



Case Western Reserve Law Review

Volume 30 | Issue 3

1980

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Recommended Citation

William H. Coquillette, *Guaranty of and Security for the Debt of a Parent Corporation by a Subsidiary Corporation*, 30 Case W. Res. L. Rev. 433 (1980)

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Guaranty of and Security for the Debt of a Parent Corporation by a Subsidiary Corporation

*William H. Coquillette**

The upstream guaranty, where a subsidiary guarantees a loan to its parent by a third party and perhaps supports it by a grant of security interests, is a sometimes desirable financial device which may involve pitfalls for unwary counsel. The author examines these pitfalls, including possible lack of corporate authority, possible construction as dividends, distributions, or loans to shareholders, and potential avoidability as fraudulent conveyances. He concludes that, with specified precautions taken, counsel can confidently advise his or her clients that such transactions are valid, binding, and enforceable. He notes, however, that particularly where the subsidiary's financial condition is weak, counsel must be prepared to advise the client that an upstream guaranty and related grant of security interests will be ineffective.

INTRODUCTION

LIMITATION OF liability is one of the well-recognized advantages of using the corporate form to conduct business. In the standard situation where a corporation ("Parent") uses a wholly owned corporation ("Subsidiary") to conduct all or a part of Parent's business, Parent's liabilities with respect to the business owned and operated by Subsidiary are limited in the sense that Subsidiary's creditors have no legal right under normal circumstances to look to Parent's assets for satisfaction of their claims.¹ The law recognizes separate identities for Parent and Subsidiary, each responsible only for its own debts even though both are part of a single business enterprise and form an economic unit with a single group of beneficial owners.

This recognition of separate legal identities also means that Subsidiary's liability is limited with respect to Parent. Subsidiary

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1. Subsidiary's creditors may look to Parent's assets if Subsidiary is thinly capitalized or other facts cause a court to "pierce the corporate veil." Some of Subsidiary's statutory liabilities may attach to Parent's assets. See, e.g., Employee Retirement Income Security Act of 1974, 29 U.S.C. §§ 1001 *et seq.* (1976); N.Y. BUS. CORP. LAW § 63 (McKinney 1963).

is not liable for Parent's debts, and Parent's creditors cannot look to Subsidiary's assets for satisfaction of their claims until each and every creditor of Subsidiary has been provided for in full and Subsidiary is liquidated or its surplus property distributed to Parent.² Because a financially distressed Parent is likely to have drawn off Subsidiary's surplus property to the extent permitted by law, Parent's creditors should not rely on finding substantial value in their last priority rights to Subsidiary's property.

Limited liability worries the creditors of a corporation and their legal counsel. Unless Parent and Subsidiary are each outstandingly creditworthy, a future creditor of either corporation in a deal of any size may seek ways to circumvent these limitations of liability by means of an intercorporate guaranty.³ Although a trade creditor may insist on guaranties, the intercorporate guaranty is typically encountered in financings by banks or other lenders. In the case of a loan to Subsidiary, the lender may require that Parent guarantee repayment by Subsidiary. This type of financing arrangement is commonly referred to as a "downstream guaranty." In the case of a loan to Parent, the lender may require an "upstream guaranty," where Subsidiary guarantees the repayment by Parent.⁴ To further secure its loan, the lender may require that Subsidiary grant it a mortgage on all or part of its real property and a security interest in all or part of its personal property (hereinafter collectively referred to as "security interests"). To have any commercial value, the guaranty and the grant of se-

2. State laws generally require that dividends or distributions to shareholders only be made to the extent of earned or capital surplus and often impose restrictions to assure that such dividends or distributions will not jeopardize the solvency of the corporation. *See, e.g.*, ABA-ALI MODEL BUS. CORP. ACT, §§ 45, 46 (1978) [hereinafter cited as MBCA]; CAL. CORP. CODE: §§ 500-03, 506 (WEST 1977); DILL. CODE ANN. tit. 8, §§ 170-74 (1975); N.Y. Bus. Corp. Law, §§ 510-11 (McKinney 1963); OHIO REV. CODE ANN. §§ 1701.33-95 (Page 1978). In the event of the Subsidiary's dissolution or liquidation, state laws generally require that adequate provision be made for creditors before the shareholders receive any of the corporation's property or assets. *See, e.g.*, MBCA §§ 87, 98; CAL. CORP. CODE § 2004 (West 1977); DEL. CODE ANN. tit. 8, §§ 279, 281 (1975); N.Y. BUS. CORP. LAW §§ 1005-09 (McKinney 1963); OHIO REV. CODE ANN. §§ 1701.88-.89 (Page 1978); Butler v. New Keystone Copper Co., 10 Del. Ch. 371, 93 A. 380 (1915).

3. Another possible means of providing security to a lender or other creditor is an investment contract or other supporting contract. *See* Dwyer, *A Legal and Business Examination of the Contractually Supported Investment in Relation to the Corporate Guaranty*, 23 SYRACUSE L. REV. 33 (1972); Everdell & Longstreth, *Some Special Problems Raised by Debt Financing of Corporations Under Common Control*, 17 BUS. LAW. 500 (1962).

4. A guaranty by Subsidiary of the repayment by another subsidiary of Parent (a "cross-stream guaranty") is similar to an upstream guaranty in that in the usual case the benefit of such a guaranty runs most directly to Parent. In most cases, the analysis of the validity of an upstream guaranty is applicable to a cross-stream guaranty.

curity interests must be valid, binding, and enforceable so that the lender is justified in relying on them in making the loan.⁵ Whether the making of such upstream guaranties or the granting of such security interests can be valid, binding, and enforceable against Subsidiary with the certainty required by commercial practice will be the focus of this Article.

I. DESIRABILITY OF UPSTREAM GUARANTIES

Several different circumstances in which loans to Parent are commonly made can be distinguished. Where Parent is a holding company with several subsidiaries in addition to Subsidiary, or has substantial assets in addition to its interest in Subsidiary, Parent may have the ability to borrow larger amounts of money at more favorable rates than would normally be offered to Subsidiary, and may be able to provide for the financial needs of all its affiliated businesses with one borrowing. Subsidiary may be subject to regulatory or contractual restrictions on borrowing which require that Parent seek funds on its behalf, or Parent may wish for a variety of staff or public relations motives to keep its financial arrangements separate from the affairs of Subsidiary. If Subsidiary holds a substantial portion of Parent's consolidated assets, the lender may insist on the additional protection of Subsidiary's guaranty or grant of security interests. For the purposes of analysis, the following example ("Holding Company Example") is designed to capture the characteristics of a loan to a holding company for the purpose of financing its business operations.

Holding Company owns all of the issued and outstanding common stock of Operating Companies 1, 2, 3, and 4. Except for some office furniture, equipment, and supplies, Holding Company has no assets other than the common stock of Operating Companies 1, 2, 3, and 4, which have no security holders other than Holding Company. Operating Companies 1, 2, 3, and 4 each own substantial real and personal property. Operating Companies 1, 2, and 3 each have a net worth of \$15,000,000. Operating Company 4 has a net worth of only \$10,000. Each of Operating Companies 1, 2, 3, and 4 needs additional funds for working capital. Holding Company proposes to borrow \$20,000,000 from Bank. Because Holding Company has no as-

5. Of course, the fact that the management of Parent and Subsidiary may feel obliged as a matter of principle to honor the guaranty or grant of security is of little value to the lender. At the time when the lender is forced to collect on the guaranty or foreclose on the secured property, the lender will most likely be facing a receiver or trustee in bankruptcy who is under a strict duty to raise every legal defense to defeat claims against Subsidiary.

sets other than stock of Operating Companies 1, 2, 3, and 4, Bank insists that the loan be guaranteed by each of Operating Companies 1, 2, 3, and 4 and secured by security interests in their respective inventories and accounts receivable.

Another situation in which an upstream guaranty may be encountered is that of a leveraged acquisition. Here, Parent borrows the money required to purchase all of the outstanding stock of Subsidiary. The lender insists that, once the purchase is complete, the loan be secured by a guaranty by the new Subsidiary and security interests in Subsidiary's property. This situation is reflected in the following example ("Acquisition Example").

Buyer Company is formed by a syndicate of wealthy investors to purchase all of the outstanding stock of Target Company. Target Company has substantial assets and a net worth of \$4,200,000. Buyer Company has no assets except for \$200,000 of capital paid in by its shareholders. Buyer Company intends to borrow \$4,000,000 from Bank and to purchase all of the issued and outstanding capital stock of Target Company for an aggregate purchase price equal to its book value of \$4,200,000. To avoid direct responsibility for Target Company's liabilities and to preserve Target Company's valuable contracts which cannot be assigned, Buyer Company intends to maintain Target Company's existence. Bank insists that, immediately after the purchase, Buyer Company cause Target Company to guarantee the loan to Buyer Company and to grant a security interest in all of Target Company's real or personal property.

