. In this respect, fraudulent transfer law and bankruptcy law serve to protect unsecured creditors and preserve the hierarchy of priority in the event of bankruptcy. 101 Although courts have relied on these laws to (1) avoid fraudulent transactions and (2) collapse related transaction that, when combined, constitute fraudulent transactions, they have also (3) shielded from avoidance powers payments made to shareholders.

1. Avoidance of the Transaction

In an effort to bring funds into the bankruptcy estate, creditors are likely to rely on fraudulent transfer law to attack the LBO that precipitated the debtor’s insolvency. The primary remedy for creditors under fraudulent transfer law is the “avoidance of the transfer or obligation to the extent necessary to satisfy the [harmed] creditor’s claim.”102 Bankruptcy law requires that all classes with higher priority be paid in full (the creditors) before lower priority claims or interests, such as shareholder, receive payment.103 This means that creditors should be paid before shareholders. Shareholders may realize that in the event of bankruptcy their chances of recovery are unlikely and attempt to siphon away funds to themselves or third parties to the detriment of the creditors. Therefore, the Bankruptcy Code recognizes this potential for abuse and provides avoidance of the transfer as a remedy to maintain the hierarchy between claims of creditors and interests of shareholders.

Avoidance powers can be found in several sections of the Bankruptcy Code.104 Under § 544 (the “strong arm” statute), a trustee can assert claims based on applicable state law to avoid a transfer incurred by the debtor, in the event that state law would permit an unsecured creditor to avoid the transfer.105 Most states have incorporated fraudulent transfer law into state law, using the Uniform Fraudulent Transfer Act (UFTA) or the Uniform Fraudulent Conveyance Act (UFCA) as the main foundation.106 Although the terminology of the two acts is slightly different, the application is substantively the same in so far as it allows a creditor to void any fraudulent

103 See generally 8B C.J.S. Bankruptcy §§1101-02 (discussing claim priority). In Chapter 11, a plan cannot be confirmed unless it complies with the absolute priority rule, i.e. each class in the hierarchy must be paid in full, or must agree to accept less than full payment, before any junior class is paid.
transfer based upon actual or constructive fraud.\textsuperscript{107} Therefore, in the event of a bankruptcy, a party seeking to avoid a fraudulent transfer can rely on either §548 of the Bankruptcy Code or applicable state law.\textsuperscript{108}

Moreover, whereas the Bankruptcy Code provides that a transfer or obligation can only be avoided if it occurred or was incurred on or within two years prior to the petition date, the statute of limitations under state fraudulent transfer law can range from four to seven years after the transfer. In some instances, the transfer can be avoided, within one year after the transfer was or could reasonably have been discovered by the claimant.\textsuperscript{109} Therefore, the fact that parties can rely on both the Bankruptcy Code and the state fraudulent transfer law can prove to be a valuable asset for creditors.

Both the Bankruptcy Code and the UFTA provide Courts with broad freedoms in selecting remedies.\textsuperscript{110} The statute does not limit avoidance to the extent the debtor received less than reasonably equivalent value.\textsuperscript{111} When courts determine that the LBO involved a fraudulent transfer, their power to avoid the transfer may include: (1) stripping secured LBO-lenders of their liens; (2) recovery of loan payments made to bank lenders; (3) subordination or disallowance of LBO-lenders’ claims; and recovery of (4) fees paid to professionals in connection with the LBO (this includes bonuses, stock awards or dividends), (5) all dividends paid immediately before the sale closed, (6) any transferred assets to the bankruptcy estate or payment to the debtor’s bankruptcy estate of an amount equal to the avoided transfer.\textsuperscript{112}

\textsuperscript{107} Irina V. Fox. Settlement Payment Exception to Avoidance Powers in Bankruptcy: An Unsettling Method of Avoiding Recovery from Shareholders of Failed Closely Held Company LBOs, 84 Am. Bankr. L.J. 576 (2010) (noting generally 4-65 Collier Bankruptcy Practice Guide P 65.05 (comparing the two acts). Essentially, the UFCA allows constructively fraudulent transfers to be avoided if not for “fair consideration” rather than the UFTA’s and Bankruptcy Code’s “reasonably equivalent value.” This difference allows transfers to be avoided under the UFCA that would not be avoided under the UFTA or the Bankruptcy Code because “fair consideration” has a “good faith” component whereas “reasonably equivalent value” does not).

\textsuperscript{108} Section 544(b) of the Bankruptcy Code allows a debtor or a trustee in bankruptcy to avoid a transfer by the debtor or an obligation incurred by the debtor if a creditor holding an allowed claim could avoid the transfer or obligation under “applicable law,” including state law. 11 U.S.C. § 544.


\textsuperscript{111} As a means of balancing out what may be an inequitably harsh result, section 548(c) affords the transferee a lien or the right to retain an obligation “to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation.” Further, the monies gained from the remedies process become part of the debtor’s bankruptcy estate and will usually be distributed in large part to unsecured creditors. If unsecured creditors are paid in full, any remaining funds will go to the company’s equity holders, who often times are the very shareholders from whom the monies were retrieved. See Boyer v. Crown Stock Dist. (In re Boyer), 587 F.3d 787, 797-98 (7th Cir. 2009).

Therefore, avoidance essentially allows the trustee to recover from the initial transferee or, in certain circumstances, from a subsequent transferee or shareholder. In light of the risks and uncertainty involved in an LBO, lenders can avoid fraudulent transfer litigation by being aware of the elements of a fraudulent transfer claims, understanding their purpose and structuring the LBO in a way that avoids or reduces the likelihood of fraudulent transfer litigation.

2. Collapsing Related Transactions

LBO can involve multiple transfers of assets between parties, with each transfer being a legitimate transfer when taken alone. However, these transfers, when combined, may shed light on a transfer that falls under the scope of fraudulent transfer law. Although courts may consider LBOs as legitimate transactions when they are untainted by clear elements of fraud, the majority of fraudulent transfer case law has revealed that most courts will collapse the related transactions of a LBO into a single transaction.113

In United States v. Gleneagles Investment Co.,114 as part of a LBO, the target corporation used its assets as collateral in exchange for a loan. The proceeds of the loan were then loaned to the acquirer, who used the loan to purchase the target’s stock. The LBO was challenged under both the actual and constructive fraud provisions of Pennsylvania’s fraudulent transfer law. The court concluded that the collateral granted by the target to the lenders constituted both constructive and actual fraud because the target did not receive a reasonably equivalent value for the loan.115

The court analyzed the reasonably equivalent value test by evaluating the impact of the entire transaction on the creditors of the target rather than focusing solely on the individual transactions.116 Although “the borrowing companies appeared to receive fair consideration from the lender” in the initial stage of the transaction, the court collapsed all of the related transactions into one transaction and determined that the target had not retained sufficient loan proceeds to constitute adequate consideration for the collateral granted to the lender.117

The court also noted that the target and its creditors had incurred huge secured debts despite not retaining benefits from the loan, thereby jeopardizing the target’s ability to service the company’s debt as it matured. On appeal, the Third Circuit upheld the district court’s decision and its “collapsing” of the related transactions, holding that the lender knew that the loan proceeds would ultimately be transferred to the selling shareholders at the expense of the target entity.118

