

Guarantees and Section 548(a)(2) of the Bankruptcy Code

Guarantees¹ of one company's obligations by another company are common in the business community. When a company seeks financing, the lender,² unwilling to rely solely on the borrower's promise to repay the loan, may require the company to supply a guarantor before it will agree to the loan.³ The guarantor might be either an affiliate⁴ of the company seeking the loan or an independent party. Under the terms of a typical guarantee, the guarantor is responsible for repaying the loan in the event of a default by the borrower (known as the obligor).⁵

This comment considers the circumstances in which a guarantee given by a guarantor who has become a debtor⁶ in bankruptcy can be set aside as a fraudulent conveyance under section 548(a)(2)

¹ A "guarantee," or "guaranty," is "[a]n undertaking or promise that is collateral to primary or principal obligation and that binds guarantor to performance in event of nonperformance by the principal obligor." BLACK'S LAW DICTIONARY 634 (5th ed. 1979).

In this comment, the term "guarantee" embraces both guarantees and sureties; the differences between these two obligations are not relevant in the present context. For a discussion of the distinction between guarantees and sureties, see ARTHUR STEARNS, *THE LAW OF SURETYSHIP* § 1.5 (5th ed. 1951); Peters, *Suretyship Under Article 3 of the Uniform Commercial Code*, 77 YALE L.J. 833, 837-43 (1968); 38 AM. JUR. 2D *Guaranty* § 15 (1968).

² In this comment, a "lender" is any party that is willing to extend, or that is considering extending, credit to the obligor.

³ As part of a guarantee, the guarantor may grant the lender a security interest in some of the guarantor's property. The Bankruptcy Code (the Code) defines a "security interest" as a "lien created by an agreement." 11 U.S.C.A. § 101(43) (West Pamphlet No. 2 (Sept. 1984)). This term includes interests in both real and personal property. S. REP. No. 989, 95th Cong., 2d Sess. 26 (1978) [hereinafter cited as SENATE REPORT]. Acquiring a security interest will further reduce the lender's risk. See Jackson & Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143, 1149-58 (1979).

⁴ "Affiliate" is defined in the Code as a corporation 20 percent or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by the debtor, or by an entity that directly or indirectly owns, controls, or holds with power to vote, 20 percent or more of the outstanding voting securities of the debtor.
11 U.S.C. § 101(2)(B) (1982).

⁵ The three parties in the guarantee transaction are the obligor (who makes the principal promise), the obligee (to whom the promise is made), and the guarantor. In the transactions examined in this comment, the obligee is always the lender, see *supra* note 2, and the guarantor is always the debtor in bankruptcy, see *infra* note 6.

⁶ A "debtor" is a "person or municipality concerning which a case under [the Code] has been commenced." 11 U.S.C. § 101(12) (1982).

of the Bankruptcy Code.⁷ The courts and commentators have not properly analyzed the relationship between the three parties in the guarantee transaction.⁸ They have focused on the relationship between the debtor and the lender and have asked whether the guarantee constituted a fraudulent conveyance from the debtor to the lender. This comment will show that it is the obligor, not the lender, that benefits from the debtor's guarantee and that one should therefore examine the transaction between the debtor and the obligor to determine whether a fraudulent conveyance under section 548(a)(2) has occurred.

Part I of this comment examines the structure and scope of section 548(a)(2). It concludes that this provision protects creditors from transactions that decrease the debtor's net worth and impair the rights of creditors to repayment from the debtor's assets. Part II argues that courts should treat the grant of a guarantee as a conveyance by the debtor to the obligor. Part III illustrates the application of section 548(a)(2) to the transaction between the debtor and the obligor and concludes that the debtor conveys value to the obligor when it becomes bound under the terms of the lending agreement and that the value of the debtor's promise should be measured by computing the expected value of the debtor's liability under the guarantee. Part III also examines the special case of an intercorporate guarantee, suggesting that there be a rebuttable presumption that the debtor received a reasonably equivalent value in exchange for its guarantee if the debtor was the parent of the obligor.

I. SECTION 548(a)(2) OF THE BANKRUPTCY CODE

The Bankruptcy Code (the Code)⁹ gives the trustee in bankruptcy¹⁰ the power to avoid, as fraudulent conveyances, certain

⁷ 11 U.S.C.A. § 548(a)(2) (West 1979 & Pamphlet No. 2 (Sept. 1984)). The text of this provision is quoted *infra* note 12.

⁸ See *Rubin v. Manufacturers Hanover Trust*, 661 F.2d 979, 991-96 (2d Cir. 1981); *Zellerbach Paper Co. v. Valley Nat'l Bank*, 13 Ariz. App. 431, 433-36, 477 P.2d 550, 552-55 (1970); Coquillet, *Guaranty of and Security for the Debt of a Parent Corporation by a Subsidiary Corporation*, 30 CASE W. RES. L. REV. 433, 448-60 (1980); Rosenberg, *Intercorporate Guarantees and the Law of Fraudulent Conveyances: Lender Beware*, 125 U. PA. L. REV. 235, 242-46 (1976).

Professor Rosenberg offers two possible explanations for the paucity of case law addressing this issue. First, many bankruptcy decisions are not reported; second, there is an institutional preference for settling this sort of case. Rosenberg, *supra*, at 239.

⁹ 11 U.S.C. §§ 101-151,326 (1982) (subsequent amendments codified at 11 U.S.C.A. §§ 101-151,326 (West 1979 & Pamphlet No. 2 (Sept. 1984))).

¹⁰ The trustee is the court-appointed manager of the debtor's estate. See 11 U.S.C.A.

transactions in which the debtor transferred property or incurred an obligation within one year of filing a petition in bankruptcy.¹¹ Under section 548 of the Code,¹² there are two ways in which a

§§ 321-325 (West 1979 & Pamphlet No. 2 (Sept. 1984)).

¹¹ *Id.* § 548. This is one of the trustee's "avoiding powers." See *id.* §§ 544-548. These powers permit the trustee to avoid the transfer to other entities of property that belonged to the debtor prior to bankruptcy. See Jackson, *Avoiding Powers in Bankruptcy*, 36 STAN. L. REV. 725, 725 n.1 (1984). The trustee can also attack a fraudulent conveyance under state fraudulent conveyance law. See *infra* note 12.

Fraudulent conveyance law has a history dating back to the sixteenth century. For a discussion of this history, see 1 GARRARD GLENN, *FRAUDULENT CONVEYANCES AND PREFERENCES* §§ 58-62(b) (1940); *infra* note 16.

¹² Section 548 reads as follows:

Fraudulent transfers and obligations

(a) The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor voluntarily or involuntarily—

(1) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud an 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

(2)(A) received less than a reasonably equivalent value in exchange for such transfer or obligation; and

(B)(i) was insolvent on the date that such transfer was made or such obligation incurred, or became insolvent as a result of such transfer or obligation;

(ii) was engaged in business, or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or

(iii) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured.

(b) The trustee of a partnership debtor may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, to a general partner in the debtor, if the debtor was insolvent on the date such transfer was made or such obligation incurred, or became insolvent as a result of such transfer or obligation.

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

(d)(1) For the purposes of this section, a transfer is made when such transfer is so far perfected that a bona fide purchaser from the debtor against whom applicable law permits such transfer to be perfected cannot acquire an interest in the property transferred that is superior to the interest in such property of the transferee, but if such transfer is not so perfected before the commencement of the case, such transfer is made immediately before the date of the filing of the petition.

