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FRAUDULENT CONVEYANCE LAW AND LEVERAGED BUYOUTS: REMEDY OR INSURANCE POLICY?

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INTRODUCTION

Rules of liability influence behavior. Rewards encourage; penalties deter. Despite application in other areas of the law,[1] this axiom has received only limited attention in the context of levereged buyouts (LBOs) and fraudulent conveyances. The most influential commentary on the subject, Baird and Jackson's *Fraudulent Conveyance Law and Its Proper Domain*,[2] focuses on the risk that fraudulent conveyance law (with its constructive fraud provisions taking effect in specified circumstances) is subject to abuse. The result, the authors maintain, is deterrence of beneficial LBOs, inhibition of the market for corporate control, and lost efficiencies.

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1. *See, e.g.*, W. LANDES & R. POSNER, THE ECONOMIC STRUCTURE OF TORT LAW (1987); S. SHAVELL, ECONOMIC ANALYSIS OF ACCIDENT LAW (1987); R. POSNER, ECONOMIC ANALYSIS OF LAW (1986) (Economic analysis tests the assumption that man is a rational maximizer of his own interests who responds to incentives and penalties. For example, economists predict that increasing the severity of punishment or the likelihood of its being imposed will cause the criminal to substitute other activity for the criminal acts); C. VELJANOVSKI, THE NEW LAW AND ECONOMICS: A RESEARCH REVIEW (1982); R. POSNER, TORT LAW (1982); G. BECKER, THE ECONOMIC APPROACH TO HUMAN BEHAVIOR (1976) (especially Crime and Punishment: An Economic Approach); Coase, *The Problem of Social Cost*, 3 J. LAW & ECON. 1 (1960) (Coase assumes an absence of transactions costs and argues that, between two parties, each of whose property use interferes with the other's, the property use that ultimately prevails does not depend upon how the court imposes liability. Rather, the party whose property is used in the most productive capacity will pay the other party to discontinue use of the property.).

2. Baird & Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VANDERBILT L. REV. 829 (1985).

In fact, the *per se* desirability of LBOs is unproven and the deterrent effect of the statute is not well understood. This paper addresses these gaps. We begin by considering the general structure of fraudulent conveyance law and its potential applicability to LBOs. After reviewing the literature in support of the hypothesis that LBOs enhance creditors' welfare, we suggest that, in many instances, LBOs may have the reverse effect. We then examine assumptions concerning the deterrent effect fraudulent conveyance statutes have on LBOs, and conclude that the constructive fraud provisions do not necessarily lead to over deterrence of justified takeovers. Indeed, the reverse is true: absence of fraudulent conveyance remedies could under deter unjustified LBOs. We then propose guidelines for allocating liability among parties to the LBO. Finally, we look beyond liability rules and examine economic criteria for evaluating the wisdom of legal and economic policies that encourage unfettered LBOs.

I. LBOs and Fraudulent Conveyance Law: An Overview

In 1571 Parliament adopted the Statute of 13 Elizabeth[3] to protect creditors from elusive debtors who dodged their obligations by sham sales of assets to friends. In the paradigmatic case, the friends held the assets until the creditors relented or ceased to press their demands for judgment. The Statute, with modifications, survived the centuries and was adopted in the United States Bankruptcy Code.[4] The rule supporting avoidance of such transfers was also codified in numerous states through the Uniform Fraudulent Conveyance Act (UFCA)[5] and the Uniform Fraudulent Transfer Act (UFTA).[6]

With the wave of LBOs that has swept the American corporate economy in the last decade,[7] fraudulent conveyance law has taken on a new importance that could hardly have been

3. 13 ELIZ., ch. 5 (1571).

4. 11 U.S.C. § 548 (1988).

5. In Minnesota, the UFCA was codified at MINN. STAT. §§ 513.20-.32 (1986) until its repeal in 1987.

6. In Minnesota, the UFTA is codified at MINN. STAT. §§ 513.41-.51 (1988).

7. The approximate annual total dollar values of LBOs that took place from 1983 to 1988 are $4.5 billion, $18.8 billion, $18 billion, $46.6 billion, $35.8 billion, and $67 billion, respectively. *See* Cross, *Intangible Assets: Extra Comfort for LBO Lenders*, 23 MERGERS & ACQUISITIONS 46, 50 (1988); Vise & Mufson, *The Buyouts That Are Going Bust*, Wash. Post Nat'l Weekly Ed., Aug. 28, 1989, 8-9.

foreseen in 1571. Faced with occasionally floundering LBOs, creditors have invoked the centuries-old fraudulent conveyance statute to undo the leveraged deals and to recover their funds from LBO participants.[8] As might be expected, however, the sixteenth-century remedy is not well calibrated to the complexities of a commercial dispute arising from the failure of a modern-day LBO.

A. *The Typical LBO*

In a typical LBO transaction, potential buyers wish to purchase and manage an existing business, but they discover that their entrepreneurial appetites exceed their available capital. As a result, the buyers borrow heavily to purchase their intended target; hence, the label "leveraged buyout." The heavy debt load accompanying the purchase is secured by the assets of the target itself, which protects the lender from risks arising from the transaction. The United States Court of Appeals for the Third Circuit described the term "leveraged buyout" as:

> a shorthand expression describing a business practice wherein a company is sold to a small number of investors, typically including members of the company's management, under financial arrangements in which there is a minimum amount of equity and a maximum amount of debt. The financing typically provides for a substantial return of investment capital by means of mortgages or high-risk bonds, popularly known as "junk bonds."[9]

Perhaps the most distinctive feature of the leveraged buyout is that the purchasers invest very little equity capital. Instead, the purchasers pledge the assets of the acquired company as security for the acquisition debt.[10]

8. *See, e.g.*, Kupetz v. Wolf, 845 F.2d 842, 846 (9th Cir. 1988); United States v. Tabor Court Realty Corp., 803 F.2d 1288, 1307 (3d Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987); Wieboldt Stores, Inc. v. Schottenstein, 94 Bankr. 488, 499 (Bankr. N.D. Ill. 1988); Credit Managers Ass'n v. Federal Co., 629 F. Supp. 175, 179 (C.D. Cal. 1986); United States v. Gleneagles Investment Co., 565 F. Supp. 556, 585–86 (M.D. Pa. 1983), *aff'd sub nom.* United States v. Tabor Court Realty, 803 F.2d 1288 (3d Cir. 1986); *In re* Ohio Corrugating Co., 70 Bankr. 920, 925 (Bankr. N.D. Ohio 1987).

As a practical matter, fraudulent conveyance litigation is complex and expensive, and is undertaken by bankruptcy trustees in the relatively infrequent circumstance where the bankruptcy estate retains sufficient resources to pay for the litigation.

9. *Tabor Court*, 803 F.2d at 1292.

10. *See Kupetz*, 845 F.2d at 845–46.

A numerical example demonstrates the alignment of financial interests in a hypothetical LBO. Suppose a firm worth $10 million ("target") has $5 million in general creditor debt and no secured debt. Purchasers who wish to acquire the target put up $500,000 of their own money and borrow the $9.5 million balance from lenders, who are often high-risk venture capitalists. To protect themselves, the lenders take a security interest in the target's assets. As a result, the general creditors of the target (who could previously look to a $5 million equity cushion to secure the credit they had extended) now stand in line behind the lenders (who possess a higher priority secured interest). Equally important, the level of risk faced by the target rises significantly as its debt-to-equity ratio increases.

This hypothetical LBO transaction conjures up the specter of fraudulent conveyance. Like the hapless sixteenth-century creditors that Parliament sought to protect, the target's general creditors lose access to the target's previously available funds as the LBO lenders gain priority. Typically, general creditors do not participate in the LBO transaction, nor do they authorize the lender's extension of credit to the target. As a result of the reordering of creditors caused by the LBO, the added risk facing the managers of the newly leveraged target is not borne by the managers themselves, nor by the new or old shareholders, nor by the lenders who financed the deal. Rather, the transaction shifts the greater risk of operating the highly leveraged target to the general creditors.[11]

B. *Application of Fraudulent Conveyance Law to LBOs*

The fraudulent conveyance statutes—whether under the Bankruptcy Code or the two uniform enactments—seek to allow the general creditors a remedy in certain prescribed circumstances.[12] For purposes of discussion, the Bankruptcy Code provisions are used here as the illustrative paradigm.

The Code provides that the trustee-in-bankruptcy may avoid

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11. Some risk remains for equityholders, but this risk is reduced by spreading it to general creditors.

12. Statutory particulars differ, but the broad outlines of the three statutes are essentially similar. Statutory and case commentary included below is not intended to be a complete review of legal details; rather, this discussion is meant to provide text and context for the general reader. For a comparative discussion of the specific statutory elements, see Sherwin, *Creditors' Rights Against Participants in a Leveraged Buyout*, 72 MINN. L. REV. 449, 466–72 (1988).

any transfer accomplished by means of either actual or constructive fraud. Actual fraud exists where the debtor enters into a transaction "with actual intent to hinder, delay or defraud any entity . . . ."[13] The courts have identified certain "badges of fraud" that they accept as indicia of an actually fraudulent transaction.[14]

The constructive fraud provision of the Code is more commonly used because of the practical difficulties in proving actual intent to defraud. Because constructive fraud is a legal fiction used when actual intent to defraud cannot be adduced, the provision is also more controversial in the LBO context. This is a function of the provision's potential for over- or under-inclusiveness.

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13. 11 U.S.C. § 548(a).

14. Among the circumstances that give rise to an inference of fraud are:

> concealment of facts and false pretenses by the transferor, reservation by him of rights in the transferred property, his absconding with or secreting the proceeds of the transfer immediately after their receipt, a transfer for no consideration where the transferor and the transferee have knowledge of the claims of creditors and know the creditors cannot be paid, the existence of an unconscionable discrepancy between the value of property transferred and the consideration received therefor, the fact that the transfer was made to satisfy or secure a debt long since forgiven, the fact that the transferee was an officer or was an agent or creditor of an officer of an embarrassed corporate transferor, the creation by an oppressed debtor of a closely held corporation to receive the transfer of his property.

4 COLLIER ON BANKRUPTCY ¶ 548.02, at 548-39-44 (15th ed. 1989).

The bankruptcy court in *In re* Sergio, Inc., 16 Bankr. 898 (Bankr. D. Hawaii 1981), also provides a list of the objective indicia of fraud under § 548(a):

> a. The transferor is indebted or insolvent;
> b. The conveyance is general, *i.e.*, that the debtor's entire estate is diminished, thereby leaving him insolvent;
> c. Consideration for the conveyance is absent;
> d. The conveyance is secret and concealed;
> e. The conveyance is made to a family member or to one of close relationship;
> f. The conveyance is made while a suit against the debtor is pending or threatening;
> g. The transferee takes the property in trust for the debtor;
> h. The debtor remains in possession, reserves the use and benefit, and deals with the property as his own.

Id. at 908.

In *Tabor Court*, the court posited a relatively straightforward test under Pennsylvania's version of the UFCA: "[i]ntent to hinder, delay, or defraud creditors may be inferred from transfers in which consideration is lacking and where the transferor and the transferee have knowledge of the claims of creditors and know that the creditors cannot be paid." 803 F.2d at 1304 (citations omitted). In conventional business transactions involving large leveraged financing plans, the incidence of reported cases relying on theories of actual rather than constructive fraud is apparently relatively low. *See generally* 4 COLLIER ON BANKRUPTCY ¶ 548.02[5], at 548-38-48 (15th ed. 1989).