However, in Kupetz v. Wolf,119 the court determined that a sale of a business through a LBO was not a fraudulent conveyance. In its reasoning, the court noted four factors that were central to its decision: (1) there was no evidence existed that the defendant shareholders intended to defraud the corporation, (2) the selling shareholders were not aware of the acquirer’s plan to finance the purchase through an LBO, (3) the bankruptcy trustee did not represent any creditors whose claims arose prior to the date of the LBO and who did not have an opportunity to evaluate

115 United States v. Gleneagles Investment Co., 803 F.2d at 1292.
119 Kupetz v. Wolf 845 F.2d 842 (9th Cir. 1988).
the effect of the LBO on them specifically, and (4) the transactions that were involved in the LBO appeared to reflect a straight sale, as opposed to a redemption by the corporation of its own stock.\textsuperscript{120}

In \textit{Wieboldt Stores, Inc. v. Shottenstein},\textsuperscript{121} the court applied the analysis of both \textit{Kupetz} and \textit{Gleneagles} to a LBO, dismissing a complaint against the debtor’s shareholders who were not insiders or controlling shareholders. The court noted that both \textit{Gleneagles} and \textit{Kupetz} focused on the parties’ knowledge and intent regarding the transaction, distinguishing “outsider” shareholders from insider shareholders because the former were unaware that the LBO encumbered all of the debtor’s assets, that the assets transferred to the shareholders belonged to the debtor or that the debtor was insolvent prior to the transaction and would be rendered further insolvent by the transaction.\textsuperscript{122}

Consequently, although courts have been inclined to view LBOs as legitimate business transactions, they still entail substantial risk with respect to the reasonably equivalent value element of the fraudulent transfer test. Therefore, it is important for lenders to carefully analyze (1) whether the Target is solvent, (2) whether it will be rendered insolvent by the contemplated transaction and (3) whether it will be adequately capitalized and be able to service its debts as they mature.

3. \textbf{Settlement Payments Exception}

If the lenders and borrowers do not carefully plan the LBO, the company may be unable to bear the debt burden and will go into bankruptcy. Once in bankruptcy, the debtor’s assets are subject to clear distribution priorities in which secured creditors are paid before shareholders. To protect creditors and to preserve the hierarchy of priority, bankruptcy law employs avoidance powers designed to restore to the creditors the value of fraudulent transfers made on the verge of bankruptcy.

However, three recent decisions by federal appellate courts impede bankruptcy avoidance powers, allowing the shareholders to siphon cash away from an entity on the verge of collapse.\textsuperscript{123} Broadly interpreting the literal language of Bankruptcy Code§§546(e) and 741(8), these Court determined that payments made to selling shareholders in connection with a LBO qualify as “settlement payments”. This interpretation of the Code effectively shields from avoidance powers payments made to shareholders in connection with LBOs.\textsuperscript{124}

\textsuperscript{120} \textit{Kupetz v. Wolf} 845 F.2d 842, 848-50 (9th Cir. 1988).

\textsuperscript{121} \textit{Wieboldt Stores, Inc. v. Shottenstein} 94 B.R. 488 (N.D. Ill. 1988)

\textsuperscript{122} James M. Lawniczak. 2-16 Asset Based Financing: A Transactional Guide § 16.12.

\textsuperscript{123} Contemporary Indus. Corp. v. Frost, 564 F.3d 981 (8th Cir. 2009), where the debtor sought to avoid payments made to former shareholders in exchange for their stock as part of a leveraged buyout. QSI Holdings, Inc. v. Alford (In re QSI Holdings, Inc.), 571 F.3d 545 (6th Cir. 2009), cert. denied, 130 S. Ct. 1141 (2010) where the Court concluded that the § 546(e) defense shields payments made to equity-holders of private companies; Brandt v. B.A. Capital Co. LP (In re Plassein Int’l Corp.), 590F.3d 252 (3d Cir. 2009), cert. denied, 130 S. Ct. 2389 (2010). Irina V. Fox. Settlement Payment Exception to Avoidance Powers in Bankruptcy: An Unsettling Method of Avoiding Recovery from Shareholders of Failed Closely Held Company LBOs, 84 Am. Bankr. L.J. 572. (2010); Mark A. Bogdanowicz. Column, Last in Line, Section 546(e) Provides Defense to Former Equity-Holders in Private-Company LBOs, 29-1 ABIJ 38 (2010).

\textsuperscript{124} Contemporary Indus., 564 F.3d at 989; QSI Holdings, 571 F.3d at 550-51;Plassein Int’l., 590 F.3d at 258-59. Irina V. Fox. Settlement Payment Exception to Avoidance Powers in Bankruptcy: An Unsettling Method of Avoiding Recovery from Shareholders of Failed Closely Held Company LBOs, 84 Am. Bankr. L.J. 572 (2010);
Congress originally enacted this exception to protect the securities market from the impact of the bankruptcy on the clearing systems for publicly held stock. The sale of publicly held stock is a complex process, regulated by governmental and non-governmental entities, with numerous actors and intermediaries whose guarantees add reliability and certainty to a process that is not instantaneous. The system depends on these guarantees and the bankruptcy of one of the parties to the process threatens the integrity of the entire system. Consequently, allowing a trustee to recover from one of the participants would impact the entire system and risk bringing it to a halt.

In holding that § 546(e) and 741(8) immunize shareholders’ LBO payments from fraudulent transfer claims, these courts disregard the fact that the LBO left the company insolvent or with inadequate capital to pay its debts. Many failed LBOs are the result of irresponsible lending and borrowing without well-developed business and financial strategies, which contributed, in part, to the current financial crisis. Stripping the bankruptcy trustee or debtor of avoidance powers for payments to shareholders in connection with an LBO potentially encourages poorly planned LBOs and may facilitate funneling cash away from failing companies to the detriment of the creditors.

The application of the settlement payment exception is problematic because of the contradiction between the broad literal wording of the exception and its narrow legislative purpose. The language of the statute is quite expansive and arguably exempts all stock transactions from avoidance, while the legislative history indicates that the statute meant to protect only the market for publicly traded stock. This inconsistency has caused courts to reach different results when analyzing the settlement payment exception.

The three recent appellate decisions expand the scope of § 546(e) to shield consideration received by former holders of private stock in an LBO, which in effect shields all LBOs from avoidance. Other courts restrict the application of the settlement payment exception to sales of

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Mark A. Bogdanowicz. Column, Last in Line, Section 546(e) Provides Defense to Former Equity-Holders in Private-Company LBOs, 29-1 ABIJ 38, (2010).
129 11 U.S.C. §§546 (e), 741(8).
130 Contemporary Indus. Corp. v. Frost, 564 F.3d 981 (8th Cir. 2009); QSI Holdings, Inc. v. Alford (In re QSI Holdings, Inc.), 571 F.3d 545 (6th Cir. 2009), cert. denied, 130 S. Ct. 1141 (2010); Brandt v. B.A. Capital Co. LP (In re Plassein Int’l Corp.), 590
publicly held stock, and the narrowest reading of the settlement payment exception limits its protection to intermediaries in the clearing and settlement system, i.e. stock brokers and clearing houses. Although all courts agree that a trustee cannot recover from the market intermediaries, the circuit split over shareholders creates additional market uncertainty.