(2) In this section—

(A) "value" means property, or satisfaction or securing of a present or antecedent debt of the debtor, but does not include an unperformed promise to furnish support to the debtor or to a relative of the debtor;

(B) a commodity broker, forward contract merchant, stockbroker financial institution, or securities clearing agency that receives a margin payment, as defined

trustee may avoid such a transaction as a fraudulent conveyance.¹³ Section 548(a)(1) allows the trustee to avoid a conveyance if he can prove that the debtor made the conveyance with the "actual intent to hinder, delay, or defraud" its creditors.¹⁴ While this method of attacking a fraudulent conveyance is available to the trustee in the case of guarantee transactions, this comment will focus on the more troublesome cases where evidence of actual fraudulent intent on the part of the debtor is lacking.¹⁵

Section 548(a)(2) allows the trustee to avoid all transactions that decrease the debtor's net worth and impair the rights of the debtor's creditors to payment in full.¹⁶ Under section 548(a)(2), the

in section 741(5) or 761(15) of this title, or settlement payment, as defined in section 741(8) of this title, takes for value to the extent of such payment.

11 U.S.C.A. § 548 (West 1979 & Pamphlet No. 2 (Sept. 1984)).

The trustee can also avoid a fraudulent conveyance under the appropriate state law. 11 U.S.C. § 544(b) (1982). In many instances the state law provisions will be similar to section 548 because this section has been derived from the Uniform Fraudulent Conveyance Act (the U.F.C.A.), 7A U.L.A. 161 (1978). See *infra* note 16.

¹³ 11 U.S.C.A. § 548(a) (West 1979 & Pamphlet No. 2 (Sept. 1984)) (quoted *supra* note 12).

¹⁴ *Id.* § 548(a)(1).

¹⁵ Because establishing the existence of actual intent to defraud turns upon the facts of each case, the important issues in litigation under section 548(a)(1) are evidentiary. Thus, a resolution based upon general principles, like the one suggested in this comment, would be less helpful in the context of a fraudulent conveyance under section 548(a)(1).

¹⁶ This comment asserts only that section 548(a)(2) reaches those transactions that decrease the debtor's net worth and impair the rights of the debtor's creditors; it does not go so far as to argue that Congress had this purpose specifically in mind when it enacted the section. Although it seems plausible that the draftsmen of this section intended to protect creditors against this type of transaction, at least one commentator has taken a slightly different position. See Jackson, *supra* note 11, at 777-80. Professor Jackson argues that the objective standard of fraudulent conveyance law codified in section 548(a)(2) serves as a substitute for a subjective standard that would avoid only those transactions in which the debtor intended to defraud his creditors. In his view, the objective standard, which is both under- and overinclusive, was adopted because of the difficulty of proving intent. *Id.* at 778. This comment's approach to section 548(a)(2) differs from Professor Jackson's with respect to only one question: whether an insolvent debtor that conveys property in exchange for less than a reasonably equivalent value without the intent to defraud, delay, or hinder its creditors *should* be deemed to have made a fraudulent conveyance. This comment and Professor Jackson agree that, under section 548(a)(2) as it is written, such a debtor *is* deemed to have made a fraudulent conveyance.

The history of fraudulent conveyance law lends support to the notion that section 548(a)(2) protects creditors from transactions that decrease the debtor's estate and impair their rights, regardless of the debtor's intent. As first enacted in 1571, the Elizabethan Statute of Fraudulent Conveyances, 13 Eliz., ch. 5 (1571), was both a penal and a revenue-raising measure aimed at debtors who hid assets from their creditors. In 1603, Parliament revised the Bankruptcy Act, 13 Eliz., ch. 5 (1571), to give the trustee the power to recapture all property that the debtor conveyed away unless the transfer had been made for marriage or "some good consideration." 1 Jac., ch. 15 (1603). This law allowed the trustee to set aside transactions that decreased the debtor's net worth even when the debtor was not insolvent.

trustee may avoid a conveyance if (1) the debtor did not receive a "reasonably equivalent value" for the property it transferred or the obligation it incurred and (2) the debtor was in poor financial condition before or as a result of the transaction.¹⁷ The requirement that the debtor receive less than a "reasonably equivalent value"¹⁸ isolates those transactions that decrease the debtor's net worth, while the requirement that the debtor be in poor financial condition ensures that only those transactions that impair the rights of the debtor's creditors will be set aside. If a transaction meets these requirements, the Code provides that the parties to this transaction be restored to the positions they would have occupied had no fraudulent conveyance occurred.¹⁹

Section 548(a)(2) apparently contemplates a paradigmatic two-party transaction. Assume that Debtor gives \$100 to Friend for Friend's birthday. Debtor, who has given Friend \$100 on each

A major development in modern fraudulent conveyance law was the drafting of the Uniform Fraudulent Conveyance Act, 7A U.L.A. 161 (1978), from which section 67(d) of the old Bankruptcy Act, 11 U.S.C. § 107(d) (1976) (superseded 1979), and section 548 of the present Code were in turn derived. See SENATE REPORT, *supra* note 3, at 89-90; H.R. REP. No. 595, 95th Cong., 1st Sess. 375 (1977) [hereinafter cited as HOUSE REPORT]; Analysis of H.R. 12889, 74th Cong., 2d Sess. 214 (1936), reprinted in 4 COLLIER ON BANKRUPTCY ¶ 548.01 n.7 (15th ed. 1979) ("We have condensed the provisions of the Uniform Fraudulent Conveyance Act, retaining its substance and, as far as possible, its language."); see also JACOB WEINSTEIN, THE BANKRUPTCY LAW OF 1938, at 139 (1938) ("The Chandler Act has recast [§ 67] in a more orderly form and has made it more comprehensive."). The draftsmen of the U.F.C.A. indicated that the purpose of these provisions was to protect creditors from conveyances that injured their rights:

The Statute of Elizabeth condemns conveyances as fraudulent only when made with the "intent" to "hinder, delay or defraud." There are many conveyances which wrong creditors where an intent to defraud on the part of the debtor does not in fact exist. In order to avoid these conveyances, the courts have called to their assistance presumptions of law as to intent, and in equity have pushed the presumption of fraud as a fact to an unwarranted extent; with the result that, while in the main the decisions under the facts do justice, the reasoning supporting them leaves much to be desired.

In the Act as drafted all possibility of a presumption of law as to intent is avoided. Certain conveyances which the courts have in practice condemned, *such as a gift by an insolvent*, are declared fraudulent irrespective of intent.

U.F.C.A. commissioners' prefatory note, 7A U.L.A. 162 (1978) (emphasis added). The legislative history of section 548 does not indicate that the framers of that section viewed the role of fraudulent conveyance law any differently than did the draftsmen of the U.F.C.A. See SENATE REPORT, *supra* note 3, at 5-6, 89-90; HOUSE REPORT, *supra*, at 375.

¹⁷ 11 U.S.C.A. § 548(a)(2) (West 1979 & Pamphlet No. 2 (Sept. 1984)) (quoted *supra* note 12).

¹⁸ In the analogous section of the U.F.C.A., U.F.C.A. § 3, 7A U.L.A. 181 (1978), the term "fair consideration" is used. The legislative history, which gives no reason for the change in terminology, suggests that "reasonably equivalent value" means the same as "fair consideration." See SENATE REPORT, *supra* note 3, at 89-90; HOUSE REPORT, *supra* note 16, at 375.