As will be discussed below, the validity of Target Company's guaranty of the financing of such a leveraged acquisition is a particularly difficult problem because the benefits which Target Company receives from such financing can be remote.

The above examples may not occur on a daily basis, but they are far from rare.⁶ Because Parent and Subsidiary are part of a single economic unit, it is both logical and desirable that Parent be able to borrow based on the value of its subsidiaries' property and assets and that lenders be able to enjoy the full amount of protection which the borrower can make available. Clear legal treatment of these transactions would enable borrowers and lenders to

6. For a case involving a leveraged acquisition, see *Roxbury State Bank v. The Clarendon*, 129 N.J. Super. 358, 324 A.2d 24 (1974). Similar problems arise where the selling shareholders help to finance the acquisition by agreeing to accept a deferred purchase price. See *Hartwell v. Hartwell Co., Inc.*, 167 N.J. Super. 91, 400 A.2d 529 (1979); *In re Knox Creations, Inc.*, 474 F. Supp. 567 (E.D. Tenn. 1979); *Haynie v. Milan Exchange, Inc.*, 62 Tenn. App. 36, 458 S.W.2d 23 (1970); *Miller's Shoes and Clothing v. Hawkins Furniture and Appliances, Inc.*, 300 Minn. 460, 221 N.W.2d 113 (1974); *Annot.*, 71 A.L.R.3d 639 (1976).

enjoy commercially required confidence in the effectiveness of their arrangements, but the law relating to upstream guaranties and associated grants of security interests is at present difficult to determine and to apply.⁷ Commentators have recently suggested that Subsidiary may not have corporate authority to guarantee or to secure Parent's indebtedness⁸ and that such a guaranty or grant of security interest is likely to be voidable under the Uniform Fraudulent Conveyances Act.⁹ Counsel to lender, Parent, and Subsidiary should be aware that Subsidiary's guaranty of Parent's debts may not be valid, binding, or enforceable in certain circumstances. This is a major problem for lender's counsel who must be able to confirm that a loan being made to Parent in part in reliance on the strength of Subsidiary's property and assets is secured by a guaranty which is enforceable against Subsidiary in all events. If the lender relies on security interests in Subsidiary's property, lender's counsel must also ensure that such security interests are effective against other creditors of Subsidiary. These issues become problems for counsel to Parent and Subsidiary when the lender insists on a legal opinion from such counsel on the validity and enforceability of the guaranty and grant of security interests.

The remainder of this Article attempts to assist counsel in thinking through the problems posed by a guaranty or grant of security interests in instances similar to those described above. There are a variety of issues.¹⁰ Part II deals with Subsidiary's cor-

7. One commentator recently summarized the state of the law as follows:

In summary, the attorney for the lender whose positive credit judgment requires a collateralized or noncollateralized "cross-stream" or "upstream" corporate guaranty of the lending transaction faces a morass of problems in determining the validity of the obligation under the statutory provisions: sparse, confusing, and poorly written statutes; poorly rationalized and articulated case law; a dearth of recent interpretive case law on some central concepts; and a dearth of any case law at all on others.

Rosenberg, *Intercorporate Guaranties and the Law of Fraudulent Conveyances: Lender Beware*, 125 U. PA. L. REV. 235, 257 (1976). To many attorneys, the above is a description of business as usual.

8. See Note, *The Corporate Guaranty Revisited: Upstream, Downstream, and Beyond—A Statutory Approach*, 32 RUTGERS L. REV. 312 (1979); Note, *Upstream Financing and Use of the Corporate Guaranty*, 53 NOTRE DAME LAW. 841 (1978); Annot., 71 A.L.R.3d 639 (1976).

9. See Rosenberg, *supra* note 7.

10. The issue of whether consideration exists for an upstream guaranty and the related grant of security interests appears to be easily resolved, for in almost every case there will have been detrimental reliance by the lender on the guaranty. See *Woods Lumber Co. v. Moore*, 183 Cal. 497, 191 P. 405 (1920); *New England Merchants Nat'l Bank v. Lost Valley Corp.*, 400 A.2d 1178, 1181 (N.H. 1979); 1 A. CORBIN, CONTRACTS § 121 (1963); Everdell

porate authority to make the guaranty or grant security interests. While the doctrine of corporate *ultra vires* is in decline with respect to corporate guaranties,¹¹ the question of corporate authority still has substance where minority or preferred shareholders are present.¹² Part III deals with the restrictions which may apply to constructive distributions to shareholders. A guaranty or grant of security interests in violation of these could be avoided by other creditors. Part IV analyzes the applicable restrictions on conveyances which might be voidable as fraudulent to creditors. While acknowledging several of the problems which have recently troubled commentators, this three-part analysis reaches the more positive conclusion that, in appropriate cases and with careful drafting and design, upstream guaranties and the associated grants of security interests can be made to work under existing law.

The precise statutory provisions are fundamental to the analysis of these questions. Although the exact statutory language which may be applicable in a particular case will vary from state to state, most issues discussed are common to all states. This Article will discuss each issue specifically in the context of the Uniform Fraudulent Conveyances Act (UFCA) and the Model Business Corporation Act (MBCA); reference will also be made to the provisions of the corporation and fraudulent conveyance laws of California, Delaware, New York, and Ohio.

II. CORPORATE AUTHORITY

Although the role of the *ultra vires* doctrine has been significantly circumscribed under modern corporation laws,¹³ the existence of corporate power and authority is not merely academic. Under section 7 of the MBCA, a court may be persuaded by shareholders to enjoin performance of a contract for lack of corporate authority, or the directors and officers may be held person-

& Longstreth, *supra* note 3, at 501 n.4. *But see* *Miller's Shoes and Clothing v. Hawkins Furniture and Appliances, Inc.*, 300 Minn. 460, 468, 221 N.W.2d 113, 118 (1974). In the Acquisition Example, there is a "past consideration" problem because the loan must be extended prior to the making of the guaranty or the grant of security by Target Company, but this problem appears to be solvable by making the loan on a demand note basis or by making the failure to guarantee or to grant the security interests an event of default.

11. *See* MBCA § 7; CAL. CORP. CODE § 208 (West 1977); DEL. CODE ANN. tit. 8, § 124 (1975); N.Y. BUS. CORP. LAW § 203 (McKinney 1963); Note, *Upstream Financing and Use of the Corporate Guaranty*, *supra* note 8, at 845-46. *But see* Kreidmann, *The Corporate Guaranty*, 13 VAND. L. REV. 229 (1959).

12. *See, e.g.*, *Real Estate Capital Corp. v. Thunder Corp.*, 31 Ohio Misc. 169, 287 N.E.2d 838 (C.P. 1972).

13. *See* note 11 *supra*.

ally liable for such actions on the suit of a receiver or the shareholders.¹⁴ These are, of course, exactly the problems that counsel for Subsidiary has been retained to avoid.

Subsidiary's corporate authority to guarantee or to secure Parent's obligations is determined not only by statute but also by the provisions of its articles of incorporation and its bylaws. This discussion proceeds on the assumption that counsel has determined that neither Subsidiary's articles of incorporation nor its bylaws by their terms restrict Subsidiary's authority to guarantee or to secure the obligations of any party. Even so, counsel may find it desirable to amend the articles of incorporation to take advantage of the full breadth of powers permitted under modern state corporation statutes.

Under the MBCA, as with other modern state corporation statutes, there is little restriction on a corporation's purposes; in general, Subsidiary may be organized for and pursue "any lawful purpose."¹⁵ Because there is nothing unlawful in the guaranty which Subsidiary intends to make or the security interests which Subsidiary intends to grant, there should be no exposure to a charge that its actions exceed the statutory limits on the purposes of corporations. Nevertheless, purposes stated in Subsidiary's articles of incorporation remain important because they may define Subsidiary's purposes more narrowly than the full breadth allowed by statute.

Only a few of the general powers of a corporation enumerated

14. Similar remedies are available in California, Delaware, and New York. See sources cited in note 11 *supra*. In California, shareholders can enjoin *ultra vires* transactions only "where third parties have not acquired rights thereby." CAL. CORP. CODE § 208 (West 1977). In Ohio, the *ultra vires* defense is also allowed in the case of an overissue of shares. OHIO REV. CODE ANN. § 1701.13(H) (Page 1978). Both California and Ohio apply their limitations on the *ultra vires* defense to contracts of foreign corporations. CAL. CORP. CODE § 208 (West 1977); OHIO REV. CODE ANN. § 1701.13(H) (Page 1978).

