

Fall 1988

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Recommended Citation

Price A. Sloan, *Leveraged Buyouts and Fraudulent Conveyances: Lenders and Shareholders Beware*, 53 Mo. L. REV. (1988)

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COMMENTS

LEVERAGED BUYOUTS AND FRAUDULENT CONVEYANCES: LENDERS AND SHAREHOLDERS BEWARE

INTRODUCTION

In recent years leveraged buyouts [LBOs], in which a small group of investors purchase an ongoing business with almost entirely borrowed funds, have become an increasingly popular form of investment.¹ Banks, insurance companies and Wall Street investment firms, among others, lend money to “buy out” the previous owners and use the purchased company’s assets and cash flow as collateral.² Consequently, the post-buyout company’s capital is used almost entirely as security for the purchase debt.³

LBOs have proved enormously profitable, in large part because of the power of leverage and the federal income tax deduction on interest payments.⁴ For example, former Treasury Secretary William Simon and his partners in Wesray Corp. purchased Gibson Greeting Cards, Inc. in a leveraged buyout in early 1982. In less than two years, Simon and another partner’s initial \$330,000 investment had increased in value to over \$66 million.⁵

This profitability associated with LBOs has resulted in many such transactions in the 1980’s.⁶ The economic conditions in this decade have been ideal for LBOs: low interest rates and an expanding economy.⁷ But the very characteristic that helps make LBOs so profitable, leverage, also makes them very

1. Dannen, *LBOs: How Long Can This Go On?*, INSTITUTIONAL INVESTOR, Nov. 1986, at 151. In the United States, \$9.2 billion in LBOs were transacted in 1983; \$17.2 billion in 1984, \$32 billion in 1985, and over \$36 billion in 1986.

2. *Id.*

3. Comment, *The Leveraged Buyout and Appraisal Rights: Balancing the Interests of Majority and Minority Shareholders*, 21 WILLAMETTE L. REV. 123 (1985).

4. Dannen, *supra* note 1, at 151, 153. Mr. Dannen interviewed several LBO investors. No one interviewed reported an annualized return of less than 35%. Indeed most of the same investors reported returns of twice that amount.

5. Comment, *supra* note 3, at 123; Dannen, *supra* note 1, at 154.

6. *Id.* at 151.

7. *Id.*

risky.⁸ Such risk prompts the concern that with the next economic downturn will come the failure of many LBOs.⁹ As cash flow is reduced, a highly leveraged company could have difficulty meeting its debt payments.¹⁰ Cash flow is especially important in LBOs financed with high-interest debt, commonly referred to as junk bonds. The interest rates paid on these bonds can approach 20% per year.¹¹ Less risky LBOs, however, are financed by banks at only a few points over the prime interest rate.¹²

If a post-LBO firm fails to meet its debt payments, it could fall prey to bankruptcy.¹³ In addition to the normal ramifications associated with bankruptcy, fraudulent conveyance laws can magnify the adverse consequences suffered by certain secured creditors and selling shareholders of the pre-LBO firm.¹⁴ Courts can use both section 548 of the Bankruptcy Code¹⁵ and individual state fraudulent conveyance laws to set aside the secured status of lenders and to recover any funds paid to the pre-LBO shareholders who sold their stock in the transaction.¹⁶

This Comment will discuss the risks associated with fraudulent conveyances in a LBO bankruptcy from the perspective of both secured debtholders and selling shareholders. It will suggest ways to minimize these risks by handling the leveraged buyout properly from the outset.

8. Loomis, *LBOs are Taking Their Lumps*, FORTUNE, Dec. 7, 1987, at 63. This is where the big risks of LBOs lie. When a company is primarily equity structured, shareholders' dividends always can be forgone if cash flow is tight. Conversely when a company is primarily debt structured, there is no option to withhold interest payments to debt holders.

9. *Id.*; Comment, *supra* note 3, at 123.

10. *Id.*

11. *Id.*

12. Weiner & Parr, *Private Thoughts*, FORBES, Nov. 30, 1987, at 246. In the last quarter of 1987 the prime lending rate was approximately 8.75%. *Id.* (the prime lending rate is the rate charged to the lender's most credit worthy customers).