¹⁹ See 11 U.S.C.A. § 548(c) (West 1979 & Pamphlet No. 2 (Sept. 1984)) (quoted *supra* note 12); *infra* notes 30-33 and accompanying text.

of his past ten birthdays, makes this conveyance without the intent to hinder, delay, or defraud his creditors.²⁰ If Debtor was insolvent at the time of this transfer, the trustee can recover the \$100 as a fraudulent conveyance under section 548(a)(2). Because Debtor did not receive a reasonably equivalent value in this transaction, he lost value on the exchange and his net worth has necessarily been reduced.²¹

Not all transactions that decrease the debtor's net worth, however, can be set aside as fraudulent conveyances. In addition to having received less than a reasonably equivalent value, the debtor must have been in poor financial condition immediately after the challenged transaction.²² The Code provides three alternative tests by which the trustee can satisfy this requirement: he can show (1) that the debtor was insolvent,²³ (2) that the debtor was undercapitalized,²⁴ or (3) that the debtor thought that it would be unable to pay its debts as they matured.²⁵

In order for the debtor to be insolvent under the first test for poor financial condition, its liabilities must exceed its assets,²⁶ so

²⁰ The draftsmen of the U.F.C.A. indicated that the objective insolvency standard was designed for this type of conveyance. U.F.C.A. commissioners' prefatory note, 7A U.L.A. 162 (1978); cf. Clark, *The Duties of the Corporate Debtor to Its Creditors*, 90 HARV. L. REV. 505, 509-10 (1977) (using a similar example to examine the normative underpinnings of fraudulent conveyance law).

²¹ Further, to be set aside as a fraudulent conveyance, the transaction must decrease the debtor's net worth significantly. Under section 548(a)(2) the trustee must prove not only that the debtor received less than it gave but also that these two amounts were not even *reasonably* equivalent. Thus, the total decrease in the debtor's net worth attributable to the fraudulent conveyance is irrelevant: the existence of a reasonably equivalent value depends upon the values exchanged in the transaction. A hundred-dollar loss in a multi-million-dollar transaction is insignificant in comparison with a hundred-dollar loss in a hundred-dollar transaction. The debtor has received a reasonably equivalent value in the first transaction, but not in the second.

²² The Code does not use the term "poor financial condition," but the tests that it provides can best be understood as tests of the debtor's financial condition. See *infra* notes 23-30 and accompanying text.

²³ 11 U.S.C.A. § 548(a)(2)(B)(i) (West 1979 & Pamphlet No. 2 (Sept. 1984)) (quoted *supra* note 12). The corresponding section of the U.F.C.A. is U.F.C.A. § 4, 7A U.L.A. 205 (1978).

²⁴ 11 U.S.C.A. § 548(a)(2)(B)(ii) (West 1979 & Pamphlet No. 2 (Sept. 1984)) (quoted *supra* note 12). The corresponding section of the U.F.C.A. is U.F.C.A. § 5, 7A U.L.A. 237 (1978).

²⁵ 11 U.S.C.A. § 548(a)(2)(B)(iii) (West 1979 & Pamphlet No. 2 (Sept. 1984)) (quoted *supra* note 12). The corresponding section of the U.F.C.A. is U.F.C.A. § 4, 7A U.L.A. 240 (1978). Section 548(a)(2) also requires that the challenged conveyance have occurred within one year of the filing of the petition in bankruptcy. 11 U.S.C.A. § 548(a)(2) (West 1979 & Pamphlet No. 2 (Sept. 1984)) (quoted *supra* note 12).

²⁶ The Code defines "insolvent" for an entity other than a partnership as financial condition such that the sum of such entity's debts is greater than all such

that all of its assets are subject to its creditors' claims. When this occurs, any diminution of its assets without a corresponding diminution of its liabilities will reduce the amount that the creditors will receive in satisfaction of their claims. In our paradigmatic case, if Debtor is solvent after he transfers \$100 to Friend, his creditors' rights have not been impaired because Debtor still has enough assets to pay them off in full. The situation changes dramatically, however, if Debtor has creditors with \$1000 of unsecured claims²⁷ and only \$600 in unencumbered assets before the conveyance. Before Debtor gives \$100 to Friend, Debtor's creditors stand to receive sixty percent of the face amount of their claims. After the gift, his creditors will receive only fifty percent. By decreasing his net worth, Debtor has decreased the value of his creditors' claims.

The trustee can also set aside transactions that, in addition to decreasing the debtor's net worth, leave the debtor undercapitalized. The rationale behind this test for poor financial condition is that if a debtor is solvent after a conveyance but nevertheless has "an unreasonably small capital"²⁸ remaining, the likelihood of insolvency is increased by the transaction. A debtor will rarely find itself transformed from a financially sound entity into an insolvent one overnight; rather, the debtor usually slides into insolvency. It would be senseless to attempt to determine the debtor's solvency immediately after the challenged transaction and to hold that the debtor's solvency at that time determines whether or not a fraudulent conveyance has been made. For example, assume that in our paradigmatic case Debtor has \$250 worth of assets and \$100 worth of liabilities before the \$100 conveyance to Friend. Assume further that Debtor makes widgets and that the cash-flow requirements of widget manufacturing are such that \$1000 of working capital must be on hand at all times. Debtor is clearly on the road to bankruptcy, and Debtor's creditors are injured just as much by a conveyance of \$100 to Friend at this time as by a similar conveyance

entity's property, at a fair valuation, exclusive of—

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

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

11 U.S.C.A. § 101(29)(A) (West Pamphlet No. 2 (Sept. 1984)).

²⁷ Unsecured general creditors share proportionately in what remains after secured creditors and employees have been paid in full. *See id.* § 726.

²⁸ *Id.* § 548(a)(2)(B)(ii) (West 1979 & Pamphlet No. 2 (Sept. 1984)) (quoted *supra* note 12).

when Debtor is insolvent: when Debtor becomes bankrupt, the conveyance will have reduced by \$100 the amount available to satisfy their claims. Thus, in determining whether a fraudulent conveyance has occurred under section 548(a)(2), it is sufficient that the debtor be undercapitalized immediately after the transaction.

Finally, the trustee may avoid a conveyance if, in addition to not receiving a reasonably equivalent value, the debtor believed that, after the conveyance, it would be unable to pay its debts as they matured.²⁹ This requirement is similar to the test under section 548(a)(1) because both require an examination of the debtor's state of mind. But this test is a distinct method of attacking a conveyance, and it is aimed at a kind of transaction not covered by section 548(a)(1). In order to illustrate the transaction for which this section is designed, assume that in our paradigmatic case Debtor is neither insolvent nor undercapitalized but knows that his business will fail in the near future due to recent technological advances. His gift of \$100 to Friend is not a fraudulent conveyance under section 548(a)(1) because it is not made with the intent to hinder, delay, or defraud his creditors. It is, however, a fraudulent conveyance under section 548(a)(2). Allowing the trustee to set aside this transaction is justified on the same ground that justifies allowing him to set aside the similar transaction that left Debtor undercapitalized: a debtor does not become insolvent overnight; rather, it slides into insolvency. A debtor that realizes that the slide into insolvency has begun should not be permitted to make a conveyance that would be prohibited on the part of another debtor merely because the other debtor's slide into bankruptcy meets certain objective standards.

Once a conveyance is deemed fraudulent under section 548(a)(2), the Code allows the trustee to restore the parties to the positions they would have occupied had the fraudulent conveyance not occurred. Under section 550(a),³⁰ the trustee can recover from

²⁹ *Id.* Such a debtor may be an entity engaged in a seasonal business. For example, a farmer may be solvent because the value of his assets, including the crop nearing harvest, exceeds his liabilities. Even though solvent, however, he may not be able to pay his debts as they mature because his assets cannot be readily converted into money.