15. The MBCA provides: "Corporations may be organized under this Act for any lawful purpose or purposes, except for the purpose of banking or insurance." MBCA § 3. State statutes generally permit incorporation for any lawful activity. *E.g.*, CAL. CORP. CODE § 206 (West 1977) (permitting "any business activity not prohibited by the respective statutes and regulations to which it is subject"); N.Y. BUS. CORP. LAW § 201(a) (McKinney 1963) (permitting "any lawful business purpose or purposes"); OHIO REV. CODE ANN. § 1701.03 (Page 1978) (permitting "any purpose or purposes . . . for which natural persons lawfully may associate themselves. . ."). The references to "business" activities and purposes in the California and New York statutes suggest that those statutes are more restrictive in that they provide a statutory basis for the argument that a gratuitous guaranty is not related to "business" and therefore is not within Subsidiary's permitted corporate purposes. The Delaware statute negates such an inference by allowing "any lawful business or purposes." DEL. CODE ANN. tit. 8, § 101 (1975) (emphasis added).

in section 4 of the MBCA are relevant to guaranties and grants of security interests.¹⁶ Those relating to guaranties will be dealt with first.

Although section 4(h) of the MBCA¹⁷ seems to permit guaranties without limitation,¹⁸ the accompanying commentary is ambiguous. It first states that "some more recent statutes have made the power to contract a general power, not limited by corporate purposes. The Model Act has adopted this course with respect to the powers listed in Section 4(h)."¹⁹ This part of the commentary seems to contemplate an unrestricted power to guarantee the debts of anyone with or without a corporate business purpose or benefit from the guaranty. Later, however, the commentary seems to suggest a more restrictive "benefit" or "business purpose" test: "Guaranties should be upheld if it is shown that the board of directors of the guarantor had in good faith, and in the exercise of reasonable business judgment, decided that the benefits derived

16. Section 4 provides in pertinent part:
Each corporation shall have power:

- ...
- (e) To sell, convey, mortgage, pledge, lease, exchange, transfer and otherwise dispose of all or any part of its property and assets.
- (f) To lend money and use its credit to assist its employees.
- ...
- (h) To make contracts and guarantees and incur liabilities, borrow money at such rates of interest as the corporation may determine, issue its notes, bonds, and other obligations, and secure any of its obligations by mortgage or pledge of all or any of its property, franchises and income.
- (i) To lend money for its corporate purposes, invest and reinvest its funds, and take and hold real and personal property as security for the payment of funds so loaned or invested.
- ...
- (q) To have and exercise all powers necessary or convenient to effect its purposes.

MBCA § 4.

17. See note 19 *infra*.

18. See, e.g., *New England Merchants Nat'l Bank v. Lost Valley Corp.*, 400 A.2d 1178 (N.H. 1979). Delaware also expressly grants corporations the unrestricted power to guarantee. DEL. CODE ANN. tit. 8, § 122(13) (1975). New York and Ohio permit guaranties only in furtherance of corporate purposes, N.Y. BUS. CORP. LAW § 202(13) (McKinney 1963); OHIO REV. CODE ANN. § 1701.13(F)(6) (Page 1978), although New York has an express provision authorizing corporate guaranties without restriction as to purpose where the requisite shareholder vote is obtained. N.Y. BUS. CORP. LAW § 908 (McKinney 1963); The Ohio statute has been held to permit a cross-stream guaranty. See *In re B-F Building Corp.*, 284 F.2d 679 (6th Cir. 1960). See Note, *The Corporate Guaranty Revisited: Upstream, Downstream and Beyond—A Statutory Approach*, *supra* note 8, at 317-27. The California statute continues to utilize the "business" concept by permitting a corporation to guarantee "in carrying out its business activities." CAL. CORP. CODE § 207(g) (West 1977). California has a particular provision governing guaranties of obligations of employees, directors, officers, and shareholders. *Id.* § 315.

19. MBCA § 4(h), Comment.

from the guaranties were sufficient to justify the liability incurred."²⁰ The use of the word "benefits" in the commentary is troublesome for several reasons. First, such a test lacks any apparent basis in the language of section 4(h). Second, it seems to refer back to the common law benefit rule which restricted the power of corporations to make guaranties.²¹ The broad powers of contract, including the power to guarantee, contained in section 4(h) were drafted to correct this and other restrictive rules which injected uncertainty into corporate transactions.²² Third, in addition to being restrictive, the benefit or business purpose test is vague. Of course there are cases where a business purpose clearly exists, such as where a guaranty helps to secure a source of supply or helps to sell a product. In other cases, however, imaginative counsel have been and will continue to be able to claim that business purposes exist in a wide range of direct and indirect benefits to a corporation.²³ With each exercise of imagination, the certainty required for commercial transactions is undercut, and the requirement of a benefit or business purpose becomes less meaningful.

However such a benefit or business purpose test is defined, whether it is met in Subsidiary's guaranty of Parent's debt may be a complicated issue turning on the facts of the case. Where Parent guarantees Subsidiary's debt, a benefit or business purpose is clearly present because any contribution to Subsidiary's financial strength enhances Parent's equity interest. In contrast, a borrowing by Parent may or may not be of assistance to Subsidiary. The benefit to Subsidiary may be obvious where Parent exists only as a holding company for Subsidiary's stock, because the funds borrowed by Parent will be advanced or contributed to Subsidiary. In the Holding Company Example, if all or a substantial part of Holding Company's borrowing of \$20,000,000 is contributed to Operating Company 1, the receipt of funds on favorable terms would constitute a sufficiently direct and substantial benefit to Operating Company 1 to satisfy any benefit or business purpose test for its guaranty or grant of security interests. The benefit to Operating Companies 2, 3, and 4 is less clear because all or a substan-

20. *Id.*

21. See Kreidmann, *supra* note 11, at 232-34; Note, *The Corporate Guaranty Revisited: Upstream, Downstream, and Beyond — A Statutory Approach*, *supra* note 8, at 314-16.

22. See MBCA § 4(h), Comment.

23. Compare *Miller's Shoes and Clothing v. Hawkins Furniture and Appliances, Inc.*, 300 Minn. at 468-71, 221 N.W.2d at 119-20 with *Haynie v. Milan Exchange, Inc.*, 62 Tenn. App. at 43-45, 458 S.W.2d at 27.

tial part of the loan proceeds is directed elsewhere. It is easy to conceive of a case where Parent might wish to cause its successful subsidiaries to guarantee a loan which would provide financial support for a struggling subsidiary. In the Holding Company Example, if the entire \$20,000,000 is advanced to Operating Company 4 to support its sagging balance sheet, the requisite benefit to Operating Companies 1, 2, and 3 exists only insofar as a general strengthening of the related group is recognized as meeting the test.

In the context of a purchase of Subsidiary's shares by Parent with takeover financing, it will be even more difficult for Subsidiary to show the required benefit for its guaranty of the loan to Parent. In the Acquisition Example, Buyer Company pays the loan proceeds to the former shareholders of Target Company; Target Company itself receives no financial benefit from the loan to Buyer Company, nor is there any strengthening of Target Company's related corporate group because the loan proceeds have gone out of the group.

As suggested above, imaginative counsel may find a sufficient indirect benefit or business purpose even in such situations. The financial strength of Parent, including the strength of its subsidiaries and its other operations, is clearly of concern to Subsidiary. In good times, a financially strong Parent is a good source of inexpensive financial and other support and may be an important customer. In bad times, the bankruptcy of Parent can bring pressure and even liquidation on Subsidiary. Such considerations have been judicially recognized.²⁴ Even in the takeover situation, Subsidiary may claim a benefit if the new Parent brings stronger management, financial resources, or other expertise which will be shared with Subsidiary. If a refusal by Subsidiary to guarantee Parent's debt were to constitute a default on the loan or to cause the lender to call its demand note, the consequences to Subsidiary could be adverse. Unfortunately, even these benefits to Subsidiary may not exist in every case.

Finally, a further difficulty exists in the MBCA commentary's reference to an exercise of "good faith" business judgment by the guarantor's directors.²⁵ Even where a benefit or business purpose

24. See, e.g., *In the Matter of Ollag Constr. Equip. Corp.*, 578 F.2d 904, 906-07 (2d Cir. 1978) (guaranty and security agreement by subsidiary served a valid corporate purpose, so that shareholder ratification was unnecessary, because executed in an attempt to avoid the bankruptcy of the parent and principal customer).