During the last ten years, the Second, Third, Sixth, Eighth, and Tenth Circuit Courts of Appeals have adopted a literal reading of the section’s language and have granted former shareholders of privately held companies the protection they seek. The Eleventh Circuit Court of Appeals and the majority of bankruptcy courts have contemplated the policy considerations behind the section and refused to apply the section in a manner that they believe undermines Congressional intent. The Supreme Court has failed to resolve this circuit split.

In the upcoming years, companies acquired through leveraged buyouts in the last decade will begin to default on their debt obligations in significant numbers. Many of these companies will be unable to rely on the credit markets and will seek the protection of the bankruptcy courts. As this dynamic emerges, the uncertainty regarding the application of section 546(e) will lead to excessive delays and the expenditure of significant resources on litigation and creditor negotiations. In response to such creditor suits, defendant-shareholders of privately held corporations have increasingly argued that section 546(e) of the Bankruptcy Code exempts Settlement Payments from fraudulent transfer law and effectively creates a shield that precludes courts from deciding suits on the merits.

IV. Constructive Fraud Solvency Analysis

Although constructive fraud represents a marked improvement over the typical elements of fraud, it only partially succeeds in reducing uncertainty and inconsistency. Constructive fraud statutes enables bankruptcy courts to develop methodologies for measuring "solvency", "capital" and "adequacy", based on the solvency analysis and valuation that were used by financial professionals. These methods essentially consist of either measuring cash-flow solvency (liquidity) or balance sheet solvency (value).
To establish a constructive fraudulent transfer claim, plaintiffs must prove that (i) the transfer was made for "less than reasonably equivalent value" and (ii) that the debtor was either: (1) "insolvent" at the time of the transfer (Insolvency Test); (2) had "unreasonably small capital" for any business in which the debtor was engaged or was about to become engaged (Capitalization Test); or (3) intended to incur or believed that it would incur debts "beyond the debtor’s ability to pay as such debts matured"140 (Discounted Cash Flow Test). Even if reasonably equivalent value was not received, there will be no constructive fraudulent transfer unless one of the three solvency tests is also failed.

1. Insolvency/Liquidity Test

The insolvency test of the Bankruptcy Code § 548(a)(1)(B)(ii)(I) focuses on whether the transferor was insolvent at the time of, or became insolvent as a result of, the transfer. Under the Code,141 a debtor is insolvent when the sum of its debts is greater than all of its assets, at a fair valuation.142 This is frequently referred to as the “balance sheet” test. Fair valuation has been construed to refer to the fair market value of the debtor’s assets and liabilities within a reasonable time of the transfer.143

Insolvency is a question of fact to be proved by the trustee by a preponderance of the evidence. There is no presumption of insolvency in a § 548 action.144 Since it is often difficult to obtain concrete evidence of a debtor’s insolvency, courts will generally permit a party to use the debtor’s schedules, unaudited balance sheets and pre-petition financial statements as evidence.145
Parties seeking to unwind large-scale LBOs tend to have little difficulty establishing that the target company did not receive reasonably equivalent value and collapsing the deal.146 Exempt assets are explicitly excluded from the calculations as well as any property which could be the subject of a § 548(a) action.147 Corporate goodwill is an “asset” of an operating company that can be considered if there is strong evidence as to its existence and value.148 Some courts have been willing to treat projected cash flow, such as orders in hand, as an asset where a company is balance sheet insolvent, although this view has not been highly adopted.149 Under this analysis, a company that had a negative net worth would not be insolvent if its business operations were expected to produce “sufficient cash to pay off its debts as they matured.150 Furthermore, when certain assets of the debtor are not easily liquidated, their face value should generally be discounted.151

The liquidity analysis focuses on whether a debtor has sufficient cash to repay debt and continue as a going concern. It focuses on cash on hand and predictable future sources and uses of cash. The analysis often includes expected future ability to borrow as a source of cash.152 In addition, courts will often consider a debtor’s value independently of its liquidity.153

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146 Samir D. Parikh. Saving Fraudulent Transfer Law, 86 Am. Bankr. L.J. 305, 320 (2012); (noting that “Collapsing” the transaction allows the court to determine “whether there was an overall scheme to defraud the estate and its creditors by depleting all the assets through the use of a leveraged buyout.” Rosener v. Majestic Mgmt., Inc. (In re OODC LLC), 321 B.R. 128, 134 (Bankr. D. Del. 2005). “Collapsing” is important for a variety of reasons; the primary one being that it prevents LBO lenders and former shareholders from relying on the “savings clauses” for subsequent transferees. These clauses appear in both state law and federal bankruptcy law. Under the savings clauses, a subsequent transferee is protected to the extent that such transferee took for value and “in good faith and without knowledge of the voidability of the transfer avoided.” 11 U.S.C. § 550(b)(2) (2006); If the transfers are collapsed, the shareholders are initial rather than subsequent transferees).


148 See Harmon v. Sorlucco (In re Sorlucco), 68 B.R. 748, 751 (Bankr. D.N.H. 1986) (a lumber company’s value included the expectations of increased profitability when at the time of the transfer, the debtor fully expected that the Small Business Administration would roll over the company’s financing in a way that would enhance the value of the enterprise). James M. Lawniczak. 2-16 Asset Based Financing: A Transactional Guide § 16.12.


151 Constructora Maza, Inc. v. Banco de Ponce, 616 F.2d 573, 577 (1st Cir. 1980); Join-In Int’l (U.S.A.) Ltd. v N.Y. Wholesale Distrbs. Corp. (In re Join-In Int’l (U.S.A.) Ltd.), 56 B.R. 555, 560 (Bankr. S.D.N.Y. 1986) (noting that the rights of subrogation and of contribution are assets that must be quantified and included and the value of remote or contingent claims should be valued at less than face value); In re Xonics Photochemical, Inc. 841 F.2d 198 (7th Cir. 1988) (where the court, in determining the value of corporate guarantees, noted many compelling reasons exist not to value contingent liabilities at their face value on a balance sheet, including the remote nature of the liability and the fact that the liability must be discounted by the probability of occurrence).

152 Michael Simkovic and Benjamin S. Kaminetzky. Leveraged Buyout Bankruptcies, the Problem of Hindsight Bias and the Credit Default Swap Solution, 2011 Colum. Bus. L. Rev. 118, 208 (2011) (citing Peltz v. Hatten, 279 B.R. 710, 747 (D. Del. 2002) (finding that debtor would likely have been able to finance itself through, inter alia, the high-yield bond markets during two years of negative projected EBITDA)).

could theoretically have a high net worth, yet be unable to pay its debts as they become due or continue operations because the debtor has limited access to cash. The courts require a liquidity cushion capable of withstanding reasonably foreseeable setbacks, but not any and all setbacks.\textsuperscript{154} While this standard may seem prudent, in practice it introduces tremendous uncertainty and potential for hindsight bias.\textsuperscript{155}

The majority of case law indicates that the correct time at which to determine the insolvency of the debtor is the date on which the transfer is deemed to have occurred under § 548(d)(1).\textsuperscript{156} However, the court is allowed to take into account subsequent events and evidence, so long as that evidence bears on the question of solvency at the time of the transfer.\textsuperscript{157} While the logic behind the insolvency requirement seems plausible when a debt is 100\% certain to come due, it breaks down when the obligation to pay is contingent upon a future event that is correlated with the firm’s insolvency risk. In that case, the firm does not have to be insolvent now for its managers to anticipate that it will be if the liability ever comes due.\textsuperscript{158} Therefore, a fraudulent transfer doctrine that applies an insolvency requirement to contingent debts will be badly under-inclusive, omitting several instances where opportunism may arise.\textsuperscript{159}