³⁰ Section 550(a) reads as follows:

(a) Except as otherwise provided in this section, to the extent that a transfer is avoided under section 544, 545, 547, 548, 549, or 724(a) of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from—

(1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or
(2) any immediate or mediate transferee of such initial transferee.

the recipient any fraudulent conveyance made by the debtor. Thus, in our paradigmatic case, Friend would have to return \$100 to Debtor's estate. Section 548(c), however, protects parties that give value to the debtor in good faith. To the extent they have given value, these parties are given a lien on any property transferred back to the debtor or are allowed to enforce any obligation to them that was incurred by the debtor in the transaction.³¹ If Friend, instead of receiving the \$100 as a birthday present, had in good faith sold Debtor his torts book, valued at \$10, for \$100, then Friend would have to give back \$100 and would have a \$10 lien on the torts book. Even though Friend may not receive \$10 from the lien he holds,³² Friend is placed in the same position he would occupy if the fraudulent conveyance had not occurred.³³

II. SECTION 548(a)(2) AND THE GUARANTEE TRANSACTION

A guarantee is part of a three-party transaction: the lender extends credit to the obligor in return for the promise of both the obligor and the guarantor to repay the loan. Confusion about the proper application of section 548(a)(2) to guarantees has arisen for two reasons: (1) the guarantee transaction is conceptually complex and (2) section 548 was not drafted with such three-party transactions in mind.

A. Analyzing the Guarantee Transaction

The guarantee transaction can best be analyzed by modifying the paradigm discussed in Part I. Assume that the insolvent

Id. § 550(a).

³¹ *Id.* § 548(c) (quoted *supra* note 12).

³² The value of the book may have decreased in the period between the conveyance and the bankruptcy proceeding.

³³ Friend's conveyance of the torts book to Debtor imposes an obligation on Debtor to pay for it. If there had been no fraudulent conveyance, we cannot be certain whether Debtor would have bought it for cash or on credit. If Friend were allowed to return only the excess value received over the value of the book, the transaction could, in effect, be characterized as a sale for cash, and Friend would receive the full value of the book. But in situations where it is unclear what would have happened, the Code resolves the uncertainty against the creditor. For example, a trustee given the status of a hypothetical lien creditor by 11 U.S.C.A. § 544(a) (West Pamphlet No. 2 (Sept. 1984)) can set aside an unperfected security interest even though an unsecured creditor might not be able to do so. Outside of bankruptcy, an unsecured creditor could reduce his claim to judgment and become a lien creditor, with priority over an unperfected secured creditor. See U.C.C. § 9-301(1)(b) (1978). At the time of a bankruptcy petition, it is impossible to determine whether the secured creditor would perfect his security interest before an unsecured creditor reduced his claim to judgment. In the face of this uncertainty, the Bankruptcy Code resolves the doubt against the secured creditor. See Jackson, *supra* note 11, at 732-36.

Debtor, wishing to make his yearly gift to Friend but finding himself short of cash, borrows \$100 from Bank at an appropriate interest rate and then conveys this money to Friend. (This case is "Variation One.") Here there are two separate transactions: (1) the exchange of Debtor's promise to pay \$100 in return for \$100 from Bank and (2) the conveyance of the \$100 by Debtor to Friend. Considered by itself, the second transaction is clearly a fraudulent conveyance because the gift of \$100 to Friend impaired Debtor's net worth. The first transaction, however, is not a fraudulent conveyance: Debtor received a reasonably equivalent value from Bank—\$100 in cash—in exchange for its promise to repay the \$100 plus interest. Thus, the transaction with *Bank* did not impair Debtor's net worth.

Now assume that instead of receiving \$100 from Bank and then giving it to Friend, Debtor instructs Bank to give the \$100 directly to Friend. ("Variation Two.") In substance, this transaction is identical to the previous one: both result in Bank exchanging \$100 for a promise of equal value while the net worth of Debtor is decreased by \$100 and the net worth of Friend is increased by \$100. Debtor's promise to *Bank* should not be treated as a fraudulent conveyance.³⁴ Debtor has given a promise worth \$100 to Bank, but Bank has not been enriched by it because Bank also gave \$100 to Friend at Debtor's request. Because fraudulent conveyance law seeks to place the parties in the position they would have been in had no fraudulent conveyance occurred, it would be anomalous to set aside Debtor's obligation to Bank, leaving Bank \$100 poorer than it would have been had it not entered into the transaction. Yet the language of the Code seems to demand precisely this result.

A literal reading of the Code would protect Bank in Variation One and not in Variation Two simply because in Variation Two Bank transfers the money directly to Friend while in Variation One it gives the money to Debtor who then transfers it to Friend. Section 548(a) provides: "The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor"³⁵ In Variation One, Debtor transferred an inter-

³⁴ This is true under either view of the purpose of fraudulent conveyance law. See *supra* note 16. Under Professor Jackson's view, section 548(a)(2) is a proxy for intent. In Variation Two, the debtor intended to give away its assets to the obligor, not to the lender. Under the view adopted in this comment, the lender's receipt of the guarantee did not decrease the debtor's net worth and impair the right of the debtor's creditors; the lack of value from the obligor did.

³⁵ 11 U.S.C.A. § 548(a) (West 1979 & Pamphlet No. 2 (Sept. 1984)) (emphasis added)

est in property to Friend, and the Code recognizes this transfer as a fraudulent conveyance. In Variation Two, Debtor incurred an obligation to Bank; he neither incurred an obligation nor transferred property to Friend. Thus, the Code does not recognize the transfer of value to Friend as a fraudulent conveyance. Although Variations One and Two have the same economic effect, section 548 appears to treat them differently. Further, Bank cannot claim protection under section 548(c) because that section only protects those parties that in good faith give value to the debtor,³⁶ and Bank has given value only to Friend.

This anomalous effect of section 548 was not a result intended by Congress. In fact, it is apparent that such a three-party transaction was not even considered when section 548 was drafted. The report prepared by the Bankruptcy Commission refused to take a position on how section 548 would affect the grant of a guarantee, expressly leaving this problem to be resolved by the courts.³⁷ Had it considered this three-party transaction when it drafted the Code, the Commission might have been able to supply a more definitive statement; in fact, however, it did not.

The legislative history of section 548(c) also suggests that Congress did not consider three-party transactions. Section 548(c) protects those creditors that in good faith enter into a transaction with the debtor that is later avoided as a fraudulent conveyance. This protection is of no avail to the lender in a three-party guarantee transaction because the language of section 548(c) limits its protection to those who have given value *to the debtor*.³⁸ Yet the legislative history of the section suggests a different and broader concern: "If a [creditor's] only liability to the trustee is under [section 548], and if he takes for value and in good faith, then subsection (c) grants him a lien on the property transferred, or other similar protection."³⁹ This language shows that Congress was concerned more with the creditor's behavior—his good faith—than with the mechanics of how and where value passes. Following the language in the legislative history, a good-faith lender, liable to the

(quoted *supra* note 12).

³⁶ *Id.* § 548(c) (quoted *supra* note 12).

³⁷ COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, REPORT OF THE COMM'N ON THE BANKRUPTCY LAW OF THE UNITED STATES, H.R. DOC. NO. 137, 93d Cong., 1st Sess. 177 (1973) ("It is left to case law to determine when an attack on a guarantee . . . by the debtor is proper on the ground that the debtor did not receive a reasonably equivalent value.").

³⁸ See *supra* text accompanying note 36.

³⁹ SENATE REPORT, *supra* note 3, at 89.

trustee under a literal reading of section 548(a)(2), would be protected in Variation Two just as in Variation One. If Congress had intended that different treatment be accorded the two variations under consideration, it would not have characterized the scope of section 548(c) so broadly. The discrepancy between the legislative history and the language of the statute thus suggests that Congress did not consider the three-party guarantee transaction when it enacted section 548. The legislative history envisions a judicial solution to problems of guarantee transactions. The next section of this comment proposes an analysis consonant with the overall scheme of section 548.