Under the Code,[15] the trustee may avoid any transaction if the consideration received by the debtor reflects "less than a reasonably equivalent value"[16] *and* if the transaction manifests

15. 11 U.S.C. § 548(a)(2).

16. Under the UFCA (previously in effect in Minnesota), "fair consideration" is the prerequisite parallel to equivalent value for the determination of constructive fraud in cases of undercapitalization, assumption of debts that will not reasonably be paid, or insolvency. "Fair consideration" is defined as that which is:

> given for property, or obligation,
>
> (1) When in exchange for such property, or obligation, it is a fair equivalent therefore, and in good faith, property is conveyed or an antecedent debt is satisfied, or
>
> (2) 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.

MINN. STAT. § 513.22 (1986).

The fact that the definition of fair consideration includes a good faith element poses a problem in constructive fraud cases: a constructive standard eliminates intent, but the good faith element comes close to reinjecting intent back into the statute. In fact, the Bankruptcy Code was, in part, an attempt to create an objective standard by eliminating the good faith issue. *See In re* Richardson, 23 Bankr. 434, 444 (Bankr. D. Utah 1982) (citations omitted). *Tabor Court* discusses three factors to be considered in determining good faith: 1. an honest belief in the propriety of the activities in question; 2. an absence of intent to take unconscionable advantage of others; and 3. an absence of intent to, or knowledge of the fact that the activities in question will hinder, delay, or defraud others. 803 F.2d at 1296.

In a more general sense, the trial court in *Credit Managers* found that the debtor did not receive fair consideration for its transfer where the debtor signed a note with a market value of $900,000 in return for "management services" provided by debtor's former parent. Credit Managers Ass'n v. Federal Co., 629 F.Supp. 175, 182 (C.D. Cal. 1986). The court observed that "this is probably the case in every leveraged buyout." *Id.* The court found that "as a matter of law, management services do not constitute fair consideration when they have no identifiable monetary value." *Id.* at 182.

For a broader test for fair consideration, see *In re* Anderson Industries, Inc., 55 Bankr. 922, 926 (Bankr. W.D. Mich. 1985) ("A determination of what constitutes fair consideration must be made from the creditors' standpoint and depends upon whether the conveyance renders the debtor execution-proof."). *Anderson* appears to state a broad rule that is not dictated by the UFCA. The more reasonable middle ground appears to be that taken by the court in *Tabor Court* which sets forth the criteria that constitute "a fair equivalent . . . in good faith." 803 F.2d at 1298. Whatever the specifics of the test, the determination will rest on the facts of the transaction.

Under the federal statutory provisions and the UFTA (which is presently in effect in Minnesota), the operative phrase "less than a reasonably equivalent value" is undefined. "Value," however, is defined in the Bankruptcy Code as "property, or satisfaction or securing of a present or antecedent debt of the debtor, but does not include an unperformed promise to furnish support to the debtor or to a relative of the debtor." 11 U.S.C. § 548(d)(2) (1988). Unfortunately, this definition of value does not illuminate the process of valuation inherent in making the comparative judgment contemplated by the phrase "less than reasonably equivalent value." For discussions of valuation, see *In re* Richardson, 23 Bankr. 434, 442 n.12 (Bankr. D. Utah 1982) (the notion of "value" subsumes the separate concepts of "market value," "value to the owner," "utility," "cost," "fair price," "intrinsic or justified one of three types of financial infirmities. The debtor must have: (1) been insolvent at the time of the transfer or become insolvent as a result of the transfer;[17] (2) been engaged or

price," and "normal value."). *See In re* Ohio Corrugating Co., 70 Bankr. 920, 927 (Bankr. N.D. Ohio 1987) (Plaintiff must show the absence of "an economic benefit to the entity incurring the obligation or making the transfer." Analysis of the transaction "must be directed at what the Debtor surrendered and what the Debtor received, irrespective of what any third party may have gained or lost.").

Transactional context determines how the court selects the proper method for studying value. In *In re* Join-In Int'l (U.S.A.), 56 Bankr. 555 (Bankr. S.D.N.Y. 1986), the court noted that "reasonably equivalent value" under § 548(a)(2) is a question of fact that cannot be determined according to a rigid test. *Id.* at 559–60.

> The court must consider *all* the factors of the transaction including, but not limited to, whether it was a close-out sale, the nature of the Plaintiffs' business at the time of sale, the cost of the goods to the Plaintiffs, the ability of the Plaintiffs to sell the inventory in question elsewhere and a reasonable profit to the purchaser on the resale of these goods.

Id. at 560. Because of transactional complexity in *Join-In*, the court declined to decide the issues of equivalent value or insolvency on summary judgment. *See id.*

Some courts have relied on the *Durrett* standard to determine whether the values are less than "reasonably equivalent." Durrett v. Washington Nat'l Ins. Co., 621 F.2d 201, 203 (5th Cir. 1980). The court did not set forth a generalized 70% standard, but declared that it had been unable "to locate a decision of any district or appellate court dealing only with a transfer of real property as the subject of attack under Section 67(d) of the [Bankruptcy] Act, which has approved the transfer for less than 70% of the market value of the property." For discussions of *Durrett*, see *In re* Jacobson, 48 Bankr. 497, 499 (Bankr. D. Minn. 1985) and *In re* Willis, 48 Bankr. 295, 300 (Bankr. S.D.N.Y. 1985), and compare with *In re* Richardson, 23 Bankr. 434, 437 (Bankr. D. Utah 1982) and *In re* Fargo Biltmore Motor Hotel Corp., 49 Bankr. 782, 788–90 (Bankr. N.D. 1985).

An additional question concerning "reasonably equivalent value" arises when the transfer at issue is made for the benefit of third parties. *See, e.g.*, *In re* Royal Crown Bottlers, Inc., 23 Bankr. 28, 30 (Bankr. N.D. Ala. 1982) ("[A]n insolvent debtor receives 'less than a reasonably equivalent value' where it transfers its property in exchange for a consideration which passes to a third party. In such case, it ordinarily receives little or no value.").

An exception exists to the rule that consideration on behalf of a third party does not convey reasonably equivalent value: where the debtor and the third party have an identity of interests, the consideration benefits the debtor. Rubin v. Manufacturers Hanover Trust Co., 661 F.2d 979, 991–92 (2d Cir. 1981). The *Rubin* court stated:

> [i]f the consideration given to the third person has ultimately landed in the debtor's hands, or if the giving of the consideration to the third person otherwise confers an economic benefit upon the debtor, then the debtor's net worth has been preserved, and § 67(d) [now the "less than reasonably equivalent value" test] has been satisfied—provided, of course, that the value of the benefit received by the debtor approximates the value of the property or obligation he has given up.

Id.

17. "Insolvent" is defined as:

> financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation, exclusive of —
>
> (i) property transferred, concealed or removed with intent to hinder, delay, or defraud such entity's creditors; and

about to engage in business with unreasonably small capital;[18] or (3) intended to incur or believed that it would incur debts beyond its ability to pay.[19] In challenging an LBO, the trustee

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

11 U.S.C. § 101(31)(A) (1988).

It seems that most courts will rely on book value as a starting point in determining the solvency of an entity and, when necessary, will discount book value appropriately to determine fair value. Going concern value and appraisal methods that reflect the business's cash flow are sometimes factored into this determination. *See In re* Roco Corp., 701 F.2d 978, 983 (1st Cir. 1983) (historical cost balance sheet approximated the fair value of the debtor's assets); *In re* Ohio Corrugating Co., 91 Bankr. 430, 437 (Bankr. N.D. Ohio 1988) (Fair value is "the amount of money the debtor could raise from its property in a short period of time, but not so short as to approximate a forced sale . . . ." *Id.* at 436-37. The court used the debtor's balance sheet for the transaction month "as a basis upon which to determine the Debtor's solvency." *Id.* at 437); *see also* Kupetz v. Continental Ill. Nat'l Bank and Trust Co. Chicago, 77 Bankr. 754, 758 (Bankr. C.D. Cal. 1987) (The court used a beginning book value of $2.7 million, which the court adjusted upward to $3.0 million after discussing appraised values of various assets.).

The UFCA, as formerly adopted in Minnesota, provides:

> Every conveyance made and every obligation incurred by a person who is or will be thereby rendered insolvent is fraudulent as to creditors without regard to the person's actual intent if the conveyance is made or the obligation is incurred without a fair consideration.

MINN. STAT. § 513.23 (1986).

The UFCA defines insolvency as follows: "[a] person is insolvent when the present fair saleable value of the person's assets is less than the amount that will be required to pay probable liability on the person's existing debts as they become absolute and matured." MINN. STAT. § 513.21. One commentator has observed that this standard resembles "the traditional equity test of insolvency, which focuses on a debtor's ability to pay debts in the ordinary course of business. It introduces additional variables to the inquiry, including the nature of particular liabilities and the resources necessary to make timely payment." *See* Sherwin, *supra* note 12, at 498–99 (citations omitted).

18. Neither the Bankruptcy Code nor the UFCA define "capital" nor the phrase "unreasonably small capital." As with the other requirements of these statutes, the question of undercapitalization has been determined to be "a question of fact that must be ascertained on a case by case basis." Credit Managers v. Federal Co., 629 F. Supp. 175, 183 (citing Wells Fargo Bank v. Desert View Bldg. Supplies, Inc., 475 F. Supp. 693 (D. Nev. 1978), *aff'd*, 633 F.2d 225 (9th Cir. 1980)). The bankruptcy court in Minnesota has assumed, without deciding, that the term "capital" as used in the Bankruptcy Code could be interpreted broadly to include "the unadjusted value of all assets, however encumbered . . . ." *In re* Jacobson, 48 Bankr. 497, 499 (Bankr. D. Minn. 1985). For discussion of undercapitalization, see *Credit Managers*, 629 F. Supp. at 184–86 (court evaluates reasonableness of LBO decision when made, and evaluates it according to projected sales data, gross profit margins and inventory turnover, accounts receivable collections periods, and financial ratios). *See also* New York Credit Men's Adjustment Bureau, Inc. v. Adler, 2 Bankr. 752, 756 (Bankr. S.D.N.Y. 1980) (evidence that the debtor was "constantly" behind on paying bills supports finding of undercapitalization).

19. Under both the UFCA and the United States Bankruptcy Code, the plaintiff

(and/or a creditor under state statutes) may avoid the transaction against either the seller of the target or the lender who extended credit for the buyout.[20]

II. Is Fraudulent Conveyance Law Appropriate for LBOs?: Ancient Statutes Meet Modern Transactions

A. *The View of the Courts*

Some defendants argue that LBOs are simply outside the ambit of fraudulent conveyance law: drafters of the sixteenth-century statutes codified in 1930s America could not have contemplated sophisticated finance mechanisms of the 1980s, and therefore such statutes should not be applied to modern-day LBOs. This argument assumes that the sole purpose of the statute is superannuated: fraudulent conveyance law was designed not for LBOs, but to keep debtors from sheltering their property by conveying it to friends for a fraction of its ordinary value and reclaiming the property after they and their creditors settle their differences.

Defendants also argue that allowing creditors to challenge LBOs using fraudulent conveyance law threatens the use of modern LBOs and deprives the business world of an important tool in the effective management of businesses and takeovers. They maintain that, as a result, the law hamstrings the efficient market for corporate control.