2. Capitalization Test

The Capitalization Test in Code § 548(a)(1)(B)(ii)(II) involves an analysis of whether the target in an LBO was left with "unreasonably small capital." 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, considering all sources of operating capital, including loans and sales of assets unnecessary to operations.\textsuperscript{160} Although,
the Code does not define “unreasonably small capital,” it must be understood that unreasonably small capital is not the equivalent of insolvency and generally is a financial condition short of insolvency.\footnote{\textit{Vadnais Lumber Supply, Inc. v. Byrne (In re Vadnais Lumber Supply, Inc.), 100 B.R. 127, 137 (Bankr. D. Mass. 1989).}}

Determining whether a business has unreasonably small capital requires an objective assessment of the company’s financial projections.\footnote{\textit{Moody v. Sec. Pac. Bus. Credit, 971 F.2d 1056 (3d Cir. 1992).}} The critical question is whether the projections are reasonable in light of the relevant data (such as cash flows, net sales, gross profit margins and net profits and losses). Since projections tend to be optimistic, their reasonableness must be tested by an objective standard anchored in the company’s actual performance history.\footnote{\textit{Murphy v. Meritor Sav. Bank (In re O’Day Corp.), 126 B.R. 370, 398 (Bankr. D. Mass. 1991).}}

However, reliance on historical data alone is insufficient. The projections must also account for difficulties that are likely to arise, including interest rate fluctuations and general economic downturns, and some margin for error.\footnote{\textit{Credit Managers Ass’n. v. Fed. Co., 629 F. Supp. 175 (C.D. Cal. 1985) (despite positive projections, the company failed due to the devastating effects of a strike).}} Moreover, the test for unreasonably small capital should include all reasonably anticipated sources of operating funds, which may include new equity infusions, cash from operations, or cash from secured or unsecured loans over the relevant time period.\footnote{\textit{James M. Lawniczak. 2-16 Asset Based Financing: A Transactional Guide § 16.12 (citing Peltz v. Hatten, 279 B.R. 710, 744–45 (D. Del. 2002), aff’d by unpublished opinion, 60 Fed. Appx. 401 (3d Cir. 2003); Murphy v. Meritor Sav. Bank (In re O’Day Corp.), 126 B.R. 370, 398 (Bankr. D. Mass. 1991).}} Defendants in a fraudulent transfer claim can bolster their case if they can demonstrate why the Company failed and that the reasons were not in contemplation when the transfer occurred.\footnote{\textit{Id. at 406. The court found these projections unreasonable, because the parties did not take into account O’Day’s performance prior to the leveraged buyout (which was much worse than its previous peak financial performance). Therefore, the court concluded that O’Day was left with unreasonably small capital after the leveraged buyout. Id. at 407.}}
Unfortunately, this test falls short of providing a certain remedy for creditors because it is too vague to enable aggrieved unsecured creditors to confidently predict the outcome of litigation.\footnote{In re Lyondell Chem. Co., No. 09-10023 (REG), 2011 WL 11413, at *1 (Bankr. S.D.N.Y. Jan. 4, 2011) (none of the parties could agree on the likelihood of success on the merits, while the court limited itself to declaring the settlement reasonable). John H. Ginsberg, M. Katie Burgess, Daniel R. Czerwonka & Zachary R. Caldwell. Befuddlement Betwixt Two Fulcrums: Calibrating the Scales of Justice to Ascertain Fraudulent Transfers in Leveraged Buyouts 19 Am. Bankr. Inst. L. Rev. 71, 90 (2011).} It experts need to be hired 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.\footnote{John H. Ginsberg, M. Katie Burgess, Daniel R. Czerwonka & Zachary R. Caldwell. Befuddlement Betwixt Two Fulcrums: Calibrating the Scales of Justice to Ascertain Fraudulent Transfers in Leveraged Buyouts 19 Am. Bankr. Inst. L. Rev. 90 (2011).} 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.\footnote{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). John H. Ginsberg, M. Katie Burgess, Daniel R. Czerwonka & Zachary R. Caldwell. Befuddlement Betwixt Two Fulcrums: Calibrating the Scales of Justice to Ascertain Fraudulent Transfers in Leveraged Buyouts 19 Am. Bankr. Inst. L. Rev. 90 (2011).} The inherent 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.\footnote{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).} For instance, the law fails to define the percentage of likelihood of insolvency at which point the transfer is considered fraudulent or the period of time over which the likelihood of insolvency is to be determined. Even if such a percentage threshold or scope of time were defined, the test remains impracticable because of the difficulty in determining whether a company hit such a threshold and the fact that, when confronted with a set period of time, LBO lenders concerned about facing fraudulent transfer claims in the event of insolvency have incentives to nurse the company until the statutory limitation periods has lapsed.\footnote{Boy v. Crown Stock Distrib., Inc., 587 F.3d 787, 795 (7th Cir. 2009).}

In Boyer, the Seventh Circuit expressed skepticism of judicial decisions indicating that a "reasonable period" may be only a year, upholding a decision that held than an LBO that led to bankruptcy after three-and-a half years was a fraudulent transfer.\footnote{John H. Ginsberg, M. Katie Burgess, Daniel R. Czerwonka & Zachary R. Caldwell. Befuddlement Betwixt Two Fulcrums: Calibrating the Scales of Justice to Ascertain Fraudulent Transfers in Leveraged Buyouts 19 Am. Bankr. Inst. L. Rev. 95 (2011).} Although extending the test period makes the test more creditor protective, it also decreases the foreseeable element necessary to prove a fraudulent transfer.\footnote{In re Lyondell Chem. Co., No. 09-10023 (REG), 2011 WL 11413, at *1 (Bankr. S.D.N.Y. Jan. 4, 2011) (none of the parties could agree on the likelihood of success on the merits, while the court limited itself to declaring the settlement reasonable). John H. Ginsberg, M. Katie Burgess, Daniel R. Czerwonka & Zachary R. Caldwell. Befuddlement Betwixt Two Fulcrums: Calibrating the Scales of Justice to Ascertain Fraudulent Transfers in Leveraged Buyouts 19 Am. Bankr. Inst. L. Rev. 71, 90 (2011). John H. Ginsberg, M. Katie Burgess, Daniel R. Czerwonka & Zachary R. Caldwell. Befuddlement Betwixt Two Fulcrums: Calibrating the Scales of Justice to Ascertain Fraudulent Transfers in Leveraged Buyouts 19 Am. Bankr. Inst. L. Rev. 90 (2011).}
insolvency was reasonable foreseeable, then the test must use limit its scope to a projection period where the projections are reasonably reliable or the potential insolvency is no longer reasonably foreseeable.

One might consider that the proper balance might be struck with a test period that extends through the year of the transaction and five years thereafter, thereby extending the test period to encompass the four-year peak default period of LBO-debt. However, if the period is too long and encompasses the company’s refinancing period, is it reasonable to consider that the LBO was the cause of the insolvency?