B. Isolating the Fraudulent Conveyance in a Guarantee Transaction

In Variation Two above, Friend has been enriched by \$100 while Debtor's net worth has been decreased by \$100 as a result of the transaction. This would seem to be the result of a fraudulent conveyance, but Friend has received neither property nor an obligation from Debtor.⁴⁰ Debtor has incurred an obligation to Bank, but Bank has not been enriched by it: the value of Debtor's promise, worth \$100, is offset by the \$100 that Bank has passed to Friend. If Bank is to be protected, the trustee must be required to seek the return of the \$100 from Friend, not Bank. It is therefore sensible and consistent with the intended application of section 548 to recharacterize the three-party transaction as two two-party transactions. Variation Two should be treated as (1) a transfer of \$100 from Bank to Debtor in exchange for Debtor's promise of repayment and (2) a transfer from Debtor to Friend of this same \$100.⁴¹

⁴⁰ The trustee does not have an action against Friend under section 550(a) (West 1979 & Pamphlet No. 2 (Sept. 1984)) because that section, by its terms, applies only to avoided transfers. 11 U.S.C.A. § 550(a) (quoted *supra* note 30). In Variation Two, the fraudulent conveyance results from the incurring of an obligation, not from a transfer.

⁴¹ The Eleventh Circuit recently adopted a similar approach in a case involving a leveraged buyout. See *In re Greenbrook Carpet Co.*, 722 F.2d 659 (11th Cir. 1984). The Greens, owners of Greenbrook Carpet Co., wished to acquire a controlling interest in Lewis Carpet Mills, Inc. The National City Bank of Rome refused to lend money to the Greens but did lend money to Greenbrook Carpet. Greenbrook Carpet immediately transferred the funds to the Greens, who used them to purchase the Lewis stock, granting Greenbrook Carpet a security interest in that stock. *Id.* at 660. The trustee sought to have this transaction treated as a loan from the bank to the Greens in which Greenbrook granted a security interest in its inventory in exchange for a worthless security interest in Lewis's stock. *Id.* The court refused to adopt this analysis because "[t]he issue under section [548](a)(2) is whether the bank received more consideration than it was due." *Id.* at 661 (emphasis in original). The

The grant of a guarantee by a party who later enters bankruptcy is closely analogous to Variation Two, with the debtor-guarantor occupying the position of Debtor and the obligor occupying the position of Friend. The only difference is that in a guarantee transaction, the obligor has not simply received a transfer from the bank: it is primarily liable on an obligation to the lender. Thus, the relevant inquiry aims to identify the party to whom the debtor's promise has value. If, as in Variation Two, the obligor is the only party that receives value from the debtor's promise, the transaction should be recharacterized as a fraudulent conveyance to the obligor.

Before considering who receives the benefit from the debtor's guarantee in a three-party lending arrangement, it is helpful to consider the simpler two-party lending transaction. In the two-party context, a lender who considers extending credit to an entity will base the terms of the loan upon the entity's ability to repay.⁴² Thus, if Bank lends money to Friend, the interest rate that Friend must pay will be based on Friend's ability to repay the loan.⁴³ As long as this is an arm's-length transaction, no one could seriously contend that it is a fraudulent conveyance: Friend's promise equals the value transferred by Bank, and Friend's creditors' rights of repayment have not been impaired.

In some instances, however, a lender will not be willing to extend credit to an entity if all that entity can offer in return is its own promise to repay. For example, if the entity is a subsidiary in a closely held group of corporations, the lender may be wary of the possibility that intercorporate transfers might significantly deplete the assets upon which it could levy in the event of a default. Thus, the lender may require that the parent add its promise to that of its subsidiary. In this transaction, the lender will set the rate of interest as it would in a normal two-party transaction: it will determine the value of the promises to repay the loan. The only difference is that the lender is now evaluating the worth of two separate

court's opinion does not indicate whether this analysis is derived from considerations such as those suggested in this comment or from a literal application of section 548(a)(2).

⁴² See RICHARD POSNER, *ECONOMIC ANALYSIS OF LAW* 293-94 (2d ed. 1977) ("The interest rate on a loan to a corporation will reflect the risk of default as that risk is estimated when the loan agreement is signed."); Jackson & Kronman, *supra* note 3, at 1149 ("The price a creditor charges for extending credit . . . varies directly with the riskiness of the loan itself.").

⁴³ For example, if there is only a 50% probability that the borrower will be able to keep its promise to repay the loan, with interest, and a 50% probability that nothing will be repaid, the lender will demand a stated rate of interest such that 0.50 of the principal plus 0.50 of the stated rate of interest will equal the lender's required rate of interest.

promises. For example, assume that Debtor Co., the parent of Subsidiary Co., guarantees Bank's loan to Subsidiary Co. The rate of interest that Bank will charge should be less than it would be for an unguaranteed loan to Subsidiary Co. because Bank faces less risk. In this situation, Bank has not gained any value by virtue of the addition of Debtor Co.'s guarantee. By taking the guarantee into account in setting the rate of interest, Bank has simply exchanged value in the form of a reduction in the interest rate for an equivalent value in the form of Debtor Co.'s promise to pay if Subsidiary Co. defaults. The only party that has gained by the addition of the guarantee is Subsidiary Co., which is now charged a lower rate of interest. Since Bank passes the whole value of Debtor Co.'s promise to Subsidiary Co., Bank could not have received a fraudulent conveyance.

Although the grant of a guarantee by an insolvent debtor for less than a reasonably equivalent value is not a fraudulent conveyance to the lender, it is a fraudulent conveyance to the obligor. The obligor has received the benefit of the guarantee, i.e., the value of the debtor's promise. This either enables the obligor to receive a loan for which it otherwise would have been ineligible or reduces the interest rate charged by the lender. In many guarantee transactions, the obligor will not have given value to the debtor for this benefit.⁴⁴ Where this is the case, the grant of the guarantee is a fraudulent conveyance by the debtor to the obligor. Just as with Variation Two, the grant of a guarantee should be recharacterized as two two-party transactions: (1) the transfer of the guarantee's value from the lender to the debtor in exchange for the debtor's promise and (2) the debtor's conveyance of this value to the obligor.

III. APPLICATION OF SECTION 548(a)(2) TO THE CONVEYANCE FROM DEBTOR TO OBLIGOR

Viewing the debtor's guarantee as a conveyance of value to the obligor clarifies the status of a guarantee as a fraudulent convey-

⁴⁴ A guarantee given without a return of value from the obligor is usually an intercorporate guarantee. See, e.g., *Rubin v. Manufacturers Hanover Trust*, 661 F.2d 979, 983-84 (2d Cir. 1981); cf. *Coquillotte*, *supra* note 8, at 452 (examining transaction for possible indirect benefits to the debtor); *Rosenberg*, *supra* note 8, at 238-39 (same). Yet one can easily imagine such a guarantee transaction in which the guarantor is not related to the obligor. For example, if *O* makes a unique kind of microchip that *G* needs to build its line of personal computers, and *O* needs a loan to help it through current cash-flow problems, *G* may agree to guarantee the loan without receiving direct compensation from *O* because if *O* ceased operations, *G* would have to discontinue this line of computers.

ance. It also, however, raises questions about the mechanics of applying section 548(a)(2) to the transaction between debtor and obligor that is implicit in the three-party guarantee transaction.⁴⁵ Two issues remain to be resolved: (1) at what point in the transaction the debtor conveys value to the obligor and (2) how one determines whether the debtor has received a reasonably equivalent value for its guarantee.

A. When the Fraudulent Conveyance Occurs

In order for a transfer of value from the debtor to the obligor to be considered a fraudulent conveyance under section 548, the transfer must have occurred "within one year before the date of the filing of the petition in bankruptcy."⁴⁶ To determine whether this is the case, one must first locate the time at which the conveyance is made. If the transaction involves only a single loan, the answer is obvious: the conveyance occurs on the date the lending agreement is signed. At this point, the obligor has received a loan with more favorable terms than it could have received absent the guarantee. For example, if Debtor guarantees Bank's \$1000 loan to Friend, and if this guarantee is worth \$100,⁴⁷ this transaction should be treated as a \$100 transfer from Bank to Debtor in exchange for Debtor's promise, followed by a transfer of this \$100 from Debtor to Friend, each occurring on the date of the loan.