Courts respond to these arguments in different ways, but have generally made the threshold determination that LBOs

must show that the debtor actually intended to incur debts that exceeded his ability to pay. Significantly, this statutory section uses an active verb phrase ("intended to incur"), rather than a passive verb phrase ("was insolvent" or "was engaged"), which underscores the intent element.

To prove a case under this section, a leading commentator suggests that it is sufficient to demonstrate that the transaction was contemporaneous with the belief that the debtor's creditors would be injured by the transfer at issue. 4 Collier on Bankruptcy ¶ 548-58 (15th ed. 1989). *See Kupetz*, 77 Bankr. at 763-67 (plaintiff/debtor failed to present evidence indicating that the debtor incurred debts that he knew he would be unable to pay as they became due).

20. Although buyers of the target companies are also theoretically vulnerable to liability in fraudulent conveyance litigation, they are frequently insolvent and, practically speaking, are not usually sued. *See Ohio Corrugating*, 91 Bankr. at 434, and cases cited therein. Most fraudulent conveyance litigation regarding LBOs is directed against lenders and sellers. For simplicity's sake, therefore, we do not discuss buyer liability in fraudulent conveyance lawsuits.

are subject to the fraudulent conveyance statutes. Definitionally, both the UFCA and the Bankruptcy Code are broadly framed to encompass LBOs.

The prohibition against fraudulent transfers, enumerated in section 548 of the Bankruptcy Code, includes any "transfer." The Code defines "transfer" as "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest . . . ."[21] Similarly, the UFCA, as enacted in Minnesota, defines "conveyance" as including "every payment of money, assignment, release, transfer, lease, mortgage or pledge of tangible or intangible property, and also the creation of any lien or encumbrance."[22] The statutory definitions, therefore, may not explicitly include LBOs, but they show a flexibility of purpose and a breadth of scope that appear inconsistent with a narrow application of the statute.

A strong argument can also be made that definitional narrowing of the statute's application is the proper domain of the legislatures, not the courts. The bankruptcy court in *In re Kaiser Steel Corp.*[23] asserted, "the fact that [a law] has been applied in situations not expressly anticipated by Congress does not demonstrate ambiguity. It demonstrates breadth."[24] The court in *United States v. Tabor Court Realty Corp.* declared that "[i]f the UFCA is not to be applied to leveraged buyouts, it should be for the state legislatures, not the courts, to decide."[25] The court in *In re Ohio Corrugating Co.* drew on the structure of the statute itself to show that the statute was intended to reach beyond traditional scenarios of creditor avoidance:

> If it had been intended that fraudulent conveyance law be applied only to situations where the debtor attempts to place his property out of the reach of creditors, the constructive fraud provisions would have been unnecessary, since, theoretically, the actual fraud provisions would cover

21. 11 U.S.C. § 101(48). *See also Ohio Corrugating*, 70 Bankr. at 925–26.

22. MINN. STAT. § 513.20 (1986).

23. 87 Bankr. 154, 161 (Bankr. D. Colo. 1988).

24. *Id.* (citations omitted).

25. United States v. Tabor Court Realty Corp., 803 F.2d 1288, 1297 (3d Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987).

those situations.[26]

Beyond the specific statutory definitions and the debate over judicial prerogatives, it makes economic sense to use fraudulent conveyance law to challenge LBOs that are constructively fraudulent. The statutes create a remedy for unsuspecting general creditors on whom uncompensated risk is bestowed by lenders and sellers that have assembled the LBO. The application of the law requires careful consideration, however, because the statutes speak only in terms of debtors and creditors, as do most commentators. Indeed, Professors Baird and Jackson wryly observe that "[a] firm that incurs obligations in the course of a buyout does not seem at all like the Elizabethan deadbeat who sells his sheep to his brother for a pittance."[27] Yet the alignment of parties in a LBO needs to be articulated more specifically than the simple bifurcation between debtors and creditors allows. The category of "creditors" includes the first-priority secured lenders who have bankrolled the transaction, along with the general creditors who enjoy, at best, a secondary priority. On the debtor's side, the target corporation stands alone, usually having received no consideration in exchange for the added burden of its debts assumed as part of the LBO. In the shadows stands the seller, who has received whatever purchase price the managers have cobbled together from their own pockets and from their venture-capital lenders.

Courts that apply fraudulent conveyance law to LBOs according to the terms of the statute correctly recognize that fraudulent conveyance law offers a flexible remedy where the lender and the shareholder—old *and* new—shift the risk of operation and, due to the leverage, add an increment of risk to the target and its general creditors. To answer Baird and Jackson, the target firm may not at all reflect the deadbeat depicted in their tableau, but may in fact wind up as a sacrificial lamb. The former controlling shareholders play the rapscallion, the lender the role of the brother. And the general creditors get fleeced.

The risk of unbridled application of fraudulent conveyance

26. *In re* Ohio Corrugating Co., 70 Bankr. 920, 925 (Bankr. N.D. Ohio 1987). *See also In re* Vadnais Lumber Supply, Inc., 100 Bankr. 127, 134–35 (Bankr. D. Mass. 1989); Wieboldt Stores, Inc. v. Schottenstein, 94 Bankr. 488, 499–500 (Bankr. N.D. Ill. 1988); *In re* Ohio Corrugating Co., 91 Bankr. 430, 433 (Bankr. N.D. Ohio 1988).

27. Baird & Jackson, *supra* note 2, at 852.

law to LBOs, of course, is the risk that lenders and sellers will become guarantors of risky transactions. As discussed in the following section, the upshot of such a guaranty arrangement may be the marginal deterrence of many promising, but risky, transactions that would otherwise take place.

B. *The Deterrent Effect of Fraudulent Conveyance Law*

Not only may fraudulent conveyance law require some tailoring to fit modern transactions, according to opponents, but the economic wisdom of applying it to LBOs is an unsettled issue. The principal academic opponents to its use are Professors Baird and Jackson.[28] They argue that the constructive fraud features of fraudulent conveyance law are overbroad and risk deterring desirable LBOs. Moreover, they assert that fraudulent conveyance law is redundant because parties affected by LBOs will find it easier to negotiate the protections of fraudulent conveyance law *into* contracts rather than to negotiate the excesses of fraudulent conveyance law *out of* contracts.

Baird and Jackson's main concern about using fraudulent conveyance law to avoid LBOs that hurt creditors *ex post* is that some LBOs that benefit creditors *ex ante* will not take place.[29] They argue that creditors will negotiate contractual provisions to allow the use of fraudulent conveyance law if it is to their advantage.[30] This approach arguably protects all creditors, even those not negotiating protective provisions, because the debtor's adherence to the provisions will restrict the formation of risky LBOs that injure creditors.[31]

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28. *See* Baird & Jackson, *supra* note 2.

29. *Id.* at 854-55.. In an uncertain world, economic behavior is shaped by expectations, or *ex ante* assessments, of future events. For example, businesses make investment decisions on the basis of expectations, or *ex ante* beliefs about the future performance of different projects. Because the future does not always turn out as expected, the *ex post* realization of an event may differ from the *ex ante* assessment. For instance, a construction project may not be as profitable as anticipated because Congress unexpectedly changes tax law or because a union turns down a wage offer that management thought would be accepted.

30. *Id.* at 835-36. Note, *Fraudulent Conveyance Law and Leveraged Buyouts*, 87 COLUM. L. REV. 1491, 1511 (1987) argues that creditors would negotiate a prohibition on LBOs. This misses the mark; presumably not all LBOs would be restricted, only the ones that are perceived to hurt creditors.

31. This assumes that all creditors would be affected similarly by a LBO and all creditors would benefit by using fraudulent conveyance law. If a creditor is strong enough to insert contractual provisions, it might also be strong enough to be the only

By contrast, if the statute applied uniformly to LBOs, creditors would have to agree unanimously to exclude the use of fraudulent conveyance law as a remedy. (In actuality, transactions costs are likely to prevent such a unanimous agreement.) If creditors did agree to ban the use of the statute, trustees in bankruptcy would still be able to use fraudulent conveyance law. As a result, general application of fraudulent conveyance law could deter some LBOs that should take place merely because they increase the expected welfare[32] of the parties involved. This can be termed a "Type I" error.[33]

Why might LBOs benefit creditors? Because LBOs might increase the target company's expected income (for reasons discussed in the following section),[34] and because general creditors are likely to negotiate to receive part of the expected incremental income.[35] Creditors would bring suit using fraudulent conveyance law only if a deal went bad later. Therefore, to Baird and Jackson, the threat of fraudulent conveyance law gives creditors the luxury of sharing increases in realized income, while bearing no realized losses. As a result, sellers and lenders would be less willing to enter into LBOs because they

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one to benefit from invoking the provisions, perhaps by positioning itself as the first to be paid off when a LBO fails.

32. "Welfare" in this context is equivalent to the utility or well-being of the party considered. Welfare does not increase in proportion to income if a party is risk-averse. That is, a risk-averse creditor might be willing to accept a certain income of $100 over a gamble with expected income of $110.

33. A "Type I" error is a standard statistical concept that, in this context, refers to the inadvertent exclusion or destruction of a desirable category of behavior when a rule or policy is applied. A hypothetical case is illustrative. Suppose there are two categories of LBOs: (A) those that increase creditors' welfare *ex ante*, and (B) those that decrease creditors' welfare *ex ante*. Assuming that LBOs are always beneficial for the other parties directly involved in the LBO, all parties would agree beforehand that LBOs in category (A) should always take place. If fraudulent conveyance law can be used whenever LBOs go bad *ex post*, however, then marginal LBOs in category (A) will not take place. These rejections of "good" LBOs correspond to the statistical concept called "Type I" errors. If, on the other hand, fraudulent conveyance law can never be used for LBOs, another problem can occur. Creditors would protest LBOs in category (B), but might not be able to prevent them from occurring. If fraudulent conveyance law cannot be applied to LBOs, there may be no remedy for the injured creditors. These acceptances of "bad" LBOs correspond to a statistical concept called "Type II" errors.

34. LBOs, however, are also likely to increase the probability that general creditors might not get paid because the newly acquired debt will create a greater interest burden for the target company.

35. This arrangement results because the benefits from voluntary exchange tend to be shared. Economists call this the "gains from trade."

alone would bear the risk of failures but must share all the gains. Baird and Jackson claim that this asymmetric sharing of risks and gains could inhibit LBOs that actually increase creditors' expected welfare.[36]

III. Would Barring Fraudulent Conveyance Law Underdeter LBOs? Counterarguments to Baird and Jackson

Baird and Jackson's argument rests on a key assumption: LBOs may increase creditors' welfare *ex ante*. Yet Baird and Jackson overlook the fact that, in some circumstances, LBOs might never increase creditors' welfare *ex ante*. Thus, Baird and Jackson do not contemplate the occurrence of "Type II" errors.[37] These errors imply that, if fraudulent conveyance law cannot be invoked in LBO cases, some creditors may be hurt *ex ante*. Contrary to Baird and Jackson's assumption, some LBOs might be expected to injure creditors, particularly LBOs occurring in industries characterized by many small general creditors and in transactions involving involuntary creditors. Adverse effects of LBOs on creditor welfare occur for three reasons.