3. Cash Flow Test

The Cash Flow Test is contained in Code § 548(a)(1)(B)(ii)(III) and involves an analysis of whether the debtor “intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor’s ability to pay as such debts matured.” Important factors include the debtor’s general financial situation and stability at the time of the transfer, the debtor’s ability to obtain credit or operating capital with which to pay debts, and knowledge and awareness of an impending financially unstable condition.

More importantly, the Cash Flow Test provides valuable insight into how courts, companies and plaintiffs derive their final projections through discounted cash flow (“DCF”) analysis. DCF has three primary components: (1) forecasts of future cash flows of the debtor for a given period; (2) a terminal value used to limit the necessary projection period; and (3) a estimated discount rate that is used to convert future cash flows and the terminal value into their present value.

Cash flows are normally projected for a limited number of years. Cash flows beyond the explicit projection period are accounted for through a more loosely estimated “terminal value,” based on an assumed constant perpetual growth rate or some form of multiples analysis.

Cash flow forecasts are generally derived from a financial model, which is an estimation of the debtor’s future business derived from estimated assumptions about the future components of the debtor’s business and accounting for several years of the debtor’s historical performance. Generated through the use of assumptions of how future conditions will differ from the recent past, such as fluctuations in the price of raw materials or labor, synergies from a merger, demand for the debtor’s products or services, the forecasts are little more than educated guesses about the

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176 See 4 Collier on Bankruptcy, ¶ 548.05[4]; cf. Credit Managers Ass’n, 629 F. Supp. at 187 (using a cash-flow analysis to determine adequate capitalization and indicating that the court should not examine what actually happened but whether the projections at the time of the transfer were prudent). James M. Lawniczak. 2-16 Asset Based Financing: A Transactional Guide § 16.12.
future state of a debtor’s business. As such, they are subject to error and are fundamentally subjective.

Discount rates are used to convert future cash flows into their present values. Future cash must be discounted because cash today is more valuable than cash in the future. This is because cash today can be invested and will grow over time and cash in the future is subject to uncertainty as a result of risk and inflation. The use of discount rates is an attempt account for the risk inherent with future cash flows by reducing the value of those cash flows.

The terminal value is relevant to a static, balance sheet view of solvency, but not to a dynamic cashflow view. Since forecasts become more and more uncertain for each additional year that is projected, it is more accurate to make forecasts for several years before estimating the cash flows beyond this period as a terminal value, which usually depends on the cash flows projected in the last period of the explicit forecast, the discount rate and the perpetual growth rate. Essentially, the company is being valued as a perpetuity using the Gordon Growth Model. Consequently, we have the following equation:

\[
\text{Company Value} = C_0 + \text{PV} = C_0 + \sum_{t=1}^{T} \frac{C_t}{(1+r)^t} + \text{Terminal Value}
\]

Where, \( C_0 \) is the current cash flow, \( PV \) is the present value, \( C_t \) is the cash flow at year \( t \) and \( r \) is the discount rate. The terminal value is equal to following equation, where \( g \) is the long-term cash flow growth rate:

\[
\text{Terminal Value} = \frac{\text{Final Projected Year Cash Flow} \times (1 + g)}{(r - g)}
\]

V. Issues with current Solvency Tests

LBO waves are usually very prominent in times of easy credit and end up being broken by recessionary periods. Although recessions are a recurring phase of the modern economy, recessions are arguably very difficult to foresee when the economy is expanding. This difficulty is compounded by the fact that, with globalization, the world economy is more and more interconnected and a recession can potentially start anywhere in the world. Surprisingly, financial crises are apparently not always unforeseeable as can be seen with defaults by poor formerly communist countries, which were not foreseeable, as opposed to defaults by poor

subprime mortgage borrowers that caused the entire global economy to fall into recession, which were foreseeable. Therefore, it is questionable whether cash flow insolvency is reasonably foreseeable at the time of the transfer when there are specific conditions precipitating the insolvency that are unforeseeable.

Moreover, financial analysis is derived from quantitative values, which are largely dependent on subjective judgments. Although investors can disagree over value or which value should be used as inputs, in the context of litigation, where experts are motivated to serve the interest of the parties who pay their fees, experts often come to very different and conspicuously self-serving conclusions.

Unfortunately, the methods that bankruptcy courts have traditionally used to adjudicate fraudulent transfer claims have at times led to inconsistent, unpredictable, and inadvertently biased outcomes because (1) the analysis courts have of the cause of insolvency, (2) the financial analysis courts rely on is subjective and (3) the financial analysis can easily be manipulated by experts.

1. Cause of Insolvency

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188 Tim Koller, Mark Goedhart & David Wessels, Valuation Measuring and Managing the Value of Companies 355 (4th ed. 2005); Iridium Capital Corp. v. Motorola, Inc. (In re Iridium Operating LLC), 373 B.R. 283, 347-48 (Bankr. S.D.N.Y. 2007); Peltz, 279 B.R. at 737-38 (discussing subjectivity of DCF analysis); Global GT LP v. Golden Telecom, Inc., 993 A.2d 497, 497 (Del. Ch. 2010) (“The outcome of [an] appraisal proceeding largely depends on [the court’s] acceptance, rejection, or modification of the views of the parties’ valuation experts.”); JPMorgan Chase Bank, N.A. v. Charter Commc’ns Operating, LLC (In re Charter Commc’ns), 419 B.R. 221, 236 (Bankr. S.D.N.Y. 2009) (“Valuation is a malleable concept, tough to measure and tougher to pin down without a host of explanations, sensitivities and qualifiers. Because point of view is an important part of the process, outcomes are also highly dependent on the perspectives and biases of those doing the measuring. When it comes to valuation, there is no revealed, objectively verifiable truth. Values can and do vary, and consistency among valuation experts is rare, especially in the context of high stakes litigation.”). Michael Simkovic and Benjamin S. Kaminetzky. Leveraged Buyout Bankruptcies, the Problem of Hindsight Bias and the Credit Default Swap Solution, 2011 Colum. Bus. L. Rev. 118, 141 (2011).


190 Michael Simkovic and Benjamin S. Kaminetzky. Leveraged Buyout Bankruptcies, the Problem of Hindsight Bias and the Credit Default Swap Solution, 2011 Colum. Bus. L. Rev. 118, 125.
The law’s default position is that debtors are free to give away assets and fraudulent-transfer law limits this freedom in situation where creditors are harmed as a result of the asset transfer that generates 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, investors would not go through with transactions posing even the slightest risk to creditors.

In this light, courts analyze the LBO by (1) determining whether the insolvency was reasonably foreseeable at the time of transfer, before (2) addressing unforeseeable-conditions defenses under a specific-proximate-cause test or (3) under an actual cause test. The problem with using proximate causation is that there will be many factors capable of reducing cash-flows enough to precipitate insolvency. Although some insolvency scenarios will be more likely than others, only a subset of scenarios may be sufficiently likely to be foreseeable. However, whether a transfer is considered to be a fraudulent transfer should not be based solely on which of the scenarios occurred first.

Courts in at least two cases have implied that actual cause is an element of constructive-fraudulent transfer. The problem with using actual cause is that creditors are harmed by a transfer that leaves the transferor foreseeably likely to become insolvent, regardless of whether the transferor was on the path to insolvency prior to the transfer. In a bankruptcy scenario, giving away assets harms creditors by reducing the assets available to distribute among the creditors, thereby deepening the effect of the insolvency on creditors.