When the guarantee secures a line of credit,⁴⁸ determining

⁴⁵ The case law on the issues posed by section 548(a)(2)—when an obligation is incurred and what constitutes reasonably equivalent value—is sparse. Only the Second Circuit has squarely addressed them. In *Rubin v. Manufacturers Hanover Trust*, 661 F.2d 979 (2d Cir. 1981), the court held that the debtor incurred an obligation when the lender transferred value to the obligor, *id.* at 990, and that the amount covered by the debtor's security interest should be compared with the amount it actually received to determine whether the transaction was for "fair consideration," *id.* at 993. (The term "fair consideration" in the old Bankruptcy Act has been replaced by "reasonably equivalent value" in the Code.)

In *Rubin*, the court looked for a fraudulent conveyance in the transaction between the debtor and the lender. This comment has shown that the obligor, not the lender, receives the benefit of the debtor's guarantee. See *supra* notes 34-44 and accompanying text. The analysis suggested in this comment requires new approaches to the problems of applying section 548(a)(2).

⁴⁶ 11 U.S.C.A. § 548(a) (West 1979 & Pamphlet No. 2 (Sept. 1984)) (quoted *supra* note 12).

⁴⁷ On determining the value of the debtor's guarantee, see *infra* notes 54-56 and accompanying text.

⁴⁸ Under a line-of-credit lending arrangement, the obligor is entitled to borrow funds at its discretion from the lender up to a specified limit during a stated period of time. Lines of credit can be either revocable or irrevocable. Under a revocable line of credit, the lender may refuse to advance funds to the obligor at any time; under an irrevocable line of credit, the lender is obligated to advance funds to the obligor upon demand during the period of

when a debtor made a fraudulent conveyance to the obligor through its guarantee becomes slightly more difficult. When a line of credit is guaranteed, the guarantor is either irrevocably bound to guarantee future advances or it is not—if not, it may withdraw its promise to guarantee the loan at any time before funds are actually advanced.⁴⁹ If the debtor is bound to guarantee future advances, it has incurred an obligation as to these advances. By becoming bound, the debtor has conveyed value to the obligor because the obligor has acquired the opportunity to borrow funds in the future at a rate lower than it could have secured on its own. If the debtor is not bound to guarantee future advances when it signs the loan agreement, it has not given any value to the obligor. Only when the debtor loses the option of voiding its promise has it conveyed value to the obligor. For example, assume that Debtor guarantees a line of credit from Bank to Friend. The terms of the agreement provide that Bank will transfer \$1000 to Friend on the thirtieth of each month and that Debtor will become bound as to each advance as of the fifteenth of the same month. Assume further that the value of this guarantee is \$100 for each month that Debtor guarantees a loan. Under the analysis suggested in this comment, this transaction should be treated as two two-party transactions: one in which Debtor has signed a lending agreement with Bank on the fifteenth of each month providing that Bank will

the agreement.

A line of credit may be subject to covenants written into the lending agreement. For example, a lender may promise to transfer funds to the obligor upon the obligor's request provided that the obligor's inventory is worth a certain amount at the time of the request. These covenants are sought by the lender because they allow it to terminate its obligation to the obligor when the riskiness of the loan rises above the level it considers acceptable. Because of these covenants, it may be difficult to classify a line of credit as either revocable or irrevocable. For example, the conditions in an irrevocable line of credit may be set at such levels that the lender always has the option of declaring the obligor in violation of the lending agreement and refusing to disperse any more funds to the obligor. This distinction becomes unimportant under the analysis suggested in this comment because the distinction focuses on when the debtor conveyed value to the obligor, rather than when the lender becomes bound to transfer value to the obligor. Thus, one benefit of the analysis suggested in this comment is that it simplifies the inquiry about the date on which the conveyance occurred. For a discussion of lines of credit, see R. BREALEY & S. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 560, 623 (1981).

⁴⁹ A lender has an incentive to ensure that it will be bound to transfer value only upon the fulfillment of certain conditions. See *supra* note 48. Normally, it will not allow the guarantor to have this same freedom. If there is any possibility that the lender will be bound prior to the time that it transfers value, the lender will want the guarantor to be bound as well. If the guarantor were allowed to remove itself from a transaction when the lender could not, the lender could not fully rely upon the guarantee. This uncertainty would increase the cost of the loan. See *supra* note 42.

lend Debtor \$100 on the thirtieth of that month and the other in which Debtor has then promised to give Friend \$100 at the same time that Bank disburses the loan to Debtor.⁵⁰

In one special case the debtor should be found to have incurred no obligation under its guarantee even though the lending agreement requires that it guarantee future advances. This is the case in which the debtor controls the obligor, i.e., when it is a parent corporation bound to guarantee a line of credit in favor of its subsidiary.⁵¹ In this situation, the debtor has not conveyed value to the obligor because the debtor can prevent the obligor from requesting more funds under the lending agreement. For example, assume that Parent guarantees Subsidiary's line of credit from Lender and that under the terms of the lending agreement, Parent is bound upon the signing of the agreement to guarantee all future advances to Subsidiary. Parent's situation is the same as it would be if it were not bound because, in either case, Parent can control whether or not it actually becomes obligated under the guarantee. Where Parent is formally bound, it can simply instruct Subsidiary not to borrow any funds; where Parent is not formally bound, it can tell Lender that it will no longer guarantee any advances to Subsidiary. In either case, the debtor does not actually become obligated under its guarantee until the obligor requests funds from the lender. Thus, when a parent corporation is bound to guarantee credit extended to its subsidiary, each advance should be treated as an isolated loan transaction, with value passing from the debtor on the date of the actual advance.

B. Reasonably Equivalent Value

In identifying a guarantee transaction as a fraudulent conveyance under section 548(a)(2), a second requirement is that the debtor receive less than a reasonably equivalent value in exchange

⁵⁰ When a guarantee of a line of credit is challenged, courts must always determine when the obligation is incurred, not when money is transferred under the agreement. If the money has been transferred, this transfer can be set aside only if the obligation incurred under the guarantee was a fraudulent conveyance. The payment of an antecedent debt constitutes value under section 548. See 11 U.S.C.A. § 548(d)(2) (West 1979 & Pamphlet No. 2 (Sept. 1984)) (quoted *supra* note 12). Thus, if the guarantee created a valid obligation, the transfer from Debtor to Friend under the guarantee was for a reasonably equivalent value because the payment extinguished an obligation of equal value. As a result, only if the trustee can avoid the guarantee at the time the Debtor became bound can he recover any money paid under the guarantee.

⁵¹ This guarantee, however, might not be a fraudulent conveyance because the parent may have received a reasonably equivalent value in exchange for its guarantee. See *infra* notes 66-68 and accompanying text.

for its guarantee.⁵² In order to make this determination, one must first establish the point in the transaction at which the value received by the debtor should be measured. Three further determinations must then be made: (1) what value the obligor received from the debtor's guarantee; (2) what value the debtor received in exchange for its promise; and (3) whether the latter value is reasonably equivalent to the former.

1. *When to Measure for Reasonably Equivalent Value.* Traditional contract law and the basic purpose of section 548(a)(2) call for a measurement of reasonably equivalent value at the time that the debtor transferred value or incurred an obligation. Traditional contract law measures the validity of a contract at the time it is entered into, thereby preventing parties who make improvident bargains from attempting to avoid responsibility under the contract simply because the outcome is less favorable than expected.⁵³ This same rule should apply in determining whether the debtor received a reasonably equivalent value. If the debtor entered a transaction in which the expected return was reasonably equivalent to his expected liability, then he should have to live with the possibility of either gain or loss. If the transaction could later be set aside because the debtor ultimately paid out more than it received, the debtor would be able to avoid taking any risk in the transaction.