First, LBOs may not necessarily increase the target's expected income, but may simply cause wealth transfers through the abrogation of implicit or relational contracts. The price of a target's stock generally rises in the takeover, which may signify that investors expect the target to be more profitable in the future. On the other hand, the increased stock price may simply reflect an immediate transfer of wealth from general creditors to stockholders. Takeovers in general are associated with the breaking of implicit long-term contracts between "stakeholders" in a target company, including general creditors, employees, other non-equityholders, and shareholders. Breaking implicit contracts falls under Professor Muris's definition of opportunistic behavior, which occurs "when a performing party behaves contrary to the other party's understanding of their contract, but not necessarily contrary to the agreement's explicit terms, leading to a transfer of wealth

36. This conclusion, of course, assumes that increased expected income implies increased expected welfare. This assumption will not necessarily hold for creditors that eschew increased risk.

37. *See supra* note 33.

from the other party to the performer . . . ."[38] The breaking of such contracts injures general creditors, not only because creditors inadvertently transfer wealth to shareholders, but also because contract breach could force more explicit, costlier contract-writing in the future. As Professor Muris notes, "the threat of opportunism increases transactions costs because potential opportunists and victims expend resources perpetrating and protecting against opportunism."[39]

Second, even if the target's increased stock price signifies in part that the target's income is expected to rise, small creditors and involuntary creditors may not be in a position to bargain for a cut of the higher profit.

Third, even if the target's expected income increases and creditors can acquire a piece of it, general creditors' expected income is riskier after a LBO. As section II noted, shrewd equityholders can use LBOs to shift risk away from themselves and to general creditors. General creditors may be risk-averse, so that, even if general creditors' expected income increased after a LBO, their expected welfare would fall because the risk associated with the income also increases.

The following paragraphs review the literature on the performance of target firms before and after a LBO. The three reasons for a potential decrease in creditors' expected welfare are then examined in greater detail.

A. *Do Takeovers Improve a Target's Performance?*

Takeovers (including LBOs) are often justified by citing the gains in efficiency that the new business yields.[40] This greater efficiency might be manifest through economies of scale or

38. *See* Muris, *Opportunistic Behavior and the Law of Contracts*, 65 MINN. L. REV. 521, 521–22 (1981).

39. *Id.* at 524.

40. *See, e.g.*, Jarrell, Brickley, & Netter, *The Market for Corporate Control: The Empirical Evidence Since 1980*, 2 J. ECON. PERSP. Winter 1988, at 49, 58 (corporate transactions produce a beneficial reshuffling of assets); Jensen, *Takeovers: Their Causes and Consequences*, 2 J. ECON. PERSP. Winter 1988, at 21, 29 (the tendency of debt to increase efficiency has largely been ignored); Poulson & Jarrell, *Motivations for Hostile Tender Offers and the Market for Political Exchange*, 4 CONTEMP. POL. ISSUES 30, 32 (1986) (suggesting that corporate raiders serve an important role in making firms more efficient); Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1 (1982); Jarrell & Bradley, *The Economic Effects of Federal and State Regulations of Cash Tender Offers*, 23 J.L. ECON. 371 (1980) (authors assert that takeovers produce efficient management).

scope in operation.[41] Jarrell and Bradley[42] say that stock prices are bid up when bidders for targets acquire information about a more productive use of the target's resources; stock values rise in anticipation of the commitment of resources to the new uses. Jensen[43] argues, for example, that incumbent managers might have invested in inefficient projects if they had "free cash flow," so that, with these investments, incumbent managers might expand their power bases without increasing return to capital. Potential managers could take over such a target and abort the inefficient projects, thereby increasing the return to stockholders.[44] Easterbrook and Fischel[45] suggest that bidders should be treated as patent holders of information about increased productivity and that laws should be structured to allow bidders to take advantage of the information quickly.

Increased efficiency in a firm's performance should, all else equal, lead to larger expected net income for the target company by reducing costs, increasing productivity, or both. This increased income could cause the target firm to develop a greater willingness or a greater ability to pay creditors, or both. Therefore, creditors might expect more income from bought-out targets if LBOs increase efficiency.

Yet the question remains: Do takeovers increase efficiency and thereby increase the expected income of targets? The empirical evidence is mixed. Many studies point to the increase in the price of a takeover target's stock as an indicator of increased efficiency.[46] The increase in price could, however,

41. For targets that go private, greater efficiency can also come about through reduced costs of compliance with the SEC and elimination of principal-agent problems caused by diverse ownership and management. *See* Baird & Jackson, *supra* note 2, at 853–54; Maloney & McCormick, *Excess Capital, Cyclical Production, and Merger Motives*, 31 J.L. ECON. 321, 327 (1988); Halpern, *Mergers and Acquisitions*, 38 J. FIN. 297, 298–301 (1983); *see also* Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980); Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 31 J. FIN. 305 (1976); A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932) (discussing principal-agent problems associated with business management in which managers are not owners).

42. Jarrell & Bradley, *The Economic Effects of Federal and State Regulations of Cash Tender Offers*, 23 J.L. ECON. 371, 382 (1980).

43. Jensen, *Takeovers: Their Causes and Consequences*, 2 J. ECON. PERSP. 21, 28–29 (1988).

44. One might question why managers would engage in a practice that would encourage their own ouster.

45. Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1, 16 (1982).

46. *See, e.g.*, Lehn & Poulson, *Sources of Value in Leveraged Buyouts*, in PUBLIC POLICY

have nothing to do with rising efficiency; it might simply signal a wealth transfer to the target company's selling stockholders from other parties affected by the transaction, including general creditors. Some authors[47] claim that the gains to shareholders are not offset by losses to other parties, while others[48] argue that empirical evidence does not clearly show gains in efficiency. Caves[49] cites a British study that shows post-merger performances are not significantly better than pre-merger performances, and that transition costs wipe out any gains that occur.[50]

If the entire increase in the target's stock price is simply a wealth transfer, takeovers do not enhance efficiency. Even if only part of the increase is attributable to a wealth transfer, general creditors can lose money. The net wealth effect from an LBO on general creditors is detrimental if their initial wealth loss exceeds the benefits received from the target's increased efficiency.

TOWARD CORPORATE TAKEOVERS (M. Weidenbaum & K. Chilton, eds. 1987); Jarrell & Poulson, *Shark Repellents and Stock Prices: The Effects of Antitakeover Methods Since 1980*, 19 J. FIN. ECON. 127, 154–55 (1987); Easterbrook & Jarrell, *Do Targets Gain from Defeating Tender Offers?*, 59 N.Y.U. L. REV. 277, 290–92 (1984) (business managers who defeat tender offers significantly harm shareholders to the extent of at least 15% of their equity); DeAngelo, DeAngelo & Rice, *Going Private: Minority Freezeouts and Stockholder Wealth*, 27 J. LAW ECON. 367, 400 (1984) ("gains sharing hypothesis:" increase in wealth of public stockholder within two days of initial offer); Bradley, Desai & Kim, *The Rationale Behind Interfirm Offers: Information or Synergy?*, 11 J. FIN. ECON. 183 (1983); Jensen & Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5 (1983); Jensen, *Takeovers: Their Causes and Consequences*, 2 J. ECON. PERSP., Winter 1988, at 21, 28–46 (LBOs encourage cash payouts to shareholders).

47. *E.g.*, Asquith & Kim, 37 J. FIN. 1209 (1982); Jensen, *supra* note 46, at 22.

48. *E.g.*, Scherer, *Corporate Takeovers: The Efficiency Argument*, 2 J. ECON. PERSP., Winter 1988, at 69 ("Some takeovers enhance economic efficiency, some degrade it, and the balance of effects is most likely a close one."); Weidenbaum & Vogt, *Takeovers and Stockholders: Winners and Losers*, 24 CAL. MGMT. REV. 157 (1987) (the market inefficiency protects the interests of shareholders); Browne & Rosengren, *Merger Boom: An Overview*, NEW ENG. ECON. REV., Mar.–Apr. 1988, at 22, 24 (citing Ravenscraft, *The 1980's Merger Wave: An Industrial Organization Perspective*, PROCDGS. OF CONF. SER. 31, FED. RES. BK. BOSTON (1987)); Fisher & Lande, *Efficiency Considerations in Merger Enforcement*, 71 CAL. L. REV. 1580 (1983) (managers do not always capitalize on opportunities for increased efficiency).

49. *Effects on Mergers and Acquisitions on the Economy: An Industrial Organization Perspective*, PROCDGS. OF CONF. SER. 31, FED. RES. BK. BOSTON (1987).

50. *Id. See also* Summers, *LBO Debt and Taxes*, ACROSS THE BOARD 53, 54 (1989) (Summers also states that apparent increases in the profitability of post-merger firms might result from decreases in R & D expenditures).

B. *Reasons Why an LBO May Not Improve Creditors' Welfare*

1. *Implicit Contracts Between the Target and Its Creditors*

Some or all of the putative gains to shareholders in a takeover might flow from a change in the nature of the contracts between the target and its business contacts. A target firm and its creditors are bound by contractual arrangements, explicit and implicit. Explicit contracts are collections of terms that govern relations between the parties generally. Questions of detail under such contracts are usually left to a good-faith cooperative effort between the parties.

Professors Shleifer and Summers,[51] Shleifer and Vishny,[52] and Summers[53] argue that ongoing relationships between shareholders and "stakeholders" in a corporation constitute implicit contracts.[54] Stakeholders include general creditors and workers. Some contracts are implicit because the parties cannot foresee all future contingencies to be included in an explicit contract.[55] Professors Goetz and Scott define a contract as implicit or relational

> to the extent that the parties are incapable of reducing important terms of the arrangement to well-defined obligations. Such definitive obligations may be impractical because of inability to identify uncertain future conditions or because of inability to characterize complex adaptations adequately even when the contingencies themselves can be identified in advance.[56]

Implicit contracts are typically long-term so that stakeholders will develop "relation-specific" capital investments. In other words, the duration of implicit contracts encourages investment in specific resources designed to further the aims of the contracting parties. For example, a manufacturer of fancy

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51. Shleifer & Summers, *Breach of Trust in Hostile Takeovers*, in CORPORATE TAKEOVERS 33, 37–38 (A. Auerbach ed. 1988).

52. Shleifer & Vishny, *Management Buyouts as a Response to Market Pressure*, in MERGERS AND ACQUISITIONS 87, 97–98 (A. Auerbach ed. 1988).

53. *See* Summers, *supra* note 50, at 55.

54. This point is made more generally by Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937).

55. *E.g.*, White, *The Corporate Bankruptcy Decision*, 3 J. ECON. PERSP., Spring 1989, at 129, 132 (Trade credit loans are either too small or too short-term to make arranging a security interest worthwhile. Other claims, such as tort claims, are involuntarily unsecured.).

56. Goetz & Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089, 1091 (1981).

bath salts for sale to an exclusive department store might invent a special packaging machine tailored to its buyer's specifications, and subsequently make a large capital investment in the machine to solidify its supply relationship with the store.

Given the absence of remedial recourse in an implicit contract, it might initially appear to be in a company's best interest to enter into implicit contracts, reap the benefits of the other party's performance, and then renege on its part of the deal, leaving the partner with no remedy. But implicit contracts are repeated games. Companies realize that, if they acted this way, they would earn a reputation for reneging and would be unable to find new partners to engage in further implicit contracts. Professor Muris recognizes that the risk of a bad reputation might deter some opportunistic acts when implicit contracts are present.[57] By using implicit contracts, both parties benefit from the savings of negotiation, information gathering, and other transactions costs. Trust economizes.