25. See text accompanying note 20 *supra*.

for the guaranty could be established, one must inevitably suspect the objectivity of Subsidiary's directors when considering the benefit to Subsidiary in guaranteeing Parent's obligations — it is an offer Subsidiary cannot refuse.

A benefit or business purpose test is therefore troublesome and unsuited to the standards of certainty required for commercial transactions and accompanying legal opinions.²⁶ Fortunately, the benefit or business purpose test is probably not the law today, at least in those states where corporations are granted unlimited power to contract.²⁷ Not only does section 4(h) of the MBCA contain no restriction on the power to contract or to guarantee, but other general corporate powers under the MBCA are consistent with the making of guaranties in conformity with Subsidiary's corporate purposes. Because the guaranty contract is akin to lending money, one could argue either that authority for the guaranty exists under MBCA section 4(i) (dealing with the power to loan money) or that the statute could not have intended to restrict a corporation's power to make guaranties more than it restricts its power to make loans.²⁸ In addition, there is the catchall provision in section 4(q) which gives a corporation power to exercise "all powers necessary and convenient to effect its purpose."²⁹

Both sections 4(i) and 4(q) permit such action by a corporation to effect its corporate purposes. At first blush this limitation on corporate purposes appears to be no better than the restrictive business purpose standard. If broadly drawn, however, a corporation's purposes can, as discussed above,³⁰ go beyond business purposes to include "any lawful purpose." Section 54 of the MBCA

26. How attorneys can adequately satisfy themselves as to factual matters which underlie their opinions is a topic beyond the scope of this Article. It may not be enough simply to obtain a certificate from an officer of Subsidiary reciting the ultimate facts, because those relying on the opinion may quite reasonably assume that, in giving the opinion, counsel is considering a variety of more detailed facts which might be expected to come to his or her attention in the course of the transaction. Both the question of purpose and the issue of solvency, referred to in Part IV, require counsel to become thoroughly familiar with the business and financial condition of Parent and Subsidiary.

27. Such a test may well apply in certain cases, especially where Subsidiary's articles of incorporation recite only a particular line of business as the corporation's purpose or in the case of a state where the power of a corporation to contract remains limited to stated business activities. See note 18 *supra* and accompanying text. In such a case, it may be that guaranties could be made only in furtherance of Subsidiary's stated purposes. See, e.g., CAL. CORP. CODE § 207 (West 1977); N.Y. BUS. CORP. LAW § 202 (McKinney 1963); OHIO REV. CODE ANN. § 1701.13(F) (Page 1978).

28. For the text of section 4(i), see note 16 *supra*.

29. For the text of section 4(q), see note 16 *supra*.

30. See note 15 *supra* and accompanying text.

and the commentary to section 3 make it clear that the purpose clause in a corporation's articles of incorporation need not be any more descriptive or detailed than that.³¹ If Subsidiary's articles of incorporation contain a broad purpose clause reciting that its purposes include any lawful business or activity, then Subsidiary's guaranty of Parent's debt comes within the powers recited in sections 4(i) and 4(q) because the guaranty is lawful and therefore within Subsidiary's purposes.³²

Subsidiary's authority to transact any lawful business is also a helpful basis for its authority to give security for Parent's debt. Section 4(e) of the MBCA gives Subsidiary power "[t]o sell, convey, mortgage, pledge, lease, exchange, transfer and otherwise dispose of all or any part of its property and assets" without any express limitation as to business purpose,³³ but section 4(h) grants a general power to "secure any of its obligations by mortgage or pledge of all or any of its property, franchises and income."³⁴ By

31. Section 54 of the MBCA provides:
The articles of incorporation shall set forth

...
(c) The purpose or purposes for which the corporation is organized which may be stated to be, or to include, the transaction of any or all lawful business for which corporations may be incorporated under this Act.

Ohio and Delaware similarly permit the articles of incorporation to include a broad and general statement of purpose. DEL. CODE ANN. tit. 8, § 102(a)(3) (1975); OHIO REV. CODE CODE ANN. § 1701.04(A)(3) (Page 1978). California requires such a statement. CAL. CORP. § 202(b) (West 1977).

The commentary to MBCA section 3 provides background as follows:

Delaware, Iowa, Minnesota, Nevada, Oregon, Pennsylvania, Wisconsin and Wyoming, among others, permit the charter to state that the corporation will engage in "any lawful activity," without further specifications. In other jurisdictions the charter must state with varying degrees of exactness the nature of the business or businesses for which the corporation is organized.

In 1969, the Committee concluded that the broad grant concerning purposes in section 3 should be given full effect by removing the requirement in form or section 48(c) that the articles specify the purposes. As a consequence that section (now section 54) was amended appropriately and the Model Act now follows the pattern of those states permitting the "all purpose" provision.

32. Some argument could be made that, while the guaranty is lawful, it is not "business." This argument does not even arise in some states where the "all purpose" provision refers to any lawful "activity," instead of referring to any lawful "business." *E.g.*, DEL. CODE ANN. tit. 8, § 101 (1975); OHIO REV. CODE ANN. § 1701.03 (Page 1978). To say that Subsidiary's guaranty is not transacting business is to take the position that a standard business arrangement which is required by the lender in the ordinary course of its business is not transacting business merely because of the questionable business purposes of Subsidiary. Such a construction is contrary to the spirit of the broad grant concerning corporate purposes which the commentary to MBCA § 3 indicates that section was meant to provide. *See* note 31 *supra*. In short, it appears possible to have a business transaction without a business purpose.

33. MBCA § 4(e).

34. *Id.* § 4(h).

referring to "its obligations" the latter language is more limited, and it raises the question whether Subsidiary has the power to secure the obligations of another person.³⁵ Still, where Subsidiary has made a guaranty, the security interest secures "its obligations" and, in any event, the catchall provisions of section 4(q)³⁶ coupled with a broad purpose clause would further support the conclusion that corporate authority exists for the grant of security interests.

If due precautions are taken,³⁷ corporate authority should exist for Subsidiary to guarantee Parent's obligations and grant security interests to support the guaranty. The conclusion that the MBCA allows such a guaranty and grant of security interests accords with the spirit of flexible and broad corporate powers and with the realities of business relationships. Setting aside the legal details of the MBCA and the separate corporate entities, Parent and Subsidiary are, after all, only one consolidated business enterprise serving the financial interests of Parent's shareholders and obeying the orders of Parent's directors. A simple merger would make the legal configuration identical to this economic configuration. To be workable and helpful, the corporate law should facilitate, rather than complicate and hinder, a choice to transact business by pooling credit on a consolidated basis. Indeed, the entire analysis of corporate authority has a flavor of unreality to it, given the general

35. The reference to "its obligations" also appears in the California, Delaware, and New York statutes. CAL. CORP. CODE § 207(g) (West 1977); DEL. CODE ANN. tit. 8, § 122(13) (1975); N.Y. BUS. CORP. LAW § 202(7) (McKinney 1963). The Ohio law refers more broadly to "the obligations of any person." OHIO REV. CODE ANN. § 1701.13(F)(6) (Page 1978).

36. For the text of section 4(q), see note 16 *supra*.

37. Two practical points should be noted. First, if Subsidiary's articles of incorporation do not contain the broad statement of purposes permitted by MBCA § 54, counsel will want to have the articles amended to include such a statement in order to provide the greatest possible support for the existence of corporate authority. Second, this discussion has assumed that Subsidiary has no shareholders other than Parent. If other shareholders do exist, then not only is there concern that a disproportionate benefit is being received by one shareholder, Parent, but also the corporate authority question is more acute because of the existence of a potential plaintiff. In Ohio, for example, a court has enunciated, without undertaking a discussion of the statutory powers of corporations, a rule that a "gratuitous guarantee" by a corporation is valid if and only if all of the shareholders consent. *E.g.*, *Real Estate Capital Corp. v. Thunder Corp.*, 31 Ohio Misc. 169, 176-77, 287 N.E.2d 838, 843 (C.P. 1972) (applying *MacQueen v. The Dollar Savings Bank Co.*, 133 Ohio St. 579, 715 N.E.2d 529 (1938)). *See also* *Roxbury State Bank v. The Clarendon*, 129 N.J. Super. 358, 370-71, 324 A.2d 24, 30 (1974); *Haynie v. Milan Exchange, Inc.*, 62 Tenn. App. 36, 44, 458 S.W.2d 23, 27 (1970); *Miller's Shoes and Clothing v. Hawkins Furniture and Appliances, Inc.*, 300 Minn. 460, 465-66, 221 N.W.2d 113, 117 (1974). In New York, a shareholder vote will insulate the guaranty from attack. *See* note 18 *supra*. A formal consent to the transaction by all of Subsidiary's shareholders would therefore appear to be a worthwhile precaution.