13. *See, e.g.*, United States v. Tabor Court Realty Corp., 803 F.2d 1288 (3d Cir. 1986), *cert denied*, 107 S. Ct. 3229 (1987).

14. *Id.* at 1297.

15. 11 U.S.C. § 548 (1982 & Supp. IV 1986).

16. In Missouri, statutory law allows unsecured creditors to set aside a conveyance when that conveyance was made "with the intent to hinder, delay or defraud creditors . . ." MO. REV. STAT. § 428.020 (1986); *see also* Community Fed. Sav. & Loan v. Boyer, 710 S.W.2d 332 (Mo. Ct. App. 1986) (case sets forth certain "badges of fraud" constituting a presumption of fraud). In addition, many other states have adopted either the provisions of the UNIF. FRAUDULENT CONVEYANCE ACT, 7A U.L.A. (1918) [hereinafter UFCA] or the later UNIF. FRAUDULENT TRANSFER ACT, 7A U.L.A. (1985) [hereinafter UFTA] (Missouri has not adopted either the UFCA or the UFTA). *See* Kirby, McGuinness & Kandel, *Fraudulent Conveyance Concerns in Leveraged Buyout Lending*, 43 BUS. LAW. 27 (1987); Murdoch, Sartin & Zadek, *Fraudulent Conveyances and Leveraged Buyouts*, 43 BUS. LAW. 1 (1987).

FRAUDULENT CONVEYANCES AS APPLIED TO AN LBO

General Background

The history of fraudulent conveyance laws begins in 16th century England.¹⁷ Parliament passed a statute to address the problem of debtors selling their assets to friends and relatives for a small sum, with the understanding that the debtor would get the property back once he took "sanctuary."¹⁸ Such sanctuary was found in precincts where debtors could live outside the reach of creditors' executions.¹⁹ Specifically, the statute made illegal and void any transfer for the purpose of hindering, delaying, or defrauding creditors.²⁰

The basic idea underlying this statute has survived. Indeed, the Federal Bankruptcy Code adopted similar language,²¹ as did over thirty states in enacting either the Uniform Fraudulent Conveyance Act²² [hereinafter "UFCA"] or the more recent Uniform Fraudulent Transfer Act [hereinafter "UFTA"].²³

The Federal Bankruptcy Act and state fraudulent conveyance laws may be applied together to set aside fraudulent transactions. Specifically, section 548 of the Bankruptcy Code allows a bankruptcy trustee to avoid any conveyance by the debtor within one year before the bankruptcy filing if the conveyance was made "with actual intent to hinder, delay, or defraud" a creditor.²⁴ In addition the trustee may set aside the conveyance if the debtor "received less than a reasonably equivalent value in exchange for such transfer or obligation"²⁵ and any one of the following occurred: (1) the debtor was or became insolvent because of the transfer in question; (2) the debtor was left with an unreasonably small amount of capital because of the transaction; or (3) the debtor incurred or would incur liabilities beyond its ability to pay when the

17. Baird & Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829 (1985); see also *In re Madrid*, 725 F.2d 1197, 1199-1200 (9th Cir. 1984) (case gives a good review of the history of fraudulent conveyances).

18. Baird & Jackson, *supra* note 17, at 829.

19. *Id.* (citing 13 Eliz., ch. 5 (1571)).

20. *Id.*

21. 11 U.S.C. § 548(a)(1) (1982 & Supp. IV 1986). The statute provides:

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

(1) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred. . . .

22. UNIF. FRAUDULENT CONVEYANCE ACT § 7, 7A U.L.A. 509 (1918).

23. UNIF. FRAUDULENT TRANSFER ACT § 7, 7A U.L.A. 652 (1984); Kirby, McGuinness & Kandel, *supra* note 16, at 27 n.2; Murdoch, Sartin & Zadek, *supra* note 16, at 1; (the UFCA was the model for § 548 of the Bankruptcy Code and the Bankruptcy Code was the model for the UFTA); see also MO. REV. STAT. § 428.020 (1986).

24. 11 U.S.C. § 548(a)(1) (1982 & Supp. IV 1986).