Shleifer and Summers point out that bidders pay huge premiums for target stock acquired in hostile takeovers at least partly because new managers believe they can repudiate implicit contracts with impunity. Original managers are willing to pay a portion of the bath salts maker's amortized fixed costs because the target benefits from the customized packaging. New managers, however, know they can cut back the price paid to the manufacturer to cover only the manufacturer's variable costs, because the bath salts maker has no use for his specialized machine other than packaging his product to the target's specifications. Thus, creditors' net income might be lowered by a LBO because new management repudiates implicit contracts. Although original management might have been expected to honor the implicit contracts, they are ousted in a hostile takeover and the shareholders can dump the contract (through the new managers), transferring wealth from stakeholders to themselves.[58]

Professors Goetz and Scott describe the delicate balance inherent in an implicit contract between a manufacturer and a distributor:

> A more substantial problem exists when specialized invest-

57. Muris, *supra* note 38, at 527.
58. The takeover is a surprise, or stakeholders are likely to have tried to obtain explicit contracts.

> ments yield deferred returns. For example, the manufacturer often will agree to compensate the distributor at a standard rate over the entire expected life of the agreement. Thus, during the initial training period, the distributor will be "borrowing" against his future sales capacity in order to finance his human capital investment. A reciprocal analysis would apply where the distributor has invested in physical capital—equipment, inventory, etc.—that cannot be amortized completely during the term of the contract. In both cases, the financing of specialized investments creates asymmetrical vulnerability to the threats of dissolution for one bargainer or the other at different times during the life of the relationship.[59]

A LBO provides one means of dissolving an implicit contract: new management is under no obligation to fulfill implicit agreements made by old management.

It is plausible that implicit contracts are broken even in friendly takeovers, provided that incumbent management is compensated sufficiently for betraying stakeholders' trust.[60] Walkling and Long[61] report tantalizing results in support of this hypothesis. Managers with large holdings of their firm's stock are less likely to oppose takeovers than managers with small holdings. One might infer that managers are not averse to losing their jobs and breaking implicit contracts if they benefit enough (through passive investment income) from a buyout.

The repudiation of implicit contracts is most likely to occur in LBOs for industries characterized by many small general creditors. Implicit long-term contracts flourish in industries such as wholesale food distribution or retail sales. Companies in such industries depend on numerous small trade creditors with whom they develop long-term relationships. It is not generally cost-effective for general creditors to write explicit contracts with these companies. Thus, in industries with many small general creditors, it is likely that LBOs sever implicit contracts and that stock price premiums reflect a transfer of wealth from creditors to equityholders.

59. Goetz & Scott, *supra* note 56, at 1101-02.

60. For instance, departing managers may receive golden parachutes.

61. Walkling & Long, *Agency Theory, Managerial Welfare, and Takeover Bid Resistance*, 15 RAND J. ECON. 54 (1984).

2. *Insufficient Bargaining Power of Creditors*

An increase in the price of the target's stock may reflect increased efficiency, and therefore increased expected income for the target, as well as wealth transfers from stakeholders to shareholders. Nevertheless, stakeholders, including general creditors, may not benefit. In industries characterized by many small general creditors, single creditors may lack the bargaining power to tap into the target's increased future income. Single creditors will have little say over contractual terms in a competitive market. If a creditor demands better terms from a bought-out target, the target can simply go to another creditor.[62] If creditors are injured by the initial repudiation of implicit contracts and cannot bargain for better terms, their expected net income will actually fall as a result of the LBO, even if the target's expected net income rises.

3. *Risk Aversion of Creditors*

Even if a target's stock price premium reflects increased future income and if creditors have sufficient bargaining power to extract part of the increase, more income to creditors may mean little to them because it is accompanied by greater risk. The leveraged nature of the transaction means that the target firm's fixed payments increase because the company has more debt to service than before. The target company has lost the discretion to suspend some payments (such as dividends) when times are bad, so there is more risk associated with the target's increased income. Moreover, general creditors assume a lower priority status behind the LBO financiers.

For general creditors, the increased risk might weigh more heavily than the increased expected income. A small farmer who sells tomatoes to a grocer, or an individual artist who designs costume jewelry for sale to a department store, is likely to be risk-averse and is unable to diversify away risks of business. In welfare terms, therefore, risk may outweigh income. A riskier, albeit possibly larger, stream of income flowing to the general creditor may generate lower welfare to a risk-averse creditor than the smaller, more certain income stream avail-

62. If LBOs cause many firms in an industry to become more efficient, creditors may eventually be able to get better deals because competition will occur on the buyers' side of the market as well.

able before the LBO.[63]

C. Summary: Type I Versus Type II Errors

Baird and Jackson concentrate on problems caused by the application of fraudulent conveyance law to LBOs as a *per se* rule.[64] That is, they worry about overdeterrence: welfare-enhancing LBOs may not take place if fraudulent conveyance law is applied too broadly.[65] The previous paragraphs addressed the converse case, in which welfare-decreasing LBOs could take place if the constructive fraud provisions are not applied at all. In industries characterized by numerous small general creditors, the presumption that a LBO might increase creditors' expected welfare is unlikely to hold. Expected income would improve for creditors only if an increase in the target's income compensated creditors for the initial income loss caused by repudiation of implicit contracts and for the costs of writing explicit contracts that they would incur in the future.[66] Creditors' expected welfare would increase only if creditors were compensated for the increased risk as well.

If LBOs could either increase or decrease the welfare of general creditors *ex ante*, the argument over the application of fraudulent conveyance law rests upon the relative magnitudes of Type I and Type II errors. As Baird and Jackson note, if one can only contract out of fraudulent conveyance law, some LBOs that increase creditors' expected welfare may not take place because transactions costs deter creditors from joining forces.[67] Even if creditors assemble to contract out of the law,

63. Bruner, *The Use of Excess Cash and Debt Capital as a Motive for Merger*, 23 J. FIN. QUANTITATIVE ANALYSIS 199 (1988), points out, however, that some mergers could lower the risk of the income stream for merged parties if there is negative covariance between the cash flows of the two. In LBOs, then, it is possible that the increased risk of nonpayment for creditors associated with the greater debt burden could be offset in part by synergy in cash flows for acquirer and target. However, it is also likely that overall risk increases when mergers occur. Langetieng, *An Application of a Three-Factor Performance Index to Measure Stockholder Gains from Merger*, 6 J. FIN. ECON. 365 (1978).

64. Baird & Jackson, *supra* note 2, at 831.

65. *Id.* "If it is not, one should conclude either that the *per se* rule is unavoidably overbroad or that the extension of the rule is unjustified." *Id.*

66. *See* Carlson, *Leveraged Buyouts in Bankruptcy*, 20 GA. L. REV. 73, 119 n.147 (1985) (Carlson recognizes that disallowing fraudulent conveyance law would lead to more marginal LBOs that would produce more social gains, but it would also create more dishonest LBOs.).

67. *See* Baird & Jackson, *supra* note 2, at 835.

trustees in bankruptcy actions could bring fraudulent conveyance law back in.[68] This Type I error forms the basis for Baird and Jackson's argument that fraudulent conveyance law should not be instituted as a general remedy in LBOs.[69]

If, however, one can only contract into fraudulent conveyance law, some LBOs that decrease creditors' expected welfare may take place because no creditor has enough bargaining power to insert such a contractual clause. This is a Type II error. For industries like wholesale groceries or retail sales, Type II as well as Type I errors are likely to be large. If creditors are small and numerous, none is likely to have sufficient bargaining power to contract into fraudulent conveyance law. Alternatively, if creditors are involuntary (i.e., where circumstances thrust creditor status upon tort victims and tax collectors), they have no role in negotiating contract remedies.[70] Moreover, even if large voluntary creditors are present, they may well negotiate for a security interest rather than a clause contracting out of fraudulent conveyance law.[71]

Because general creditors' expected welfare is unlikely to increase and because Type II errors could be large, Baird and Jackson's recommendation against using fraudulent conveyance law to undo LBOs might be ill-founded for industries with many small general trade creditors. As the business climate becomes more attuned to the leveraged nature of takeover transactions, stakeholders would be more likely to turn to explicit contracts for protection in the absence of a fraudulent conveyance remedy. Explicit contracts might reduce the possibility of Type II errors in circumstances where creditors have sufficient information and bargaining power to write explicit

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68. *Id.*

69. *See* Baird & Jackson, *supra* note 2, at 854–55. If the transferee received some value and the transaction was entered into in the ordinary course of business, the transaction should not be viewed as fraudulent. "Fraudulent conveyance law should never apply to arms length transactions . . . ." *Id.* at 854.

70. *See, e.g.*, United States v. Tabor Court Realty Corp., 803 F.2d 1288, 1291, 1293 (3d Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987) (Pennsylvania counties and the federal government were involuntary creditors).

71. *See* Note, *supra* note 30, at 1512; Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499, 504 (1976). A lender with sufficient knowledge and bargaining power might require collateral, make a borrower agree to limit its debt, or demand a higher interest rate if more risk is contemplated. Note also that, for LBOs taking place during a time when the law is unsettled, creditors might believe themselves protected by *per se* rules. *See* Smyser, *Going Private and Going Under: Leveraged Buyouts and the Fraudulent Conveyance Problem*, 63 IND. L.J. 781, 789 (1988).

contracts. In cases where general creditors are small and diverse, however, these conditions are unlikely to hold. The small owner of the already-bought specialized bath salts packaging machine is unlikely to be in a position to drive a hard bargain with the leveraged buyer.

IV. Threshold Issues in Applying Fraudulent Conveyance Law to LBOs

The preceding section establishes that fraudulent conveyance law is a reasonable remedy under some conditions for creditors injured by LBOs. Aside from the specific statutory requirements of proving insolvency, undercapitalization, or assumption of debts without intent to pay, general creditors face two threshold issues in using fraudulent conveyance law to challenge LBOs. These are: (1) the general creditors' standing to sue, given their knowledge of the leveraged nature of the transaction, and (2) the seller's and the lender's knowledge of the leveraged nature of the transaction.

A. Standing

A difficult threshold issue in a LBO case is the standing of general creditors to sue when they had foreknowledge of the leveraged nature of the transaction. Some recent court opinions have declined to apply fraudulent conveyance law in the context of LBOs where the unsecured creditors knew about the leveraged nature of the transaction and where they extended credit after the LBO occurred.[72] The essence of the argument is that the creditors who know the leveraged status of the firm know they are taking a chance when they extend credit to a leveraged firm and should be held to their bargain.

This argument is stated most cogently perhaps in *Kupetz v. Wolf.*[73] In this case, a highly leveraged wealthy investor with the backing of a major Chicago bank bought all the shares of a mannequin manufacturer.[74] The investor secured bank loans

72. Kupetz v. Wolf, 845 F.2d 842, 849-50 (9th Cir. 1988) (case discussed later in text); Pope v. National Aero Fin. Co., 236 Cal. App. 2d 722, 728, 46 Cal. Rptr. 233, 237 (1965) (plaintiffs had to show that they were creditors on the date of the conveyance); *see also* T W M Homes, Inc. v. Atherwood Realty & Inv. Co., 214 Cal. App. 2d 826, 843, 29 Cal. Rptr. 887, 896 (1963) (to establish a fraudulent conveyance, the transferor has to be insolvent at the time of the conveyance).

73. *Kupetz*, 845 F.2d at 849-850.