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191 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. 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). John H. Ginsberg, M. Katie Burgess, Daniel R. Czerwonka & Zachary R. Caldwell. Befuddlement Betwixt Two Fulcrums: Calibrating the Scales of Justice to Ascertain Fraudulent Transfers in Leveraged Buyouts 19 Am. Bankr. Inst. L. Rev. 99 (2011).


193 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) (where, 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. ); John H. Ginsberg, M. Katie Burgess, Daniel R. Czerwonka & Zachary R. Caldwell. Befuddlement Betwixt Two Fulcrums: Calibrating the Scales of Justice to Ascertain Fraudulent Transfers in Leveraged Buyouts 19 Am. Bankr. Inst. L. Rev. 104 (2011).


2. Financial Analysis is Inherently Subjective

The most important component of a solvency analysis is the projected cash flows. It is important because the projected cash flows are relevant to both a static, balance sheet approach to solvency, and a dynamic, cash-flow concept of solvency. A static approach evaluates whether the company is currently worth more than it owes whereas a dynamic approach values whether the company can service its debt as it matures.196

Projecting future cash flows involves making subjective judgments about the future state of events based on imperfect and limited data about the past and present.197 Although projections are usually derived from sophisticated financial models, these models alone cannot prove that the assumptions on which they depend are themselves reasonable.198

The discount rate used in DCF analysis is almost always calculated using mathematical methods that require an assumption that capital markets are efficient.199 There are several methods of calculating and manipulating assumptions about financial states, such as equity premiums and systemic risk, or selecting one method of calculating the discount rate over another method.200 In the context of fraudulent transfers, it becomes increasingly difficult to determine, retroactively, whether the selected cash-flow projections and financial analysis are credible, when their credibility depends on whether unknown events are reasonably foreseeable.

Moreover, there is a certain degree of uncertainty inherent to making financial projections. A business operating in the market is a complex, multi-variable system, and even the best financial model cannot accurately provide projections without at least some margin of error. Although judicial decisions have found that cash-flow projections must account for “some margin for

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198 Prescott Group Small Cap v. Coleman Co., No. 17802, 2004 WL 2059515, at 31 (Del. Ch. Sept. 8, 2004) (“The task of enterprise valuation, even for a finance expert, is fraught with uncertainty. For a layperson, even one who wears judicial robes, it is even more so. No formula exists that can invest with scientific precision a process that is inherently judgmental.”); Cede & Co. v. Technicolor, Inc., No. Civ. A. 7129, 2003 WL 23700218, at 2 (Del. Ch. Dec. 31, 2003) (noting that “valuation decisions are impossible to make with anything approaching complete confidence. Valuing an entity is a difficult intellectual exercise, especially when business and financial experts are able to organize data in support of wildly divergent valuations for the same entity. For a judge who is not an expert in corporate finance, one can do little more than try to detect gross distortions in the experts’ opinions.”). Michael Simkovic and Benjamin S. Kaminetzky. Leveraged Buyout Bankruptcies, the Problem of Hindsight Bias and the Credit Default Swap Solution, 2011 Colum. Bus. L. Rev. 118, 144 (2011).
199 Del. Open MRI Radiology Assocs. v. Kessler, 898 A.2d 290, 338 (Del. Ch. 2006) (“There is much dispute about how to calculate the discount rate to use in valuing their future cash flows, even when one tries to stick as closely as possible to the principles undergirding the capital asset pricing model and the semi-strong form of the efficient capital markets hypothesis.”) Michael Simkovic and Benjamin S. Kaminetzky. Leveraged Buyout Bankruptcies, the Problem of Hindsight Bias and the Credit Default Swap Solution, 2011 Colum. Bus. L. Rev. 118, 150 (2011).
200 See Del. Open MRI Radiology Assocs. v. Kessler, 898 A.2d 290, 338 (Del. Ch. 2006) (noting that “testimonial feuds about discount rates often have the quality of a debate about the relative merits of competing alchemists” and that “once the experts’ techniques for coming up with their discount rates are closely analyzed, the court finds itself in an intellectual position more religious than empirical in nature, insofar as the court’s decision to prefer one position over the other is more a matter of faith than reason.”).Michael Simkovic and Benjamin S. Kaminetzky. Leveraged Buyout Bankruptcies, the Problem of Hindsight Bias and the Credit Default Swap Solution, 2011 Colum. Bus. L. Rev. 118, 146 (2011).
They remain silent on the exact margin of error that should be used in determining whether an insolvency was reasonably foreseeable. However, even if courts provided an exact margin of error for projection, there remains the issue of determining the probability of insolvency, which is the essential element necessary to quantify the degree of foreseeability necessary to fall within the spectrum of reasonability.

3. Financial Analysis can easily be Manipulated by Experts

Since projecting future cash flows is inherently subjective, experts can manipulate the DCF analysis by emphasizing certain values or selecting different ones to better suit their strategy. In *In re Exide Technologies*, for example, opposing experts used three standard valuation techniques (comparable company analysis, comparable transaction analysis, and discounted cash flow) and came to contrastingly different conclusions. Although the Court eventually found in favor of the creditors’ committee expert, the market proved that the Court was entirely incorrect as soon as the company exited bankruptcy.

As stated previously, a DCF valuation is derived from three main components: (1) projected cash flows, (2) a discount rate used to convert future cash flows into their present value and (3) a terminal value used to account for a projection period beyond which projections would be reliable. In light of the equation hereunder, it is easy to see how an incremental change in the discount rate ($r$) or the projected growth ($g$) can have an important impact on the future cash flows and the terminal value. Naturally, in the fraudulent transfer context, plaintiff’s experts will use a high discount rate, low growth rate and low projections, whereas the defendant’s experts will usually use low discount rates, high growth rates and high projections.

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204 In re Exide Techs., 303 B.R. 48, 59 (Bankr. D. Del. 2003) (where the expert financial adviser to the debtor submitted a valuation range of $950 million to $1.05 billion, while the expert financial adviser to the creditors’ committee submitted a valuation range of $1.478 billion to $1.711 billion); Michael Simkovic and Benjamin S. Kaminetzky. Leveraged Buyout Bankruptcies, the Problem of Hindsight Bias and the Credit Default Swap Solution, 2011 Colum. Bus. L. Rev. 118, 143 (2011).
205 In re Exide Techs., 303 B.R. 48, 66 (Bankr. D. Del. 2003) (where the Court determined the debtor’s valuation to be in the range of $1.4 billion to $1.6 billion. However, when the company emerged from bankruptcy in May 2004, the market valued the company at $1.03 billion. By November 16, 2005, Exide’s company value had declined to $788 million); Michael Simkovic and Benjamin S. Kaminetzky. Leveraged Buyout Bankruptcies, the Problem of Hindsight Bias and the Credit Default Swap Solution, 2011 Colum. Bus. L. Rev. 118, 143 (2011).
Company Value = \( C_0 + PV = C_0 + \sum_{t=1}^{T} \frac{C_t}{(1+r)^t} + \frac{C_{\text{final}} X (1+g)}{(r-g)} \)

Unlike a DCF analysis, which uses the market prices of the debtor, a multiples analysis embraces market value, using the market prices of similar firms.\(^{208}\) However, since no two firms are perfectly comparable, some being more cost-efficient, having better growth prospects, more effective management for example, the selection of similar companies is inherently subjective; allowing for manipulation by experts who will chose the firms that best suit their strategy.\(^{209}\)

Moreover, once at trial, Courts and financial experts can be mislead into believing that past decisions and transfers were negligent or fraudulent because they have the benefit of present knowledge to guide them.\(^{210}\) This is known as hindsight bias. There is overwhelming psychological research suggesting that judges will tend to give more credibility to projections that fit the events that actually happened than to projections that do not.\(^{211}\)

Since fraudulent transfer claims challenge the contingent debt in light of the fact that the debtor has become insolvent, the fact that the transfer was inadequate naturally appears more plausible than it would have originally appeared to the parties when the transfer occurred. This pitfall is always present in any doctrine that attempts to analyze the past after the events have transpired and can taint the analysis, favoring the plaintiffs who will claim that the insolvency was obviously foreseeable.