assumption that Subsidiary has only one shareholder.³⁸ If there is only one shareholder, or if all of the shareholders have consented, the only protectable interests are those of creditors. The protection of these interests is the inspiration for the restrictions on distributions and conveyances discussed in the next two parts. Where there are no minority shareholder interests to protect, the most rational treatment of upstream guaranties is to apply limitations based on the rules particularly designed for the protection of creditors, rather than impose restrictions based on the theory of inadequate corporate authority.³⁹

III. CONSTRUCTIVE DIVIDENDS, DISTRIBUTIONS, OR LOANS TO SHAREHOLDERS

Once the requirement of corporate authority has been satisfied, the guaranty and grant of security interests must be shown to meet the existing legal requirements for protecting Subsidiary's creditors. A major creditor may have obtained covenants from Subsidiary restricting the making of guaranties or granting of security interests. Assuming that no such contractual limitations exist, the principal restrictions in this context are (1) the statutory restrictions on distributions to shareholders and other affiliated persons and (2) the statutory restrictions on fraudulent conveyances discussed in Part IV.

If Subsidiary's guaranty and grant of security interests are characterized as a dividend, distribution, or loan to Parent of Subsidiary's credit or other assets, then they will be subject to restrictions under several provisions of the MBCA. Most important, the MBCA permits dividends and distributions in cash or property to shareholders only out of earned or capital surplus and only when the corporation is not insolvent or rendered insolvent by the dividend or distribution.⁴⁰ If Subsidiary is called on to make payment on its guaranty or the lender forecloses on the security interest and Subsidiary actually makes payments or transfers to

38. See note 35 *supra*.

39. See *Hartwell v. Hartwell Co., Inc.*, 167 N.J. Super. 91, 96, 400 A.2d 529, 532 (1979); *Roxbury State Bank v. The Clarendon*, 129 N.J. Super. 358, 372-73, 324 A.2d 24, 31 (1974).

40. MBCA §§ 45, 46. See note 2 *supra*. The California statute goes further, prohibiting dividends and distributions where the corporation would be "likely to be unable to meet its liabilities . . . as they mature." CAL. CORP. CODE § 501 (West 1977).

If Subsidiary is rendered insolvent by making the guaranty and granting the security, there are further problems under the Uniform Fraudulent Conveyances Act. Discussion of these problems is deferred to Part IV *infra*.

benefit Parent, such payments or transfers might be characterized as a dividend or a distribution to its shareholder at that time. Such a characterization might mean that if Subsidiary were to have become insolvent by that time, performance of its obligations under the guaranty would be an illegal dividend. Because the solvency of Subsidiary at a time several years in the future is never certain, characterization of the performance on the guaranty as a dividend or as a distribution to its shareholder would create a substantial uncertainty concerning the enforceability of the guaranty or the related security interests. Moreover, Subsidiary's directors will be interested to know that they are personally liable for the amount of any illegal dividends or distributions to shareholders.⁴¹ Finally, where there are minority shareholders, there is the additional problem that any dividend or distribution will not be pro rata.

Unlike some state statutes,⁴² the MBCA does not expressly restrict loans by a corporation to its shareholders.⁴³ The accompanying commentary, however, states: "Use of corporate funds for other than corporate purposes is improper. Even the sole stockholder is not entitled to use corporate funds for his individual purposes."⁴⁴ Again, counsel is faced with a broad statement in the commentary which is not supported by the statutory language. The many possible interpretations of the word "use" are particularly troublesome. One may wonder whether by obtaining Subsidiary's guaranty Parent is "using" the assets of Subsidiary that stand behind the guaranty or that are subjected to a lien to secure the guaranty. The broadest possible meaning of the word "use" appears to cover too many accepted forms of intercorporate dealing between Parent and Subsidiary, and it may be that the commentary is intended to refer to commingling of funds or similar practices rather than loans or documented intercorporate advances.

Whether recharacterization of the guaranty and grant of security as a loan, dividend, or distribution is at all supportable will depend on the facts of the case. Where the proceeds of the loan to

41. See MBCA § 48; CAL. CORP. CODE § 316 (West 1977); DEL. CODE ANN. tit. 8, § 174 (1975) (liability only for willful or negligent acts); OHIO REV. CODE ANN. § 1701.95 (Page 1978).

42. See, e.g., OHIO REV. CODE ANN. § 1701.95(A)(3) (Page 1978).

43. See MBCA § 47. See also CAL. CORP. CODE § 315 (West 1977); DEL. CODE ANN. tit. 8, § 143 (1975); N.Y. BUS. CORP. LAW § 714 (McKinney 1963).

44. MBCA § 47, Comment.

Parent flow through to Subsidiary, such a recharacterization clearly would not be justified. Where the loan proceeds come to rest in Parent or are used to pay off former shareholders in an acquisition, the similarity to a dividend, distribution, or loan is stronger, for Subsidiary's action has indirectly resulted in the receipt of funds by Parent. Nevertheless, such a recharacterization still would be inappropriate in most cases. There is no precedent for such a recharacterization known to the author, and courts have held that the terms "dividend" and "loan" in a statute or contract refer to such actions in their usual form.⁴⁵ In particular, the fact that any payment by Subsidiary on its guaranty would create a right of subrogation against Parent is inconsistent with the concept of a dividend or distribution.

Furthermore, the restrictions in the statute designed to govern simple dividends and distributions are ill-suited for the particular mechanics of a guaranty or grant of security interests. Unlike the usual dividend or distribution, which would be paid or made shortly after being declared, Subsidiary's guaranty is a contingent obligation which may never require payment, and any payment which is made will probably have to be made after passage of considerable time and under changed circumstances. Therefore, restrictions which ordinarily define legal and illegal dividends and distributions with reasonable certainty would fail to give clear guidance regarding the validity of upstream guaranties and security interests. The real concern of the law in this area is that creditors' interests be protected, and for transactions in the form of a guaranty or grant of security such protection is more appropriately afforded by the UFCA.

IV. FRAUDULENT CONVEYANCES

It should come as no surprise that fraudulent conveyances do

45. With respect to dividends, see, *e.g.*, *Rano, Inc. v. English*, 500 S.W.2d 461, 465 (Tex. 1973) ("dividend" ordinarily means a corporate distribution that the shareholder is entitled to receive and retain without repayment); *Northwest Eng'r Corp. v. Wisconsin Dep't of Tax*, 241 Wis. 324, 327, 6 N.W.2d 198, 199 (1942) (dividend does not include profit received by purchaser of discounted stock). As to loans, see, *e.g.*, *Pratt v. Robert S. Odell & Co.*, 49 Cal. App. 2d 550, 559, 122 P.2d 684, 689 (1942) (loan is a contract by which one party delivers a sum of money to the other party for which the second party agrees to return an equivalent sum at a future date); *State v. O'Brien*, 93 Conn. 643, 647, 107 A. 520, 522 (1919) (loan creates an absolute obligation, while guaranteeing a loan merely creates a conditional duty to pay a debt or perform an act in the event of a failure to do so by a party originally liable).

not receive sympathetic treatment under the law.⁴⁶ Where a conveyance is fraudulent as to creditors, section 9 of the UFCA provides that a creditor with a matured claim may

- (a) Have the conveyance set aside or obligation annulled to the extent necessary to satisfy his claim, or
- (b) Disregard the conveyance and attach or levy execution upon the property conveyed.⁴⁷

Under section 10, a creditor whose claim has not matured may request the court to

- (a) Restrain the defendant from disposing of his property,
- (b) Appoint a receiver to take charge of the property,
- (c) Set aside the conveyance or annul the obligation, or
- (d) Make any order which the circumstances of the case may require.⁴⁸

Similarly, under federal law a trustee in bankruptcy can avoid a fraudulent transfer made within one year of bankruptcy.⁴⁹ As a result, a commercial lender is unlikely to be willing to rely on a guaranty or security interest which might be deemed a fraudulent conveyance.