74. *Id.* at 843. The purchaser was backed by Continental Illinois National Bank.

and letters of credit using the assets of the mannequin manufacturer. When the company failed, the trustee sued to avoid the transaction as a fraudulent conveyance. Among the reasons cited by the appellate court in affirming the bankruptcy court's refusal to apply fraudulent conveyance law to this LBO was the fact that no general creditors were asserting claims that arose *before* the leveraged buyout. The *Kupetz* court cited dicta in *Credit Managers Association v. Federal Co.*[75] for the proposition that creditors' standing to sue under fraudulent conveyance law must be modified where the parties to the LBO had no intent to defraud. Based on this dicta, the *Kupetz* court held:

> [b]ecause fraudulent conveyance statutes were designed to protect creditors from *secret* transactions by debtors, the same rules should not apply when the transaction is made public. Future creditors may not complain when they knew or could easily have found out about the transaction. This certainly appears to be the case in this particular LBO. The transaction was well-publicized and the Trustee has not claimed or presented evidence that any of the future creditors were not aware of [the target company's] financial dealings. In the context of this well-publicized LBO, this court will not permit later-arising creditors to attack an LBO purchase transaction as a fraudulent conveyance under section five of the UFCA.[76]

Although the *Credit Managers* court did not decide the issue of standing because the parties had not briefed the issue, the court set forth forceful dicta suggesting that *ex post facto* creditors should not have standing to attack the fraudulent conveyance.[77] To support its conclusion, the court cited the trial court opinion in *Tabor Court*.[78] There the court found that each creditor who sued on a fraudulent conveyance theory held a matured claim on the date the leveraged transaction was closed. The *Credit Managers* court also cited scholarly commentary from Baird and Jackson on the same point.[79] Without reviewing legislative history, the court noted:

> The statute [California UFCA] clearly covers future as well

75. 629 F. Supp. 175, 181 (C.D. Cal. 1985).

76. *Kupetz*, 845 F.2d at 849–50 n.16 (emphasis in original).

77. *Credit Managers*, 629 F. Supp. at 180–81.

78. United States v. Gleneagles Investment Co., 565 F. Supp. 556, 572 (M.D. Penn. 1983), *aff'd sub nom.*, United States v. Tabor Court Realty Co., 803 F.2d 1288 (3d Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987).

79. *Credit Managers*, 629 F. Supp. at 180.

> as existing creditors. However, when the California legislature passed this provision in 1939, it clearly did not intend to cover leveraged buyouts which are very public events. The legislature was addressing, instead, transactions that have the earmarks of fraud. . . . If there is no limit on when a creditor can sue to set aside a transfer, fraudulent conveyance law becomes an insurance policy for creditors of companies that have gone private.[80]

In *In re Ohio Corrugating Co.*,[81] the court cited *Kupetz* in deciding that the creditors had no standing under the Code because none of the creditors was a pre-LBO creditor.[82] Many creditors had received current financial statements at the time of the deal, and no evidence suggested that any creditors were unaware of the change in management or in the debtor's financial position.[83] In fact, some accounts had turned over six or seven times in the ten months following the buyout.[84]

On the other hand, in *Wieboldt Stores, Inc. v. Schottenstein*,[85] the court rejected defendants' motion to dismiss on the ground that Wieboldt, a debtor, could not represent any post-transaction creditors in attempting to avoid the transaction. The court concluded that the argument was premature:

> [t]he court need not identify the particular creditors or group of creditors which will be entitled to share in any funds Wieboldt recovers from the [selling] directors. This proceeding is collateral to Wieboldt's Chapter 11 bankruptcy proceeding. The claim of each individual creditor will be adjudicated in the reorganization. The trustee and the bankruptcy court can subordinate the claims of any creditors who are not entitled to reimbursement from the Chapter 11 estate pursuant to Section 510(c) of the Code at the time of distribution.[86]

Courts that have relied on standing arguments concerning the claims of post-transaction general creditors have made a first step in eliminating Type I errors. But in doing so, they have ignored the plain language of the statutes, and in some

80. *Id.* at 181.

81. 91 Bankr. 430 (Bankr. N.D. Ohio 1988).

82. *Id.* at 435. The court found no basis for using the Bankruptcy Code as a "form of insurance" to creditors whose claims occurred after the LBO. *Id.*

83. *Id.* at 435.

84. *Id.* at 433.

85. 94 Bankr. 488, 497 (Bankr. N.D. Ill. 1988).

86. *Id.* at 509.

cases have inserted unnecessarily broad economic rationales for their decisions. In fact, the Bankruptcy Code does nothing to distinguish temporally between creditors in the constructive fraud section, section 548(a)(2), and it explicitly includes post-LBO creditors in the actual fraud section. (That action allows avoidance of any fraudulent transfer to "any entity to which the debtor was or became, on or after the date that such transfer was made . . . .").[87] The UFCA insolvency section does not distinguish temporally between creditors,[88] and its undercapitalization section[89] and its inability to pay section[90] include future creditors explicitly.

Implicit in the courts' rationale for accepting the standing arguments is the recognition that allowing *ex post* creditors to avoid the LBO sets up the seller and/or lender as guarantor. If courts granted *ex post* creditors standing to undo LBOs, such creditors would receive windfalls. Moreover, allowing *ex post* creditors to sue could deter future leveraged transactions from taking place, for sellers and buyers would always be vulnerable in failed deals.

On the other hand, numerous factors may be present (especially in smaller LBO transactions) that disturb this conventional scenario and argue against broad use of standing arguments to bar use of the statutes. First, the class of *ex post* creditors, if taken individually, may not have a large enough extension of credit to justify the transactions costs associated with careful monitoring of the financial status of all debtors. If taken together, however, their claims may amount to substantial debt.

For example, trade creditors may collect payables monthly, offering cash discounts for payments within ten days. However, they could ship supplies weekly so that the target company keeps its shelves full. A target company that has been taken over could cut off its payments to its supplier-creditors, without the creditors knowing this until a month or more after they had shipped their goods to the target. This tendency will

87. 11 U.S.C. § 548(a)(2).

88. MINN. STAT. § 513.23 (1986).

89. Transfer is fraudulent "as to creditors and as to other persons who become creditors during the continuance of such business . . . ." MINN. STAT. § 513.24 (1986).

90. "[F]raudulent as to both present and future creditors." MINN. STAT. § 513.25 (1986).

be accentuated when the general creditor and the debtor have enjoyed a successful credit history for a long period before the transaction.

Second, the smaller trade creditors that may characterize the general creditor class might lack sufficient bargaining power to acquire information or to avoid continuing an economic relationship begun long before the leveraged deal. General creditors who made specialized investments before the LBO, relying on implicit contracts with the target's original management, are particularly vulnerable. This distinction was made by one commentator who criticized Baird and Jackson's suggestion that creditors negotiate prohibitions against LBOs:

> The multitude of small trade creditors, principally suppliers of materials and vendors of services . . . lack information and the bargaining power of big financial institutions to similarly demand security interests or limits on the conduct of the debtor. Even if they could, the economic feasibility of the system of trade credit, which typically does not rely on debt instruments, would be undermined by the need to bargain over negative pledges and other protective devices.[91]

Third, the quality of information available to *ex post* creditors is an important factor. In some instances, publicists may attempt to cloak the terms of the LBO in less-than-candid terms, which will obscure the terms of the leveraged deal. In others, the full risk of the LBO will not be apparent, given the clever, if not byzantine, manner in which some transactions can be structured.

Finally, when targets go private as a result of the LBO, the financial data available to the public shrinks,[92] thereby putting the target's new managers in a significantly greater degree of control of the dissemination of information and putting the general creditors at a comparative information deficit.

B. *Knowledge of the Seller*

The seller's knowledge of the leveraged nature of the deal is a second issue challenging the use of fraudulent conveyance law to undo LBOs.[93] Although technically not a threshold is-

91. *See* Note, *supra* note 30, at 1512. *See also* Kupetz v. Wolf, 845 F.2d at 842, 847 n.10 (9th Cir. 1988) (small creditors lack effective bargaining power in LBO context).

92. Indeed, this has been cited as a reason for going private through LBOs. *See, e.g.*, Baird & Jackson, *supra* note 2, at 853.

93. Seller's knowledge appears to be a better developed issue than lender's

sue in the same sense as standing, the seller's (and the lender's) knowledge of the leveraged nature of the transaction is apparently an important implied prerequisite to proving theories of liability grounded in insolvency or undercapitalization, whether under the Code or under the state statutes.

Although the Bankruptcy Code does not explicitly include a *scienter* requirement in its constructive fraud section,[94] some courts have imported a *scienter* requirement into the statutes[95] for both insolvency and undercapitalization theories.[96] This phenomenon is best developed in seller liability cases. For example, in *Wieboldt Stores, Inc. v. Schottenstein*, the court considered defendant's motion to dismiss plaintiff's section 548(a)(2) suit brought under an undercapitalization theory.[97] Defendant shareholders argued, among other things, that they had tendered their shares in good faith and without the requisite knowledge of the underlying transaction's leveraged nature.[98] The court reviewed *Kupetz* and concluded that "a court should focus not on the formal structure of the transaction but rather on the knowledge or intent of the parties involved in the transaction."[99] Using this logic in evaluating the liability of certain participants in the transaction, the court collapsed the LBO and the tender offer into a single transaction. The facts the court cited are useful indicators of the degree of knowledge a seller must have had for the complaint to survive dismissal:

> The Board and the insider shareholders knew that [the purchaser] intended to finance its acquisition of Wieboldt through an LBO and not with any of its own funds. They knew that Wieboldt was insolvent before the LBO and that

knowledge due to the frequency with which seller liability is litigated. *See* United States v. Tabor Court Realty Corp., 803 F.2d 1288, 1295 (3d Cir. 1986) (discussing lender liability with reference to the lender's knowledge of the leveraged nature of the transaction); *In re* Greenbrook Carpet Co., 722 F.2d 659, 661 (11th Cir. 1984) (discussing lender liability with reference to lender's knowledge).

94. 11 U.S.C. § 548(a)(2).

95. In discussing the good faith requirements in constructive fraud cases under the UFCA, one commentator has analogized the *scienter* problem to the securities laws, and proposed a sliding scale of scienter, "adjusting the meaning of a *scienter* standard according to context and outlining principles to govern when and how it would vary . . . ." Sherwin, *supra* note 12, at 516 (1988). *See also supra* note 16.

96. *See, e.g., In re* Ohio Corrugating Co., 91 Bankr. 430, 439 (Bankr. N.D. Ohio 1988).

97. 94 Bankr. 488, 499 (Bankr. N.D. Ill. 1988).

98. *Id.* at 500. The stock purchase was accomplished through a tender offer that was financed by a LBO. *Id.* at 494–96.

99. *Id.* at 502.

> the LBO would result in further encumbrance of Wieboldt's already encumbered assets. Attorneys for [a major shareholder] apprised the Board of the fraudulent conveyance laws and suggested that they structure the LBO so as to avoid liability. Nonetheless, these shareholders recommended that Wieboldt accept the tender offer and themselves tendered their shares to [Weiboldt].[100]

On the other hand, a group of large shareholders who were not insiders were found to be outside the reach of fraudulent conveyance law. For this group, plaintiffs did not allege that the shareholders were aware that the acquisition encumbered Wieboldt's assets or that the consideration they received was Wieboldt property. In fact, the complaint alleged only their knowledge of the public tender offer, which does not suggest that they "had any part in the LBO except as innocent pawns in the scheme."[101]

The *Wieboldt* case establishes one end of the knowledge continuum necessary as a predicate for fraudulent conveyance liability. At the liability end are the *Wieboldt* insider shareholders, who knowingly disregarded the implications of the LBO. At the non-liability end of the continuum is *Kupetz*. In that case, the appeals court affirmed the district court's directed verdict under the Code and California UFCA in favor of the selling shareholders because, among other things, no evidence suggested that the seller intended to defraud the creditors or that the seller was aware that the purchaser intended to fund his purchase through a LBO.[102]

V. Suggestions for Allocating Liability for Failed LBOs Between Lender and Seller

This paper establishes that fraudulent conveyance law

100. *Id.* (citations omitted).