VI. Reducing Uncertainty and Returning Control to the Judge

In order to avoid hindsight bias and provide a more reliable method of evaluating and measuring the solvency of a company, its volatility, capital structure and debt market prices, bankruptcy courts should seek guidance from market indicators.\(^{212}\) In discussing how credit default swaps (CDSs) can reduce uncertainty and assist the judge in determining whether the LBO falls under the scope of fraudulent transfer laws, it is important to understand (1) the structure and purpose of credit default swaps, (2) how the spread can help determine the probability of default and (3) determining cumulative multiyear probabilities of default.

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\(^{209}\) Prescott Group Small Cap, L.P. v. Coleman Co., No. 17802, 2004 WL 2059515, at 22 (Del. Ch. Sept. 8, 2004) (“[A] comparable company analysis is only as valid as the ‘comparable’ firms upon which the analysis is based, are truly comparable … .”); In re Radiology Assoc., Inc., 611 A.2d 485, 490 (Del. Ch. 1991) (noting that “the utility of the comparable company approach depends on the similarity between the company the court is valuing and the companies used for comparison…” and warning that “at some point, the differences become so large that the use of the comparable company method becomes meaningless for valuation purposes”); Michael Simkovic and Benjamin S. Kaminetzky. Leveraged Buyout Bankruptcies, the Problem of Hindsight Bias and the Credit Default Swap Solution, 2011 Colum. Bus. L. Rev. 118, 148 (2011).


1. The Structure and Purpose of Credit Default Swap

When courts apply fraudulent transfer law, they typically engage in an analysis that resembles the process of fixed income investors who buy or sell corporate debt (bonds) or insurance on corporate debt (credit default swaps).\(^\text{213}\) A credit default spread is essentially the difference between the company’s corporate bond yield and the risk free rate.

\[
\text{Credit Spread} = \text{Corporate Bond Yield} - \text{Risk Free Rate}
\]

Credit default swaps are derivatives that economically resemble bond insurance but can be used to speculate and hedge.\(^\text{214}\) In a CDS transaction, there are two counterparties: a protection buyer and a protection seller, who place opposite bets on whether a third party will default on its debts (the "reference debt").\(^\text{215}\) The protection seller agrees to cover the loss of the face value of an asset if a "credit event" occurs before a specified maturity date. A credit event is a situation in which a third party defaults on its debt, restructures its debt, or files for bankruptcy.\(^\text{216}\)

In return for the protection, the buyer pays periodic fees to the seller, the premium leg.\(^\text{217}\) The premium leg is calculated based on a quoted default swap spread, which represents the losses that would be experienced by an investor who holds a "notional" amount of a third party’s debt.\(^\text{218}\) If a credit event occurs before the contract’s maturity date, the protection seller pays the buyer. This payment is known as a protection leg, which essentially compensates the buyer for the loss suffered.\(^\text{219}\)

When investors trade bonds and CDS, they conduct an analysis and leave a record of their conclusions.\(^\text{220}\) Since the analysis is conducted with information available to investors at the time of the trade, the analysis reflects investors’ perception of the market and company without the benefit of hindsight. Moreover, since large fixed income market participants, such as investment managers at hedge funds and investment banks, are sophisticated investors who are well-informed and data-driven, the record they complete is likely to reflect a reasonably good assessment of the probability of default.\(^\text{221}\)

\(^{214}\) Michael Simkovic and Benjamin S. Kaminetzky. Leveraged Buyout Bankruptcies, the Problem of Hindsight Bias and the Credit Default Swap Solution, 2011 Colum. Bus. L. Rev. 118, 168 (2011) (citing Frank Partnoy & David Skeel, Jr., The Promise and Perils of Credit Derivatives, 75 U. Cin. L. Rev. 1019, 1022, 1050 n.79 (2007); Stephen J. Lubben, Credit Derivatives and the Future of Chapter 11, 81 Am. Bankr. L.J. 405, 411-12 & n.49 (2007); Unlike an insurance contract, a credit default swap does not require that the protection buyer have an “insurable interest”or provide proof of actual loss. Credit default swaps likely make bond markets more complete by facilitating short positions).
\(^{216}\) Dominic O’Kane and Stuart Turnbull, Valuation of Credit Default Swap, Lehman Brothers, 3 (2003).
\(^{218}\) Michael Simkovic and Benjamin S. Kaminetzky. Leveraged Buyout Bankruptcies, the Problem of Hindsight Bias and the Credit Default Swap Solution, 2011 Colum. Bus. L. Rev. 118, 169 (2011) (noting that a company that was technically solvent in a narrow, balance sheet sense theoretically could still trigger a credit event).
\(^{219}\) Dominic O’Kane and Stuart Turnbull, Valuation of Credit Default Swap, Lehman Brothers, 3 (2003).
Whereas bond prices can trade above or below par as a result of factors that are unrelated to the probability or severity of default of the company, credit spread can reflect the difference between the bond yields, including the risk of default, with the yield on a risk-free bond. Specifically, CDS are designed to permit speculate on the likelihood of default of a particular company, credit default swaps provide a more reliable method of evaluating a company’s risk of default because it is based on market-based indicators of the likelihood of default than bond spreads. Therefore, CDS are more reliable in evaluating a company’s risk of default.

2. Using market CDSs Spreads to Determine the Probability of Default

There are two main approaches in credit modeling. The structural approach characterizes the default as being the consequence of a company event, following which the asset value of the company is insufficient to cover the repayment of the debt. The structural seeks to determine the spread of corporate bonds based on the firm’s internal structure. The reduced form approach seeks to determine the probability of the credit event, which is derived from market prices. The reduced form approach is the more useful modeling approach in this circumstance, especially since it allows for flexibility in refitting the price of a variety of credit instruments of different maturities.

A credit default swap is essentially priced using a model that has 4 main components: (1) the issue premium, (2) the LIBOR curve, (3) the credit curve for the company and (4) the recovery rate. Based off the work of Jarrow and Turnbull (1995), a credit event is characterized as the first event of a Poisson process, which occurs at some time \( \tau \) with a probability defined as \( \lambda(t) dt \), where \( \lambda(t) \) is the hazard rate and \( dt \) is the time interval. The Poisson process is a stochastic process which counts the number of events and the time that these events occur in a given time interval. From this, we can construct a simple binomial tree with the probability of survival \( s \) expressed as \( 1 - \lambda(t) dt \) and the probability of a credit event \( d \) as \( \lambda(t) dt \) with a payment of \( K \), which represents \( N(1-R) \), where \( N \) is the nominal price of the CDS and \( R \) is the recovery rate.