As stated earlier, because Subsidiary is by hypothesis wholly-owned, the only interests which are affected by the validity of the guaranty and grant of security interests are the relative rights of Parent's lender and Subsidiary's creditors. After all, the principal purpose of the guaranty and grant of security interests is to place Parent's lender in a position equal to or ahead of Subsidiary's creditors in the event that the loan goes into default and the financial condition of Parent and Subsidiary weakens. The principal test of validity for upstream guaranties and associated grants of security interests should be based on the laws which most directly relate to the protection of Subsidiary's creditors. Therefore, in passing from the problems of corporate authority and restrictions on dividends to the question of fraudulent conveyances, the discussion appears to have passed from technicality to substance. Unfortunately, while the provisions of the UFCA clearly apply to

46. The Uniform Fraudulent Conveyances Act has been adopted by a bare majority of the states. *See, e.g.*, CAL. CIV. CODE §§ 3439-3439.12 (West 1977); N.Y. DEBT. & CRED. LAW §§ 270-281 (McKinney 1963); OHIO REV. CODE ANN. §§ 1336.01-.12 (Page 1978). The language of the federal bankruptcy provision relating to fraudulent transfers incorporates the UFCA tests. *See* Bankruptcy Reform Act of 1978, 11 U.S.C.A. § 548(a) (1979).

47. UNIFORM FRAUD. CONV. ACT § 9 [hereinafter cited as UFCA].

48. *Id.* § 10.

49. Bankruptcy Reform Act of 1978, 11 U.S.C.A. § 548 (1979).

upstream guaranties and related grants of security interests,⁵⁰ there have been few decided cases and little commentary on the application of the UFCA or analogous bankruptcy statutes to upstream guaranties.

It is particularly disheartening to find that the rules governing fraudulent conveyances are difficult to apply to upstream guaranties and related security interests. In a recent article on the subject, Robert Rosenberg concluded that the difficulties encountered present such problems that unless the loan can be restructured to run directly to Subsidiary "the lender should treat the availability of the assets of a Subsidiary . . . for repayment of the obligations of the borrower as a bonus rather than a necessity."⁵¹ In light of the UFCA's fundamental importance and the need for certainty in lending transactions, such a conclusion translates to a finding that the upstream guaranty is not available as an effective financing device when it is really needed. The following analysis takes issue with that conclusion and attempts to demonstrate that, in appropriate circumstances, the upstream guaranty and related grant of security interests will not constitute fraudulent conveyances under the UFCA.⁵²

As stated before, there can be no doubt that Subsidiary's guaranty and pledge of security are subject to the provisions of the UFCA. That Act applies to "conveyance[s] made" and "obligation[s] incurred."⁵³ "Obligations" is not defined in the UFCA, but its ordinary meaning would cover a guaranty.⁵⁴ "Conveyance" is defined in section 1 of the UFCA as "every payment of money, assignment, release, transfer, lease, mortgage or pledge of tangible or intangible property, and also the creation of any lien or incumbrance."⁵⁵ It follows that in making its guaranty, Subsidiary has "incurred an obligation" and, in granting the security interests, Subsidiary has "made a conveyance" for purposes of the UFCA.

Under the UFCA, conveyances made and obligations incurred become fraudulent in either of two situations. The first situation

50. See notes 54-55 *infra* and accompanying text. See also *Zellerbach Paper Co. v. Valley Nat'l Bank of Ariz.*, 13 Ariz. App. 431, 477 P.2d 550 (1970).

51. Rosenberg, *supra* note 7, at 265.

52. This analysis is supported by the decision of the Second Circuit in *In the Matter of Ollag Constr. Equip. Corp.*, 578 F.2d 904 (2d Cir. 1978).

53. UFCA § 4.

54. See Rosenberg, *supra* note 7, at 240-41; see also *Blakely v. Superior Ct. of Pima County*, 429 P.2d 493, 494 (Ariz. App. 1967).

55. UFCA § 1.

is where there exists actual intent to hinder creditors.⁵⁶ The second situation is where the corporation does not receive fair consideration and either becomes insolvent,⁵⁷ retains an unreasonably small amount of capital,⁵⁸ or is about to incur debts which it will be unable to repay.⁵⁹ Each test will be analyzed in turn.

In normal commercial transactions, there is nothing in Subsidiary's guaranty and grant of security interests which would exhibit an intent to hinder creditors. The UFCA refers to "actual intent, as distinguished from intent presumed in law."⁶⁰ The inspiration behind the transaction is not to put the collateral out of reach of Subsidiary's creditors but rather to provide the comfort required by Parent's lender. In short, the intent is not to hinder creditors but to obtain the loan. The mere fact that the transaction is structured so that Parent's lender obtains a lien on Subsidiary's property which is prior to that of Subsidiary's other creditors does not evince a fraudulent intent to hinder those creditors any more than the making of any ordinary secured loan.⁶¹

If there is no intent to hinder creditors, then the guaranty and grant of security interests will not be deemed fraudulent as to creditors if there is "fair consideration." Section 3 of the UFCA defines fair consideration as follows:

Fair consideration is given for property, or obligation,

(a) when in exchange for such property, or obligation, as a fair equivalent therefor, and in good faith, property is conveyed or an antecedent debt is satisfied, or

(b) when such property or obligation is received in good faith to secure a present advance or antecedent debt in amount not disproportionately small as compared with the value of the property, or obligation obtained.⁶²

Fair consideration for Subsidiary's guaranty is probably determined under paragraph (a), and fair consideration for the grant of security interests is governed by paragraph (b).

56. *Id.* § 7.

57. *Id.* § 4.

58. *Id.* § 5.

59. *Id.* § 6.

60. *Id.* § 7.

61. Of course, a different situation would exist if Subsidiary's guaranty and grant of security interests were to be part of an actual scheme the inspiration of which was to delay Subsidiary's creditors. In addition, Subsidiary will, of course, need to ensure that adequate disclosure is made to future creditors when appropriate. Beyond these issues, the problem created by the "intent to defraud" test is basically one of proof at trial and should not be an obstacle to counsel, who knows the facts, in giving his or her opinion.

62. UFCA § 3.

In neither case does the language of the UFCA fit the kind of consideration which Subsidiary receives in the case of an upstream guaranty. Assuming that there is no antecedent debt, the existence of fair consideration for the guaranty would depend on whether "property is conveyed" which is "a fair equivalent" for the obligation.⁶³ The statute, unfortunately, does not specify to whom the property must be conveyed. Fair consideration for the grant of security would depend on whether the "present advance" was "disproportionately small" in comparison with the value of the property in which the security interest was granted.⁶⁴ Again, there is no specification as to whom the advance should be made. However, because the statute is for the protection of Subsidiary's creditors, the fairness of the consideration logically should be evaluated from their standpoint.⁶⁵ Since Subsidiary's creditors have no claim on Parent's assets, one is uncomfortable in considering the amount of property conveyed or advances made to Parent in determining whether Subsidiary has received fair consideration.⁶⁶

The existence of fair consideration is therefore more safely determined by what Subsidiary has obtained in the transaction. Some of the funds obtained by Parent may flow through to Subsidiary. In addition, Subsidiary will receive a right of subrogation to the lender's claim against Parent. If Parent has other subsidiaries, Subsidiary may receive cross-guaranties from the other subsidiaries and a right of contribution in the event that it must perform on the guaranty. Subsidiary also receives the intangible benefits of maintaining Parent's financial strength described in Part II. As a result of its guaranty in the Holding Company Example, Operating Company 1 might receive some portion of the \$20,000,000, a right of subrogation against Holding Company; rights of contribution from Operating Companies 2, 3, and 4, and intangible benefits from the increased financial strength of Holding Company and Operating Companies 2, 3, and 4. How much of this consideration qualifies as "property" or "advances" which are recognized in determining the existence of fair consideration

63. See Rosenberg, *supra* note 7, at 242.

64. See *id.*

65. See *United States v. West*, 299 F. Supp. 661, 665 (D. Del. 1969); *Patterson v. Missler*, 238 Cal. App. 2d 759, 766, 48 Cal. Rptr. 215, 220 (1965); *Larrimer v. Feeney*, 411 Pa. 604, 609-10, 192 A.2d 351, 354 (1963); *Zellerbach Paper Co. v. Valley Nat'l Bank of Ariz.*, 477 P.2d 550, 554 (Ariz. App. 1970).

66. See *Hansen v. Cramer*, 39 Cal. 2d 321, 324-25, 245 P.2d 1059, 1060-61 (1952); *Hollander v. Gautier*, 114 N.J. Eq. 485, 487-88, 168 A. 860, 861 (Ch. 1933).

under the UFCA is not altogether clear. The actual cash received, although indirectly, clearly should be counted. The benefits of strengthening Parent's financial status probably must be ignored.⁶⁷ Contract rights, such as the right to contribution, have been held to come within the scope of "property" for the purpose of determining fair consideration.⁶⁸ If Subsidiary's contribution and subrogation rights are taken into account, at least where some or all of the money that Parent borrows will be advanced to Subsidiary, there may well be fair consideration for Subsidiary's guaranty.