101. *Id.* at 503.

102. 845 F.2d 842 (9th Cir. 1988). The evidence summarized on this point is useful. The sellers screened and rejected several purchasers who were financially unsound. Although the seller did not ask the purchaser for a financial statement, acquisition plan, or business plan, they knew the purchaser was a successful investor worth over $5 million and that a major bank backed his purchase with irrevocable letters of credit. *Id.* at 848. The court also noted that the Trustee did not prove that a more thorough search would have uncovered facts to put the sellers "on guard." *Id.* at 848 n.11. In dicta the court noted that, "[i]n some circumstances . . . controlling shareholders of a corporation are obligated to make certain that the business's creditors are not harmed by the transactions in which the business enters." *Id.* at 848 n.12.

should not be foreclosed as a remedy for general creditors injured by LBOs. As Baird and Jackson point out, one would not want to use fraudulent conveyance law as a remedy if general creditors can help themselves: the risk of overdeterring LBOs is real. The risk, however, is also real that sellers of LBO targets and lenders that finance LBOs might not consider possible injuries to creditors, particularly if general creditors are small and numerous.

It is well known that takeover attempts tend to bid up stock prices. Some interpret this phenomenon as evidence that the bidders know more productive uses for the target's assets, so that the acquired target might prosper. Others view the increment to the stock price as a windfall wealth transfer from the target's stakeholders as new management breaks implicit contracts. For example, industries characterized by many small trade creditors are more prone to use implicit contracts, so the latter interpretation might be especially persuasive for these industries. In addition, increased expected income for the target might not mean increased income for general creditors, and, even if it does, the incremental income carries much greater risk. General creditors who had counted on a given level of risk and who are unable to point to an explicit contract can lose when a target is bought out.

How might one allocate liability among sellers and lenders if general creditors are damaged by a LBO and bring suit? One way would be to look to the economic reasoning used to assign damages when explicit contracts are not performed:[103]

1. Who can best foresee the event leading to nonperformance?
2. Who can best predict the loss from the event?
3. Who can best spread the risk of loss?

With respect to foreseeing the failure of a LBO or the breaking of implicit contracts, sellers are in a good position to assess the general nature of their industry and the riskiness of a given transaction. Lenders, on the other hand, are in a good position to assess the general credit market, and sophisticated lenders include industry-specific analysts who develop special expertise in forecasting. Therefore, the first element will point to one or the other, depending on circumstances. Was non-

103. *See* Barton, *The Economic Basis of Damages for Breach of Contract*, in THE ECONOMICS OF CONTRACT LAW 154, 163 (1979).

performance the result of trends in the economy generally, trends in the industry, or specific decisions of managers?[104] The answer to this question helps identify the party best suited for predicting an event accurately.

The second element, the magnitude of the loss to a general creditor, is probably best assessed by the creditor himself. The seller of the target will also understand the creditor's potential loss, however, as will the well-informed buyer who has studied the target's payables data and knows of creditors' specialized investments.

Finally, the risk of the loss might be most easily spread by the seller, the lender, or the creditor, depending on the situation. Suppose the creditor can cheaply incorporate in agreements with all his trading partners credit terms that protect him when LBOs can injure him. The fraudulent conveyance remedy should then be unavailable, for he can spread his risk to protect himself. As Professor Muris points out, potential victims could protect themselves by adjusting price, integrating vertically, or writing explicit contracts.[105] Where the creditor cannot cheaply spread the risk and where he is not in the best position to evaluate the risk of a LBO, however, one needs to look carefully at the seller and the lender. Professors Goetz and Scott explain why parties other than the injured party might be better able to spread risk:

> For at least two distinct reasons, it makes good economic sense that the distributor would be the efficient bearer of the risk of both his own and the manufacturer's lost profits from sales forgone due to business mistakes on the part of the distributor. First, the distributor is the party who has effective control of his own level of care invested in undertaking business activities and, hence, has the opportunity to adjust that level of care to the cost-effective extent. Second,

104. For example, in United States v. Tabor Court Realty Corp., 803 F.2d 1288, 1291–92 (3d Cir. 1986), the court cited the effect of expensive water pollution control laws and the stagnant economy's depressive effect on anthracite coal mining. In Credit Managers Ass'n v. Federal Co., 629 F. Supp. 175, 184 (C.D. Cal. 1985), the court cited as factors in the business failure the closing of a major customer of the target company and a "devastating" Teamster strike that strangled product distribution at the peak season. The relative predictive ability that the parties enjoy with respect to such micro- and macro-factors should be highly probative as to where liability should fall.

105. *See* Muris, *supra* note 38, at 527–28. This conclusion may become more important as LBOs become more commonplace. Reasonable creditors should be assumed to take such defensive measures.

> the distributor is in a better position to assess *ex ante* his own capability to achieve the ordinary or expectable level of business performance.[106]

Burnham[107] suggests that sellers should pre-fund certain obligations if they contemplate a LBO. He points out that pension funds and some bond debentures already require pre-funding. Full pre-funding of all obligations is overkill; rather, pre-funding should reflect the increased risk to general creditors. Moreover, pre-funding is appropriate only if sellers, rather than lenders or creditors, are best able to deal with nonperformance of implicit contracts. For example, suppose a company has an average monthly accounts payable balance of $100,000. Suppose also that, before the LBO, the average time period for paying off creditors was twenty-six days. After the LBO, the average payoff period rises to thirty days because LBO lenders must be paid first. Creditors are now responsible for four more days of financing receivables; at an interest rate of ten percent, creditors forego nearly $110 per month. Therefore, if creditors are not the cheapest avoiders of the increased risk, the target could set aside (before the LBO occurs) a lump-sum fund that would compensate the general creditors for the increased monthly risk resulting from the leveraged nature of the deal.[108]

Rather than have a set rule, or a rule that induces costly and uncertain litigation, one could simply leave it to the seller and the lender to divide the responsibility according to a pro-rationed assessment of their shares of the transactions, as in the DES cases in the tort context.[109]

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106. *See* Goetz & Scott, *supra* note 56, at 1118.

107. Burnham, *Limits on Liability Actually Are What Invite the LBOs*, Wall St. J., Feb. 1, 1989, at A14, col. 6.

108. Note that the document "Responding to Requests for Reports on Matters Relating to Solvency" (Feb. 1988) issued by the American Institute of Certified Public Accountants (quoted in Kirby, McGuinness & Kandel, *Fraudulent Conveyance Concerns in Leveraged Buyout Lending*, 43 Bus. Law. 27 (1987)) precludes accountants from assuring a company that it is not insolvent, does not have unreasonably small capital, and has the ability to pay debts. Therefore, companies are on their own in assessing the risk associated with a LBO.

109. The principal DES case is Sindell v. Abbott Laboratories, 26 Cal. 3d 588, 607 P.2d 924 (1980). This case drew on the reasoning in Summers v. Tice, 33 Cal. 2d 80, 199 P.2d 1 (1948). In *Summers* the plaintiff was injured when two hunters shot in his direction. The defendants were held jointly and severally liable for all damages; the burden of proof was shifted to the defendants, who were deemed to be in better positions to determine how the injury was caused. In the DES cases, plaintiffs alleged

Alternatively, one might evaluate the division of lender and seller liability according to a standard set of criteria designed to reflect culpability based on potential benefits of actual misdeeds. These might include:

1. Extent of anticipated gain;
2. Extent of risk shifting; and
3. Extent of irregular business practices.

If implicit contracts are broken, sellers in particular might gain substantially from a LBO. Professor Muris says that the existence of an investment that can be appropriated should be considered.[110] Lenders could also gain from the transaction through higher interest rates for bigger loans.

For LBOs in which the value of the target's assets greatly exceed the loan advanced for the buyout, the seller and the lender effectively shift risk to general creditors. If, however, the loan is large relative to the target's assets, the seller escapes risk by getting out of the business, but the lender may not. Finally, venture capitalists may make a practice of financing LBOs and shifting risk to general creditors, while many sellers of LBO targets are involved in a LBO only once. This could cut either way: lenders might play every angle they can find, or they might be scrupulously careful about their business. Sellers might simply want to get out of their business without any finagling, or they may try for the maximum profit they can grab.

VI. A Note on the Social Viewpoint

Most scholars (including Baird and Jackson) view fraudulent conveyance law through the narrow lens of parties that might have standing in a lawsuit. From a policy standpoint, however, an equally important question is how society's welfare is af-

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that cancer in young women had been caused by diethylstilbesterol (DES), a drug ingested by the plaintiffs' mothers when they were pregnant with plaintiffs, years before. At issue was which of the large pharmaceutical corporations had manufactured the DES ingested by plaintiffs' mothers. The defendants were not deemed to possess superior information, yet the court held it reasonable that the large producers of DES were likely to have manufactured the product ingested by the plaintiffs' mothers in proportion to the producer's market shares. The damage was spread in proportion to market shares and, as in *Summers*, the burden of proof shifted to the defendants. *Id.* at 598-603, 607 P.2d at 936-38. *See also* Hymowitz v. Eli Lilly & Co., 73 N.Y.2d 487, 541 N.Y.S.2d 941, 539 N.E.2d 1069 (N.Y. App. 1989).

110. *See* Muris, *supra* note 38, at 579.

fected by the use of fraudulent conveyance law in LBO failures and by LBOs in general. The controversy over the use of fraudulent conveyance law in LBOs should be recast to reflect the effect on society in general of alternative policies concerning fraudulent conveyances and LBOs. What matters is the magnitude of LBOs that would enhance social welfare that *will not* occur if fraudulent conveyance law is generally applied to LBOs relative to the magnitude of LBOs that would decrease social welfare that *will* occur if fraudulent conveyance law is not generally applied to LBOs.[111] Even if creditors tend to lose if fraudulent conveyance law is not generally applied, society as a whole may gain. If so, using fraudulent conveyance law to avoid LBOs would not be the best remedy for compensating general creditors. If, however, fraudulent conveyance law is determined to be an appropriate creditor remedy, a second matter of importance is its efficacy: will the law prevent ill-advised LBOs? If fraudulent conveyance law is insufficient for stopping social-welfare-decreasing LBOs, some other statutory remedy may be necessary.[112]

The empirical evidence concerning parties directly affected by a LBO is inconclusive: apparent winners and losers abound. Some scholars[113] believe parties directly involved in LBOs gain while others[114] think there might be a net loss to these parties. Losing parties could include the stockholders of the acquiring firm,[115] workers,[116] and secured creditors[117] as well as un-

111. It is appropriate to think of social welfare in terms of the value rather than the number of LBOs.

112. An important factor in assessing the social welfare effect of alternative rules is the cost associated with their implementation. Professor Muris points out that rules permitting opportunistic behavior (such as excluding fraudulent conveyance law in LBO cases) are costly because parties will spend resources on non-productive activities. *See* Muris, *supra* note 38, at 524. Recall: trust economizes. Professor Muris also notes, however, that rules intended to prohibit opportunistic behavior (such as applying fraudulent conveyance law in LBO cases) can engender costly litigation with uncertain results. *Id.* at 529. Lacking empirical information, we simply point out that the relative costs of implementing alternative rules should be considered.