Measuring the value received by the debtor at the time an obligation is incurred or property is transferred also furthers the basic purpose of section 548(a)(2). Section 548(a)(2) allows the debtor's creditors to avoid only those transactions that decrease the debtor's net worth. If a debtor makes a conveyance and receives in exchange a reasonably equivalent value at the time of the conveyance, its creditors have not been harmed. The value of the assets that they can look to in order to satisfy their claims is the same before and after the transaction. The fact that the value of the debtor's assets decreases later, because events did not turn out as expected, should not affect the determination. If ex post measurement were permitted, the debtor's creditors would in effect be

⁵² 11 U.S.C.A. § 548(a)(2)(A) (West 1979 & Pamphlet No. 2 (Sept. 1984)) (quoted *supra* note 12).

⁵³ This follows directly from the nature of a contract. As Oliver Wendell Holmes pointed out over a century ago, a contract essentially is a process by which one party accepts the risk of a certain event not happening. See O.W. HOLMES, *THE COMMON LAW* 298-300 (1881). If one were to judge the validity of the contract after the occurrence or nonoccurrence of the crucial event, one would vitiate the entire purpose of contracting before the event.

permitted to shift the risk of the transaction to the other party to the transaction. They would share in the gains if the transaction proved to be favorable and bear none of the losses if it proved to be a bad deal. Because it would do more than preserve creditors' rights to repayment out of the debtor's assets, this pattern would not serve the purpose of section 548(a)(2). It would in effect provide creditors with a windfall at the expense of other parties that had contracted with the debtor.

2. *The Value of the Debtor's Guarantee.* The value of the debtor's promise to repay the loan in case of a default by the obligor should be computed by determining the expected value of the debtor's liability under the guarantee.⁵⁴ This standard of valuation closely approximates the market value of the guarantee. A guarantor in an arm's-length transaction will demand a price determined by using such an expected-value standard.⁵⁵ For example, assume that Friend borrows one million dollars from Bank and that Debtor guarantees the loan. If there is an eighty-percent probability that Friend will repay the entire loan, a ten-percent probability of his repaying half of the loan, and a ten-percent probability of his defaulting completely, then Debtor, in an arm's-length transaction, would charge Friend \$150,000 for the guarantee.⁵⁶

This valuation standard also comports with the purpose of section 548(a)(2) because it allows only those transactions that decrease the debtor's net worth to be avoided under section 548(a)(2). If the guarantee were valued at an amount greater than that dictated by the expected-value standard, the debtor would have to receive compensation worth more than the (negative) value

⁵⁴ Reasonably equivalent value should not be determined by comparing the amount, if any, that the debtor, due to the obligor's default, paid under the guarantee with the amount the debtor received in exchange for the guarantee. This would be contrary to the notion that the value of the contract should be ascertained as of the time that it is entered into, not after events have shown that the actual value differed from the expected value. *See supra* note 53 and accompanying text.

⁵⁵ *See generally* V. BRUDNEY & M. CHIRELSTEIN, *CASES AND MATERIALS ON CORPORATE FINANCE* 35-75 (2d ed. 1979) (discussing the relationship of expected returns and risk to value).

⁵⁶ This expected value is calculated as follows: $(.80 \times \$0) + (.10 \times \$500,000) + (.10 \times \$1,000,000) = 0 + \$50,000 + \$100,000 = \$150,000$. This example assumes that Debtor is certain to repay the loan if called upon to do so. If there is only a 50% chance that Debtor will be able to meet its obligation to repay the balance of the loan at any given time, the value of its guarantee would be \$75,000. Debtor would be forced to take its own risk of insolvency into consideration when pricing its guarantee because a lending institution will do so in determining the interest rate it will charge Friend. If Debtor did not do this, other parties could offer a similar guarantee at a lower price.

of the risk it was undertaking in order to receive a reasonably equivalent value. Such a standard would allow transactions that do not decrease the net worth of the debtor to be avoided as fraudulent conveyances. If the guarantee were valued at less than the expected value of the debtor's liability—thus increasing the probability that a “reasonably equivalent value” will be found—the debtor could decrease its net worth and impair its creditors' rights in contravention of the purpose of section 548(a)(2).

3. *The Value Received by the Debtor.* After determining the value of the debtor's guarantee, i.e., the amount the debtor should have received in return for its guarantee, one must determine the value that the debtor could reasonably have expected to receive when it gave its promise. If the obligor pays the debtor in cash, the determination is straightforward. But this is not the typical scenario. In the more common case of an intercorporate guarantee, the debtor will rarely be paid in cash.⁵⁷ In these instances, it must be determined whether the debtor could reasonably have expected to receive any other value, in the form of indirect benefits from its affiliate, when it gave its guarantee and, if so, the amount of those benefits.⁵⁸ The concept of indirect benefits is well established in the case law, which recognizes that a party to a transaction may receive benefits in the absence of a direct receipt of value.⁵⁹ Thus,

⁵⁷ See, e.g., *Rubin v. Manufacturers Hanover Trust*, 661 F.2d 979, 982-84 (2d Cir. 1981). The primary benefit to the borrower from an intercorporate guarantee is that it either allows the borrower to receive a loan it would not otherwise receive or enables it to receive a lower interest rate.

⁵⁸ See *id.* at 993-94 (remanding because the district court, although it found that the guarantor received indirect benefits, failed to measure these benefits); see also *Coquillet*, *supra* note 8, at 542-54; *Rosenberg*, *supra* note 8, at 243-46.

⁵⁹ To demonstrate the concept of indirect benefits, assume that Debtor Co. is in the business of making computers. Essential to Debtor Co.'s production of computers is a certain kind of microchip made only by Friend Co. Assume further that Friend Co. needs a \$10,000 loan to repair recent fire damage at its plant. Because Debtor Co. is dependent on Friend Co. for its success, Debtor Co. guarantees the loan and receives no direct remuneration from Friend Co. This loan may be supported by a reasonably equivalent value in the form of the benefits that Debtor Co. expects to receive from Friend Co.'s operations. For cases finding the existence of indirect benefits in a variety of bankruptcy contexts, see *Klein v. Tabatchnick*, 610 F.2d 1043, 1047-48 (2d Cir. 1979) (debtor may have received fair consideration through indirect benefits when it supplied securities to third party in exchange for third party's collateralization of existing loan to a minority shareholder of the debtor; otherwise the minority shareholder would have withdrawn his capital from debtor, leaving it with severe cash and capital problems); *Williams v. Twin City Co.*, 251 F.2d 678, 681 (9th Cir. 1958) (debtor's transfer of stock to mother-in-law in exchange for mother-in-law's guarantee of note of debtor to his creditors constitutes fair consideration); *McNellis v. Raymond*, 287 F. Supp. 232, 238-39 (N.D.N.Y. 1968) (identity of interest between corporation and owner of corporation makes owner's payment of corporation's loans not fraudulent because there is

although a parent may have received no direct benefits in exchange for its guarantee, it may have received a reasonably equivalent value through indirect benefits.⁶⁰

4. *Comparing the Value Received to the Value Transferred.* Whether the value a debtor receives is reasonably equivalent to the value it conveys is an issue of fact.⁶¹ In an arm's-length transaction, the two values involved are often readily determinable.⁶² If the debtor is an affiliate⁶³ of the obligor, however, determining the value received by the debtor relative to the value of its guarantee is not so simple:⁶⁴ there usually will be no readily determinable market value for the guarantee, and often it will be difficult to compute in dollar terms the value of the indirect benefits that the debtor receives in return for the guarantee. Thus, any attempt to compare the actual values may only compound the uncertainties. In order to avoid such difficult and possibly uncertain calculations, rebuttable presumptions about the existence or nonexistence of a reasonably equivalent value should be established; these presumptions should be based upon the nature of the corporate relationship between the debtor and the obligor.⁶⁵

fair consideration), *aff'd in relevant part*, 420 F.2d 51, 53 (2d Cir. 1970); *In re Missionary Baptist Found.*, 24 Bankr. 973, 979 (Bankr. N.D. Tex. 1982) (good will generated by charitable contribution enough to constitute a reasonably equivalent value).