Reason suggests that if there is fair consideration for the guaranty, there will also be fair consideration for the grant of security interests,⁶⁹ but the UFCA's treatment of the grant of security interests is not expressed in parallel language. On the one hand, the term "advance" in UFCA section 3(b) does not so readily expand to encompass the package of contract rights to be received by Subsidiary to supplement its share of the proceeds of Parent's borrowing. On the other hand, there appears to be more leeway in the "disproportionately small" standard applied to the advances than in the "fair equivalent" standard applied to the property received for the guaranty.⁷⁰ Nevertheless, where the amount of the funds which flow through to Subsidiary is small in relation to the value of the property subject to the security interest, neither Parent's lender nor counsel in the transaction can be certain that fair consideration exists for the grant of security interests.

Fair consideration will also be difficult to demonstrate in the context of acquisition financing which is guaranteed or secured by Subsidiary, the former target. For instance, in the Acquisition Example, the proceeds of the loan will go to Target Company's former shareholders and none will be contributed to Target Company, nor will any remain in Buyer Company for the future support of Target Company. Fair consideration is therefore likely to rest entirely on the value of the subrogation and contribution rights, which value may be highly speculative as a result of Buyer

67. See Rosenberg, *supra* note 7, at 243-45. The indirect benefits of strengthening affiliated companies may be quite significant. For one thing, future borrowings may be easier to arrange. Nevertheless, such benefits are not easy to classify as "property."

68. Freitag v. The Strand of Atlantic City, Inc., 205 F.2d 778, 784 (3d Cir. 1953); Hollander v. Gautier, 114 N.J. Eq. 485, 487, 168 A. 860, 861 (Ch. 1933); Schlecht v. Schlecht, 168 Minn. 168, 171-72, 209 N.W. 883, 886-87 (1926). But see Angers v. Sabatinelli, 235 Wis. 422, 435, 293 N.W. 173, 179 (1940).

69. See Rosenberg, *supra* note 7 at 242-43.

70. *Id.*

Company's thin capitalization. Finally, one senses that the acquisition financing involves the kind of threat to creditors' interests which a court might feel should be subject to the protection of the UFCA. In such circumstances, Parent's lender and counsel in the transaction will want to ensure that the guaranty and grant of security interests will not be deemed fraudulent even if there is no fair consideration for them.

In the absence of fair consideration, Subsidiary's guaranty and grant of security interests will be deemed fraudulent under the UFCA if Subsidiary "is or will be thereby rendered insolvent,"⁷¹ if Subsidiary "is engaged or is about to engage in a business or transaction for which the property remaining in his hands after the conveyance is an unreasonably small capital",⁷² or if Subsidiary "intends or believes that he will incur debts beyond his ability to pay as they mature."⁷³ Of these three tests, only insolvency is defined in the UFCA and is the subject of much legal learning. The concepts of unreasonably small capital and inability to pay foreseen debts present highly factual issues and must be given a practical meaning.⁷⁴ In close cases, counsel will have to rely on the business judgment of the client or business experts to determine whether capital is unreasonably small or whether foreseen debts cannot be met. Nevertheless, these determinations merely complement the central concept of insolvency by assuring that creditors do not lose their protection by reason of the momentary solvency of Subsidiary at the time of the transaction.⁷⁵ The crucial underlying concept remains insolvency. Although it is also a highly factual inquiry, it presents legal as well as factual issues in the context of an upstream guaranty and associated grant of security.

The UFCA defines insolvency in terms of a formula resembling a balance sheet. Section 3 provides (as to persons other than partnerships): "A person is insolvent when the present fair salable

71. UFCA § 4.

72. *Id.* § 5.

73. *Id.* § 6.

74. *Barr & Creelman Mill & Plumbing Supply Co. v. Zoller*, 109 F.2d 924 (2d Cir. 1940); *Cohen v. Hodes*, 54 F.2d 680 (E.D.N.Y. 1931); *Patterson v. Missler*, 238 Cal. App. 2d 759, 48 Cal. Rptr. 215 (1965); *Holcomb v. Nunes*, 132 Cal. App. 2d 776, 283 P.2d 301 (1955); *Cram v. Cram*, 262 Mass. 509, 160 N.E. 337 (1928); *Zuk v. Hale*, 114 N.H. 813, 330 A.2d 448 (1974); *In re Decker's Estate*, 149 Misc. 364, 268 N.Y.S. 280 (Surr. Ct., 1933); *Fidelity Trust Co. v. Union Nat'l Bank*, 313 Pa. 467, 169 A. 209 (1933); *Harnett v. Doyle*, 16 Tenn. App. 302, 64 S.W.2d 277 (1932).

75. In so doing, the UFCA incorporates the concept of equitable insolvency. *Cellar Lumber Co. v. Holley*, 9 Ohio App. 2d 288, 224 N.E.2d 360 (1967).

value of his assets is less than the amount that will be required to pay his probable liability on his existing debts as they become absolute and matured."⁷⁶ Application of this test in ordinary circumstances may involve considerable complexity. On the asset side, "present fair salable value" is likely to be different from the value ascribed to assets on the corporation's regular books or financial statements based on generally accepted accounting principles.⁷⁷ Assets which are very valuable to the corporation in its business but which are hard to sell present a problem, and some courts would have such assets excluded from the calculation.⁷⁸ On the liability side, contingent liabilities must somehow be measured to determine "probable liability."

In the case of a sizeable loan to Parent, the treatment of Subsidiary's guaranty and grant of security interests in the calculation of insolvency is likely to be determinative of the result. If the face amount of the guaranty must be included on the liability side without the recognition of any corresponding asset, then Subsidiary is likely to be insolvent under the test set forth in the UFCA. In Holding Company Example, the face amount of the guaranty for each of Operating Companies 1, 2, 3, and 4 will far exceed the net worth of each of them with the possible exception of one of Operating Companies 1, 2 and 3 if it receives as a contribution to capital more than \$5,000,000 of the loan proceeds. Still, taken as a consolidated group, their net worth is over two times the maximum liability for the guaranty. In such a case, where the consolidated net worth of Parent and its subsidiaries is several times the face amount of the loan, it would appear totally unrealistic to characterize each individual subsidiary as insolvent.

There are two possible approaches for producing a more suitable estimation of solvency. The first, the "Asset Theory," involves recognizing value in Subsidiary's rights of subrogation and contribution. The second, the "Liability Theory," recognizes a reduction in the amount of Subsidiary's liability on its guaranty to reflect the small probability that it will have to perform.

Up to this point, this discussion and the Rosenberg analysis appear to be in substantial agreement. However, Rosenberg appears to reject both the Asset Theory and the Liability Theory,

76. UFCA § 3.

77. *F.S. Bowen Elec. Co. v. United States Fidelity & Guar. Co.*, 256 F.2d 46, 49 (4th Cir. 1958).

78. *Glenmore Distilleries Co. v. Seideman*, 267 F. Supp. 915, 918 (E.D.N.Y. 1967). See Rosenberg, *supra* note 7, at 255.

while the following discussion attempts to show that the two theories can legitimately be used to establish the validity of upstream guaranties and related grants of security interests in appropriate cases.

The Asset Theory is not without conceptual difficulties. In the first place, there is the doubtful value of a right of subrogation against a parent who has defaulted on its obligation and is probably insolvent. Rosenberg characterizes the Asset Theory as unrealistic:

The notion that the guaranty of a solvent obligor is offset by a contingent asset based on the right of subrogation is simply not realistic; when and if the grantor is called upon to perform, the value of that contingent asset in all likelihood would be discounted severely because it probably would be no longer collectible. Otherwise, the guarantor would not have been called upon to perform.⁷⁹

In addition, the Asset Theory stumbles on the requirement that the "present fair salable value" be used. Unless a default occurs, there is no market for rights of subrogation and contribution which are entirely without value. Indeed, the paradox is that the safer the guaranty is, the more difficult it becomes to justify the Asset Theory in light of the use of the term "salable" in the UFCA.