224 Dominic O’Kane and Stuart Turnbull, Valuation of Credit Default Swap, Lehman Brothers, 5 (2003).
225 Dominic O’Kane and Stuart Turnbull, Valuation of Credit Default Swap, Lehman Brothers, 5 (2003).
226 Dominic O’Kane and Stuart Turnbull, Valuation of Credit Default Swap, Lehman Brothers, 5 (2003).
227 Dominic O’Kane and Stuart Turnbull, Valuation of Credit Default Swap, Lehman Brothers, 5 (2003).
Assuming a year CDS with 4 payments, if the nominal price for the CDS is N and the issue premium is C then the size of the quarterly premium payments is NC/4. In order to find the present value of future payment, we must multiple each equation by a discount factor represented by δ. If a default even never occurs, the price of a CDS would be the discounted premium payment. Therefore, the CDS pricing model must account for the possibility of default occurring between at some time τ, which lies between t = 0 and t = 4. Assuming that the default occurs at the same time as a payment, then there are only 5 scenarios: (1-4) the credit event occurs on one of the four payment dates or (5) there is no credit event.

<table>
<thead>
<tr>
<th>Default Time</th>
<th>PV of Premium Payment PVP</th>
<th>PV of Default Payment (K = N(1-R))</th>
<th>Probability of Default (P)</th>
</tr>
</thead>
<tbody>
<tr>
<td>t_1</td>
<td>0</td>
<td>K δ_1</td>
<td>1 – s_1</td>
</tr>
<tr>
<td>t_2</td>
<td>-(NC/4) (δ_1)</td>
<td>K δ_2</td>
<td>s_1 (1 – s_2)</td>
</tr>
<tr>
<td>t_3</td>
<td>-(NC/4) (δ_1 + δ_2)</td>
<td>K δ_3</td>
<td>s_1 s_2 (1 – s_3)</td>
</tr>
<tr>
<td>t_4</td>
<td>-(NC/4) (δ_1 + δ_2 + δ_3)</td>
<td>K δ_4</td>
<td>s_1 s_2 s_3 (1 – s_4)</td>
</tr>
<tr>
<td>t_5</td>
<td>(No Default)</td>
<td>-(NC/4) (δ_1 + δ_2 + δ_3 + δ_4)</td>
<td>0</td>
</tr>
</tbody>
</table>

Therefore, the total present value of the credit default swap is the product of the probability of each outcome and the present value of the payments.
PV = (P_1 (K \delta_1 + PVP_1)) + (P_2 (K \delta_2 + PVP_2)) + (P_3 (K \delta_3 + PVP_3)) + (P_4 (K \delta_4 + PVP_4)) - (P_5 (0 + PVP_5))

Using CDS has proven to be a good market indicator of the risk of default of a company. For example, let us observe the difference in perception between the General Motor and Lehman Brothers on the CDS market. Although General Motor’s bankruptcy was unsurprising, given the high labor costs, liabilities and stiff competition from more efficient and effective rivals, such as Toyota, Honda and Mercedes, Lehman Brothers’s bankruptcy came as a surprise.\textsuperscript{228} The expectation of bankruptcy for both companies is accurately reflected in the charts hereunder.

\textbf{Figure 5: CDS market predicted General Motors’s bankruptcy years in advance}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure5.png}
\caption{CDS market participants' view of probability of GM default within 5 years}
\end{figure}

Therefore, in market where participants are informed, the charts provide a useful insight into the periods within which a transfer or asset give-away should be considered a fraudulent transfer. A transfer made by GM over the period July 2006 – March 2009 may qualify as a constructively fraudulent transfer, whereas a transfer made by Lehman Brothers prior to July 2007 will most likely not qualify as a fraudulent transfer. With this in mind, the only question left to the Courts is in determining the default probability threshold indicating a reasonably foreseeable default.

3. Determining Multiyear Cumulative Probability of Default

When reviewing fraudulent transfer cases, bankruptcy courts will generally be concerned with the cumulative probability of default over a multi-year period. Although the clawback period for fraudulent transfer claims is two years under §548 of the Bankruptcy Code, this time period can be increased to 4-6 years under §544, which incorporates state fraudulent transfer and

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fraudulent conveyance statutes. In calculating the market implied probability of default over a multi-year period, courts should use the credit default spreads that match the relevant fraudulent transfer period.

In determining the probability of default over a multi-year timeframe, courts should be cautious not to derive their determination from relatively short term credit default swaps because the probability of default may vary greatly from year to year. For example, if the Target of an LBO needs to refinance its debt or it must service a large portion of its debt in 4 years, the probability of default according to the market may be relatively low over the first 3 years. Moreover, although the market participants may believe that the probability of default is very high in year 4 due to the maturation of the a large portion of the debt, the probability of default may be relatively low in year 5, once the Target has survived the payments due in year 4. Consequently, the cumulative probability of default over 5 years for bonds maturing in 1 year or 1 year credit default swaps will tend to undervalue the probability of default for years 1-3 and year 5, whereas they will tend to overvalue the probability of default in year 4 for a 5 year timeframe.

When it is necessary to extrapolate because bonds or credit default swaps of the desired term are not trading, the bankruptcy judge or financial analyst should consider bond spreads across multiple maturities and the timing of large, predictable future cash inflows and outflows. Moreover, during the two years prior to bankruptcy, CDS pricing and equity pricing were highly inversely correlated, and were moderately inversely correlated as far out as three years before bankruptcy. This suggests that credit default swaps can be used as a substitute for equity prices when insolvency is at issue.

Conclusion

The pitfalls of hindsight bias and subjective financial analyses are among the most challenging and crucial issues in bankruptcy law. By moving away from post-hoc expert opinion and toward objectively verifiable, contemporaneous market measures, courts can fundamentally transform fraudulent transfer law for the better. Although the use of CDSs will not eliminate the need for active judicial oversight and the outside assistance of experts because courts should still confirm that markets are informed and free of manipulation, it will greatly reduce the

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importance of experts, the danger of hindsight bias, and the unfair burdens placed on judges.\textsuperscript{241} As courts begin to articulate acceptable and unacceptable market-implied probabilities of default, investors and financial institutions will be able to plan and adjust their behavior before problems arise, forgoing the funding of LBOs or other transactions that would create liability.\textsuperscript{242}

When market prices become the best predictor of fraudulent transfer liability, banks can build contractual releases into their funding commitments that are tied to the relevant prices.\textsuperscript{243} With releases in place, if the condition of the debtor deteriorates between signing and closing, the bank need not face the Hobson’s choice of either walking away empty handed and being sued immediately by the LBO sponsor for breach of contract, or staying the course, collecting fees, and being sued later by bondholders under a theory of fraudulent transfer.\textsuperscript{244} The law will be more fair, predictable, and administratively efficient, which will in turn reduce the number of ill conceived leverage transactions, rendering the economy more stable.

\textsuperscript{244} Michael Simkovic and Benjamin S. Kaminetzky. Leveraged Buyout Bankruptcies, the Problem of Hindsight Bias and the Credit Default Swap Solution, 2011 Colum. Bus. L. Rev. 118, 207 (2011).