⁶⁰ The existence of these indirect benefits is an issue of fact. *See, e.g., Klein v. Tabatchnick*, 610 F.2d 1043, 1047 (2d Cir. 1979).

⁶¹ *See Rubin v. Manufacturers Hanover Trust*, 661 F.2d 979, 993-94 (2d Cir. 1981); *Gower v. Cohn*, 643 F.2d 1146, 1159 (5th Cir. 1981).

⁶² How the trier of fact decides what a reasonably equivalent value is in a particular case is beyond the scope of this comment. Courts have been reluctant to deem a minimum fixed percentage of fair market value a "reasonably equivalent value." *See, e.g., Gilman v. Preston Family Inv. Co. (In re Richardson)*, 23 Bankr. 434, 448 (Bankr. D. Utah 1982) ("Naturally, reasonable equivalence will depend on the facts of each case. In some cases, no less than 100 percent of fair market value may be a reasonable price."). As a result, courts have reached disparate results in determining whether the debtor received a reasonably equivalent value. *See, e.g., Durrett v. Washington Nat'l Ins.*, 621 F.2d 201, 203-04 (5th Cir. 1980) (57.7% of fair market value does not constitute a reasonably equivalent value); *Moore v. Gilmore (In re Gilmore)*, 31 Bankr. 615, 617-18 (E.D. Wash. 1983) (price somewhere between 63% and 76% of fair market value constitutes a reasonably equivalent value); *Perdido Bay Country Club Estates, Inc. v. Equitable Trust (In re Perdido Bay Country Club Estates, Inc.)*, 23 Bankr. 36, 39-40 (Bankr. S.D. Fla. 1982) (70% of fair market value constitutes a reasonably equivalent value); *Madrid v. Del Mar Commerce Co. (In re Madrid)*, 21 Bankr. 424, 426-27 (Bankr. 9th Cir. 1982) (67% of fair market value constitutes a reasonably equivalent value).

⁶³ *See supra* note 4.

⁶⁴ *See, e.g., Rubin v. Manufacturers Hanover Trust*, 661 F.2d 979, 993-94 (2d Cir. 1981) (remanding to the district court, with explicit instructions for determining value received, because of complexity of transaction and relationships at issue).

⁶⁵ *See Garrett v. Falkner (In re Royal Crown Bottlers)*, 23 Bankr. 28, 30 (Bankr. D. Ala. 1982) (suggesting a similar presumption); *see also Rosenberg, supra* note 8, at 238 ("The

When a debtor guarantees the obligations of its wholly owned subsidiary, there should be a rebuttable presumption that the debtor received a reasonably equivalent value through indirect benefits. Since the parent, as sole owner of the subsidiary, is entitled to all of its subsidiary's gain in value, an increase in the value of the subsidiary results in an increase of the same magnitude in the parent's assets. The expected net increase in the value of the subsidiary is the value of the parent's guarantee. Because this increase in value accrues to the parent's benefit by virtue of the corporate relationship between the parent and its subsidiary, the parent in this situation can be presumed to receive a reasonably equivalent value in exchange for its guarantee of its subsidiary's loan.

A similar analysis is appropriate when the debtor owns less than one hundred percent of the subsidiary. For example, if the debtor owns sixty percent of its subsidiary's stock, then it can be presumed that the parent will receive only sixty percent of the net increase in the value of the subsidiary.⁶⁶ This would also be true if it owned ninety, or thirty, percent of the obligor, and although the exact percentage of ownership necessary for the benefits received to be deemed less than reasonably equivalent will depend upon how the trier of fact defines "reasonably equivalent,"⁶⁷ two elements of uncertainty have been removed from the fact-finding process. Rather than requiring the fact-finder to ascertain two absolute figures before comparing for reasonable equivalence, this method allows the fact-finder to focus exclusively on the relationship between the figures.⁶⁸

The trustee could rebut the presumption that a reasonably equivalent value was received in two ways. First, the trustee could prove that the subsidiary was insolvent at the time the debtor incurred an obligation under the guarantee. If the subsidiary were insolvent, no benefits could flow to the debtor by virtue of the cor-

legal adequacy of the consideration [when the parent guarantees the loan of its subsidiary] cannot . . . be seriously questioned.").

⁶⁶ This method of calculating the benefit it receives from an increase in the value of its subsidiary is employed by many corporations in determining what they will receive from the increase in value of a partially owned subsidiary. *See, e.g., Dower v. Mosser Indus.*, 648 F.2d 183, 184 (3d Cir. 1981) (corporation would guarantee a loan to its subsidiary only if it could acquire 100% ownership because otherwise it would "share the benefits [of the loan] with minority shareholders who did not assume any risk").

⁶⁷ *See supra* note 62.

⁶⁸ Since the Code requires only that the parent own 20% of the subsidiary to be considered an affiliate of the subsidiary, 11 U.S.C. § 101(2)(B) (1982) (quoted *supra* note 4), reliance on the Code's definition of affiliate would be inappropriate.

porate relationship between the debtor and its subsidiary—any increase in the subsidiary's value would accrue only to the benefit of its creditors.⁶⁹

Even if the trustee succeeded in rebutting the presumption that a reasonably equivalent value had been received, the obligor could still prevail if it proved that the debtor reasonably expected to receive enough indirect benefits, from sources other than the corporate structure, to constitute a reasonably equivalent value.⁷⁰ For example, it might be shown that the debtor benefited from the guarantee because the subsidiary constituted its only source for an essential raw material, and the subsidiary would have been forced into liquidation without the proceeds of a new loan. This would reintroduce into the proceeding evidentiary complications concerning the existence of indirect benefits, but it would only be necessary if the debtor's subsidiary were insolvent or if the debtor did not own a large percentage of the subsidiary's stock.

If the debtor guarantees the debts of either its parent or a fellow subsidiary, there should be a rebuttable presumption *against* the existence of a reasonably equivalent value. Since the subsidiary would have no ownership claim against the obligor arising out of their corporate relationship, none of the increase in the obligor's net worth could accrue to the benefit of the debtor. Unless some direct consideration were paid, the obligor's position would be similar to that of the debtor who was the parent of the obligor where the trustee had rebutted the presumption in favor of a reasonably equivalent value. The obligor would bear the burden of demonstrating that the debtor could have been expected to receive enough indirect benefits to constitute a reasonably equivalent value.

CONCLUSION

Section 548(a)(2) empowers the trustee to set aside conveyances that decrease the net worth of the debtor and impair the rights of its creditors. In order to apply this provision properly, it must be recognized that the grant of a guarantee is a conveyance by the debtor solely for the benefit of the obligor. It is this implicit transaction between debtor and obligor that must be examined in

⁶⁹ This is because the parent is only the residual owner of the subsidiary. If the subsidiary is insolvent, any value accruing to the subsidiary by virtue of the guarantee would go toward satisfying the claims of the subsidiary's creditors; none of the gain would go to the parent.

⁷⁰ See *supra* note 59.

order to determine whether a fraudulent conveyance has occurred under section 548(a)(2).

Under this analysis, the debtor incurs an obligation when it becomes bound to guarantee the value given by the lender to the obligor. The value of this obligation equals the debtor's expected liability under the guarantee. If the debtor owns a substantial percentage of the obligor, there should be a rebuttable presumption that the debtor received a reasonably equivalent value in exchange for its guarantee.

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