25. *Id.* § 548(a)(2).

debts became due.²⁶ Consequently, federal bankruptcy law provides for the setting aside of fraudulent conveyances upon the finding of either intentional fraud pursuant to section 548(a)(1) or constructive fraud pursuant to section 548(a)(2).²⁷

Section 544 of the Federal Bankruptcy Act authorizes the trustee to avoid any conveyances by the debtor that an unsecured creditor could avoid under relevant state law.²⁸ This is extremely important in that state fraudulent conveyance statutes usually incorporate longer statutes of limitations than the one year provided for in section 548 of the Federal Bankruptcy Code.²⁹ Most states allow a trustee to attack a fraudulent conveyance up to four to six years from the time of the transaction.³⁰ In Missouri, an unsecured creditor may attack a fraudulent conveyance within five years of the transaction.³¹ Moreover, the statute of limitations does not start running until either the creditor discovers the facts constituting fraud or ten years, whichever is less.³² Consequently, trustees are more likely to bring actions to set aside fraudulent conveyances under state law because most LBOs are unlikely to go bankrupt within a year of closing.³³

Missouri, for example, allows an unsecured creditor to avoid any conveyance "made or contrived with the intent to hinder, delay or defraud creditors."³⁴ Cases interpreting this statute have set forth certain "badges of fraud" that form a presumption of intent to make a fraudulent conveyance.³⁵ They include: (1) inadequate consideration; (2) the transaction differed from usual business transactions; (3) nearly all of the debtor's property was transferred; (4) the transfer caused insolvency of the debtor; and (5) the failure to produce evidence to rebut suspicious surrounding circumstances regarding the

26. *Id.*

27. *See id.* § 548 (a)(1)(2).

28. *Id.* § 544(b). This section also allows the trustee to avoid conveyances pursuant to other applicable federal laws.

29. *Id.* § 548(a). The statute provides that: "the trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition. . . ." *Id.*

30. *See* Much & O'Dea, *LBOs and the Risks of Fraudulent Conveyance*, 9 NAT'L L.J. 36, 37 (Nov. 3, 1986) (e.g., California has a three year statute of limitations; Texas, four years; and New York, three years).

31. MO. REV. STAT. § 516.120(5) (1986): "Within five years: (5) An action for relief on the ground of fraud, the cause of action in such case to be deemed not to have accrued until the discovery by the aggrieved party, at any time within ten years, of the facts constituting the fraud."

32. *Id.*

33. Kirby, McGuinness & Kandel, *supra* note 16, at 28 n.9.

34. MO. REV. STAT. § 428.020 (1986); *see also* Lindell Trust Co. v. Commonwealth Land Title Ins. Co., 611 S.W.2d 283, 286 (Mo. Ct. App. 1980).

35. Community Fed. Sav. & Loan Ass'n v. Boyer, 710 S.W.2d 332, 334 (Mo. 1986); Morris v. Holland, 529 S.W.2d 948, 953 (Mo. Ct. App. 1975). None of these "badges of fraud" alone establishes fraud. Rather, several must exist together to find a presumption of fraud. *Consolidated v. Columbia*, 627 S.W.2d 904, 307 (Mo. Ct. App. 1981).

transaction.³⁶

These common law badges of fraud have found their way into various statutory enactments. The UFCA and its progeny also treat certain transactions with a per se fraudulent conveyance rule.³⁷ Specifically, both treat any transfer by an insolvent debtor for less than fair consideration as a fraudulent conveyance.³⁸

Consequently the presence of such a per se rule allows courts to set aside some transfers without regard to whether the insolvent debtor had fraudulent intent.³⁹ Indeed, the UFCA drafters intended certain transfers, such as gifts to relatives, to be set aside regardless of intent because such transactions were "inherently objectionable."⁴⁰

Since fraudulent conveyance law in some situations dispenses with the requisite finding of intent to defraud creditors, the pivotal question is "what are its limits?"⁴¹ As Professors Baird and Jackson have noted, this is becoming an increasingly important issue in that courts now are applying fraudulent conveyance laws to corporate debtors; whereas, most case law in the area involves individual debtors.⁴² Indeed, Baird and Jackson point out that most challenged transactions under fraudulent conveyance laws "have been between relatives, friends, or other insiders."⁴³

Accordingly, it seems difficult to reconcile the original goal of fraudulent conveyance law — to prevent fraud or gratuitous transfers — with seemingly arms-length transactions like LBOs.⁴⁴ To fully understand this anomaly, it is helpful to understand how a typical LBO is transacted.