Nevertheless, the argument that the rights of subrogation and contribution should be given a positive value in calculating insolvency has recently received judicial recognition. In *In the Matter of Ollag Construction Equipment Corp.*,⁸⁰ the Second Circuit was asked to decide whether a subsidiary was insolvent at the time it secured its parent's note to a bank. The subsidiary had already guaranteed the note, and the issue was raised whether, in determining solvency under the Bankruptcy Act, the guaranty should be considered a liability of the subsidiary in the full unpaid amount of the note without any offsetting asset. Reversing the decisions of the bankruptcy court and the district court, the Second Circuit held that the actual value of the subsidiary's rights of subrogation against its parent and its rights of contribution against its coguarantors should have been considered in determining whether it was solvent.⁸¹

79. Rosenberg, *supra* note 7, at 256.

80. 578 F.2d 904 (2d Cir. 1978). See also *In re Bowers*, 215 F. 617, 618 (N.D. Ga. 1914); *Wingert v. President, Directors and Company of Hagerstown Bank*, 41 F.2d 660, 662 (4th Cir. 1930).

81. *Id.* at 908.

In so holding, the court effectively refuted the argument that the rights of subrogation and contribution are valueless in the event of default. Creditors do not lose their entire claim in every insolvency, and well-secured creditors may be paid in full even in bankruptcy. In *Ollag*, the court noted that the bank eventually recovered \$139,000 out of a \$200,000 total claim by foreclosing on its security interest in the parent's equipment.⁸² In short, the Asset Theory was far from "unrealistic" under the circumstances of *Ollag*.

The court was less explicit in treating the argument that the subsidiary's contingent rights of subrogation and contribution could not be liquidated at the time the conveyance was made. In the first place, the court was construing a statutory definition of insolvency which was somewhat different from the definition in the UFCA. Instead of referring to "present fair salable value" of assets, the Bankruptcy Act referred to "a fair valuation" of "the aggregate of [its] property."⁸³ This difference should not preclude application of the *Ollag* holding in the context of the UFCA. Although the concept of salability was not expressed in the Bankruptcy Act definition, it is necessarily implied in the concept of "a fair valuation."⁸⁴ The analysis of the *Ollag* court is revealed by its comment that the guaranty liabilities "were tied" to the intangible assets.⁸⁵ Because the liabilities were taken into account, the calculation assumed the fact which made the contingent assets valuable and probably salable.⁸⁶ In this way, the court seems to have given effect to a hypothetical present fair salable value. If this approach is hard to square with the UFCA, it is at least fair.

In addition, the use by the *Ollag* court of the Asset Theory should not be construed as a rejection of the Liability Theory. A reduction in the amount of the subsidiary's liability on the guaranty was not justifiable in light of the dismal financial condition of the parent in that case.

82. *Id.*

83. 11 U.S.C. § 1(19) (1976) (repealed 1979).

84. See *Grandison v. Nat'l Bank of Comm. of Rochester*, 231 F. 800 (2d Cir. 1916); *In re O'Neill Enterprises, Inc.*, 359 F. Supp. 940 (W.D. Va. 1973); *In re Schindler*, 223 F. Supp. 512 (E.D. Mo. 1963); *In re Quелlette*, 98 F. Supp. 941 (S.D. Me. 1951); *Masonite Corp. v. Robinson-Slagle Lumber Co.*, 3 F. Supp. 754 (W.D. La. 1933); *In re Sedalia Farmers' Co-op. Packing & Produce Co.*, 268 F. 898 (W.D. Mo. 1919); *Stern v. Paper*, 183 F. 228 (D. N.D. 1910), *aff'd*, 198 F. 642 (8th Cir. 1910); *In re Hines*, 144 F. 142 (D. Or. 1906).

85. 578 F.2d at 908.

86. A creditor's chances in bankruptcy seem to have an attraction for aggressive risk-takers. Witness the speculation in securities of bankrupt railroads.

The application and problems of the Asset Theory can be illustrated by using the examples described earlier. In the Holding Company Example, if one assumes that the net worth figures reflect fair salable values of assets and probable liabilities, and that Operating Companies 1, 2, and 3 were advanced \$3,000,000 each from the loan proceeds with the remainder to Operating Company 4, the insolvency test can be applied by analyzing each Operating Company separately. By assumption, Operating Companies 1, 2, and 3 would each have an additional \$20,000,000 liability and \$3,000,000 in additional assets from the proceeds offset by a corresponding \$3,000,000 liability to Parent. Operating Company 4 would have \$11,000,000 in additional assets with an equal corresponding liability to Holding Company. Because of the substantial value of Holding Company's interest in the Operating Companies and the value of the rights of contribution from Operating Companies 1, 2, and 3, each of the Operating Companies would be justified in valuing its rights of contribution and subrogation at a substantial percentage of the full face value of the guaranty liability. Operating Company 4 is in slightly worse shape because it can claim rights of contribution for only 9/20 of any payment it makes, and its rights of subrogation for the remainder place it lower in priority to creditors of the other Operating Companies. However, even assuming substantial recovery through subrogation and contribution. The difference between \$20,000,000 face value of the liability and the expected recovery is probably large enough to give Operating Company 4 a negative net worth and to cause it to fail the insolvency test. Holding Company can improve the solvency of its subsidiaries by passing on the loan proceeds as a contribution to capital rather than as a loan or advance.

In the Acquisition Example, Target Company has no right of contribution, and its rights of subrogation must be greatly discounted to reflect the absence of Buyer Company's assets other than Target Company's common stock. Nevertheless, even counting the full face value of the guaranty as a liability, Target Company will continue to have a \$200,000 net worth.

In the situation where the borrower (Parent) is strong financially, the Liability Theory seems much more appealing. The modification of "liability" by use of the word "probable" in the UFCA seems to be a clear recognition of the principle that liabilities which will not materialize have no conceivable impact on sol-

vency.⁸⁷ In the Holding Company Example, assuming that the business operations of the Operating Companies are stable and are expected to be profitable enough to pay sufficient dividends to service the debt, the probable liability is slight in light of the comfortable excess of Holding Company's consolidated net worth over the principal amount of the obligation. Where the risk of actual liability is greater, there should still be some discounting of the liability to reflect its contingent nature. Unfortunately, even attributing a small probable liability in its guaranty is likely to render operating Company 4 insolvent. In the Acquisition Example, the probability of a claim is larger because Buyer Company has no reserve to cover its debt service if Target Company falls on bad times. However, the liability probably should be considerably discounted to reflect the probability that the wealthy shareholders of Buyer Company would inject new capital in such circumstances. In this way, the Liability Theory is highly realistic. Any other rule is not only less realistic but also unfairly complicates the commercial activities of corporations faced with large but groundless claims.

The Liability Theory should probably be expanded to effect a synthesis with the Asset Theory. Both have some merit, and both seem to produce similar results in the examples considered. In construing the UFCA definition of insolvency, courts and counsel should recognize the obvious fact that in drafting such a general insolvency definition it was not possible to deal expressly with a situation, such as the guaranty and grant of security interests by Subsidiary, which involves mutually related contingent assets and contingent liabilities. Accordingly, the difficulties in applying the statutory definition create justification for taking the liberty of construing "probable liability" to mean "probable net liability." Such a construction permits a realistic appraisal of the financial strength that Subsidiary needs to adequately cover its responsibility on the guaranty. The existence of such financial strength is all that creditors can reasonably demand through the UFCA, and upstream guaranties and related grants of security interests should be enforceable in numerous cases where such strength exists at the time the guaranty is made or the related security interests granted.

Unfortunately, this happy synthesis does not end the inquiry. Counsel must somehow obtain an accurate evaluation of the true value of Subsidiary's assets and the probable exposure on its lia-

87. See *In re Knox K creations, Inc.*, 474 F. Supp. 567, 571-72 (E.D. Tenn. 1979).

bilities. There is clearly a need to use estimates which create a corresponding vulnerability to second-guessing by the creditors' litigation team and the court to which they present their pleadings. A careful attorney must leave a margin of error in his or her solvency calculations. This author's experience has shown that financially strong subsidiaries can obtain sound legal opinions that their guaranties of their parents' debts are enforceable, while financially weak subsidiaries (such as our poor Operating Company 4) will have difficulty.

V. CONCLUSION

From counsel's perspective, the attempt by Parent's lender to use an upstream guaranty and grant of security interests to circumvent the limitation of liability which would otherwise protect Subsidiary from responsibility for repayment of Parent's debts creates numerous problems. Nevertheless, in appropriate circumstances counsel can solve these problems by obtaining a unanimous consent of Subsidiary's shareholders to the transaction, an amendment to Subsidiary's articles of incorporation giving it the broadest possible corporate authority, and unconditional cross-guaranties of Subsidiary's obligations giving Subsidiary clear rights of subrogation and contribution against Parent and related entities. In addition, counsel must take a hard look at Subsidiary's financial condition to ascertain whether such a guaranty and grant of security interests will be deemed fraudulent conveyances and, most important, must recognize that an enforceable guaranty and grant of security interests cannot be given in every case.