113. *See* Poulson & Jarrell, *supra* note 40, at 36–38; Bradley, Desai & Kim, *supra* note 46, at 183–84; Easterbrook & Jarrell, *supra* note 46, at 290–92.

114. Weidenbaum & Vogt, *supra* note 48, at 166; Firth, *Takeovers, Shareholder Returns, and the Theory of the Firm*, 94 J. ECON. 248, 258 (1980).

115. Langetieng, *supra* note 63, at 379–81; *see also* presentation by Ellen B. Mangenheim and Dennis Mueller, Conference on Takeovers and Contests for Corporate Control, Columbia University (Nov. 1985) (the presentation was entitled *On Measuring the Effect of Acquisitions on Acquiring Shareholders or Are Acquiring Firm Shareholders Better Off After an Acquisition Than They Were Before?*).

secured general creditors.

Although many scholars have examined the consequences for parties directly affected by LBOs, the impact on the remainder of the macroeconomy has remained largely unmentioned. For instance, the effects on tax revenue and credit availability could be significant.

The government has acted to curtail tax revenue loss due to LBOs. Before the Tax Reform Act of 1986 and the repeal of the *General Utilities* doctrine,[118] takeovers in general created substantial tax savings for merging firms. Among the primary benefits of takeovers were acquisition of tax losses and credits, and the ability to step up the basis of the target firm's assets without paying capital gains taxes at the corporate level.[119]

116. Shleifer & Summers, *Breach of Trust in Hostile Takeovers*, in CORPORATE TAKEOVERS 33, 51-53 (A. Auerbach ed. 1988). However, Brown & Medoff, *The Impact of Firm Acquisitions on Labor*, in CORPORATE TAKEOVERS 9, 23 (A. Auerbach ed. 1988), find no empirical evidence supporting this conclusion. White, *Leveraged Buyout Financing: Trends, Issues and Concerns*, in THE PROBLEMS OF INDENTURE TRUSTEE AND BONDHOLDERS 499 (J. Spiotto ed. 1990), notes that a major union filed suit under fraudulent conveyance law in the proposed $4.2 billion LBO of Safeway in 1986.

117. Secured creditors may lose because the increased riskiness of the target firm could cause bond ratings to drop and secondary-market bond prices to fall. Lehn and Poulson argue that this last effect is not significant, but the most recent evidence seems to show that a number of LBOs are failing, indicating that LBOs tend to increase risk in the business environment. Lehn & Poulson, *supra* note 46. *See also* Vise & Mufson, *supra* note 7, at 8-9. For example, Metropolitan Life Insurance Company faces a $40 million loss on RJR Nabisco bonds that were issued before the Nabisco LBO. *See* White, *Leveraged Buyout Financing: Trends, Issues and Concerns*, in THE PROBLEMS OF INDENTURE TRUSTEE AND BONDHOLDERS 499 (J. Spiotto ed. 1990).

The default rate of junk bonds is, on average, 34% for bonds issued 12 years ago, 26% for bonds issued 8 years ago, and 6% bonds issued 4 years ago. *See* Asquith, Mullins & Wolff, *Original Issue High Yield Bonds: Aging Analyses of Defaults, Exchanges, and Calls*, 44 J. FIN. 923, 845-47 (1989). These rates of default are considerably higher than the 1.2-1.6% rate found by others, and are much higher than the default rate for investment-grade bonds. The default rate on junk bonds accompanying LBOs was 5.47% as of December 31, 1988, but this rate reflects the default on the junk bonds issued by only a single LBO. In light of the data reviewed here, we expect this rate to rise because the majority of LBOs have been financed with junk bonds within the last few years. The default rate on junk bonds is likely to affect adversely the bonds issued previously by the target.

118. The court in General Utilities Co. v. Helvering, 296 U.S. 200, 204-07 (1935), held that corporations liquidating their businesses are not subject to capital gains tax on the asset values.

119. *See* Moore & Pruitt, *The Market Pricing of NOL Carryforwards: Tax Motivations of Mergers*, 10 J. FIN. RES. 153, 153-55 (1987). However, authorities have noted that mergers and acquisitions that took place between 1968 and 1983 did not tend to be tax-driven. Auerbach & Reishus, *The Impact of Taxation on Mergers and Acquisitions*, in MERGERS AND ACQUISITIONS 69 (A. Auerbach ed. 1988).

These tax benefits of mergers no longer exist. The deductibility of interest, however, remains an important benefit to investors in LBOs.[120] In addition, the reduction in dividend payments after a LBO will reduce taxes paid by shareholders.[121] Moreover, if a LBO creates an ESOP, the tax revenue reductions can be particularly large.[122]

Revenue reductions caused by LBOs are potentially offset by several items. These items include capital gains taxes paid by selling shareholders in a LBO, tax payments by new creditors financing LBOs, and increased taxes paid by more efficiently run (hence, more profitable) companies.[123] The first two factors are unlikely to offset the revenue reductions due to LBOs in the long run, however. The increased capital gains taxes are naturally a transitional phenomenon. Furthermore, the tax bracket of many creditors financing LBOs is below the bracket of the LBO target taking interest deductions. The third offset clearly depends on whether LBOs increase efficiency *ex ante*.

In sum, *ex ante* income to those directly affected by a LBO (including shareholders and stakeholders) may increase as a result of a LBO. Nevertheless, income taken in by the government will fall if the tax benefits to lenders and purchasers of the target (and losses associated with increased bankruptcies) outweigh the expected future incremental tax revenue generated by the target firm. Whether social welfare improves with LBOs depends in part upon the opportunity cost of the foregone revenue.

In addition to LBO effects on tax revenues, mergers might bid credit away from other parties in the economy. Although

120. *See* Shleifer & Vishny, *Management Buyouts as a Response to Market Pressure*, in MERGERS AND ACQUISITIONS 87 (A. Auerbach ed. 1988). Poterba, *Comment*, in CORPORATE TAKEOVERS 183 (A. Auerbach ed. 1988).

121. *See* Saunders, *How the Government Subsidizes Leveraged Takeovers*, FORBES, Nov. 28, 1988, at 192–96.

122. Under this circumstance, the target can sometimes deduct principal as well as interest, and lenders can exempt half the interest from tax. *See* 26 I.R.C. § 133 (West Supp. 1989). Before the repeal of 26 I.R.C. section 2057, sellers of closely held companies that sold at least 30% of the company to an ESOP could defer taxes on the profit as long as the proceeds were invested in certain U.S. companies. *See* 26 I.R.C. § 2057 (West 1989) (repealed 1989). Investors could effectively defer taxes forever if they bequeath these investments to heirs, who are allowed to step up basis without paying tax.

123. Jensen, Kaplan & Stigler, *Effects of LBOs on Tax Revenues of the U.S. Treasury*, 42 TAX NOTES 727 (1989); Newport, *Why the IRS Might Love Those LBOs*, FORTUNE, Dec. 5, 1988, at 145.

Antoncic and Bennett[124] find this to be negligible, their study ends in the early 1980s, before most of the large LBOs occurred.[125] According to a 1988 Federal Reserve study, loans financing LBOs account for 9.9 percent of all commercial loans at banks with assets of $7.5 billion or more and for 5.5 percent at smaller banks.[126] Also, Taggert[127] draws attention to the volume of junk bonds that finance LBOs that are held by savings and loan associations. He quotes figures demonstrating the percentage of junk bonds used to finance mergers and acquisitions in 1984: Drexel Burnham estimates eleven percent, Morgan Stanley twenty-one percent, and the Federal Reserve forty-one percent. S&Ls, particularly in California and Texas, hold much of their assets in junk bonds. For instance, Columbia S&L of Beverly Hills held $2.3 billion in junk bonds (twenty-eight percent of their assets) as of June 30, 1986. Policy makers must factor in the opportunity cost of the credit displaced by LBO financing and the contribution of junk bond financing to the S&L crisis to find if general social welfare tends to increase or decrease as a result of LBOs.

Although it may be an effective remedy for direct participants, fraudulent conveyance law cannot, therefore, be considered as a general social solution if LBOs tend to be welfare-decreasing to society *ex ante*. Creditors would not tend to sue if the indirectly affected parts of the macroeconomy lose more *ex ante* than directly affected parties gain *ex ante* and if creditors gain *ex post*. If social welfare generally decreases *ex ante*, however, some remedy is necessary. The most direct remedy might be to change tax law. One recent proposal advocated taxing dividends and interest in a parallel fashion, but that has been dropped for the present.[128]

124. *Financial Consequences of Mergers*, FEDERAL RESERVE BANK OF NEW YORK Q. REV. 26 (1988).

125. See *supra* note 7 for monetary values of LBOs that took place from 1983 to 1988.

126. *See* Vise & Mufson, *supra* note 7, at 9.

127. Taggert, *The Growth of the Junk Bond Market and Its Role in Financing Takeovers*, in MERGERS AND ACQUISITIONS 5 (A. Auerbach ed. 1988).

128. Corporations receive a deduction for interest but not for dividends. Treasury Secretary Brady expressed some interest in allowing dividends to be deductible. *See* Hinden, *Brady Urges Tax Change to Curb LBOs*, Wash. Post, Jan. 25, 1989, at F1, col. 2. This position was quickly reversed, however, and communicated in remarks made by acting Deputy Tax Legislative Counsel Paul. *See* Murray, *Treasury Agency Backs Away from Plan for Use of Tax Code to Discourage LBOs*, Wall St. J., May 17, 1989, at A2, col. 3.

CONCLUSION

This paper initially discusses, from the viewpoint of parties directly affected by a LBO, whether fraudulent conveyance law is an appropriate remedy for general creditors injured by the LBO; the last section considers a broader social view of LBOs. In industries where general creditors are small, diverse, and numerous, we determine fraudulent conveyance law to be a reasonable remedy when LBOs hurt creditors. Our argument rests on the recognition that, in such industries, LBOs are likely to injure creditors who are powerless to stop them. These industries are characterized by implicit contracts that encourage specialized investments by creditors, who expect future returns from their investments. LBOs rob them of these returns, however, and small creditors lack the bargaining power to recoup their losses. Even if creditors are able to change credit terms to their advantage, lag time in acquiring information about the financial status of the target might mean that credit terms can not change before creditors are hurt. Additionally, the LBO shifts substantial risk to creditors, which can lower creditors' welfare if they are risk-averse.

The constructive fraud provisions of fraudulent conveyance law should not be a universal remedy for creditors injured by LBOs. If creditors understand the risks accompanying a LBO, and are strong enough to do something about it, creditors should bear the burden of writing explicit contracts to protect themselves. If creditors are unable to gain information, lack bargaining power, and experience losses from broken implicit contracts, however, fraudulent conveyance law could be used to rectify their injuries.

The loss to creditors can be parceled out to sellers of and lenders to a LBO, either by looking to the factors considered when contracts are not performed, or by letting sellers and lenders determine their respective liabilities. One could examine particularly the extent of risk shifting and the degree of gain obtained by the parties benefiting from the LBO.

Fraudulent conveyance law is available as a remedy only to parties with standing in a lawsuit, i.e., those directly affected by a LBO. The larger social question is: Are LBOs generally beneficial or generally detrimental to society as a whole? If they are beneficial, fraudulent conveyance law is not the best social remedy for injured creditors because its use will deter productive changes in the business environment. If they are injurious, however, fraudulent conveyance law is an insufficient remedy because some parties adversely affected by a LBO would not have standing to use the remedy.