Although LBOs can be structured several ways, this comment will address the stock acquisition form of LBO with respect to fraudulent

36. See *Allison v. Mildred*, 307 S.W.2d 447, 454 (Mo. 1957); *Harrison v. Harrison*, 339 S.W.2d 509, 516 (Mo. Ct. App. 1960).

37. Baird & Jackson, *supra* note 17, at 830-31.

38. *Id.*; UNIF. FRAUDULENT CONVEYANCE ACT § 4, 7A U.L.A. 474 (1918) (a transfer made by an insolvent debtor for less than fair consideration is deemed to be a fraudulent conveyance); 11 U.S.C. § 548(a)(2)(A) (1982 & Supp. IV 1986) (allows the bankruptcy trustee to set aside a transfer as a fraudulent conveyance of the debtor if the debtor "received less than a reasonably equivalent value" and if, *inter alia*, the debtor was insolvent).

39. Baird & Jackson, *supra* note 17, at 831.

40. *Id.* at 831-32 (citing Comment, *Guarantees and Section 548 (a)(2) of the Bankruptcy Code*, 52 U. CHI. L. REV. 194 (1985)). Professors Baird and Jackson note that the UFCA drafters thought that "an insolvent debtor who gives 1000 dollars to his mother makes a fraudulent conveyance, even if he has made a similar gift each year in the past and is not motivated in the slightest by a desire to thwart creditors." *Id.*

41. *Id.* at 832.

42. *Id.*

43. *Id.* The authors found that "if a case did not concern a transfer in which the possibility of a deliberate effort to hinder, delay, or defraud was high, typically it concerned a gratuitous transfer that never could have redounded to the benefit of the creditors and that creditors would have prohibited given the opportunity." *Id.*

44. *Id.* at 833.

conveyances.⁴⁵ In the garden-variety stock acquisition LBO, the acquiring parties (LBO investors) form a holding company to enter an agreement with the selling shareholders of the corporation to be purchased (the target company).⁴⁶ The holding company obtains an unsecured loan from a lender which is used to purchase the target company stock from the selling shareholders.⁴⁷ The target then takes out a loan secured by its assets. The proceeds of the target loan are transferred to the holding company, which uses the funds to repay the lender of the unsecured first loan.⁴⁸

Several of these transactions may be subject to fraudulent conveyance law. Indeed, case law illustrates the willingness of courts to find potentially fraudulent conveyances in: (1) the purchase of the target company stock from the selling shareholders; (2) the security interest given by the target on its assets to the lender; and (3) the transfer from the target's loan to the holding company.⁴⁹

Viewing these three transactions together, one can argue that a LBO will be a fraudulent conveyance.⁵⁰ The investors have a potentially highly profitable investment with little risk to their own money.⁵¹ The old shareholders get bought out with cash, while the general creditors are left with less protection in that the debt is increased with no corresponding increase in assets.⁵² This supports the view that an LBO "hinders" the creditors.⁵³ Of course, to establish a fraudulent conveyance, the creditor would have to prove intent, which could be very difficult.⁵⁴

CONSTRUCTIVE FRAUDULENT CONVEYANCES

The trustee or general creditors have a better method to assert a fraudulent conveyance. As noted earlier, the constructive fraud provisions of the UFCA and the Bankruptcy Act provide that any transfer by an insolvent debtor without receiving fair consideration can be deemed a fraudulent

45. For a good discussion of the ways in which a LBO can be structured, see Carlson, *Leveraged Buyouts in Bankruptcy*, 20 GA. L. REV. 73 (1985).

46. Murdoch, Sartin, & Zadek, *supra* note 16, at 3. The formation of a holding company protects the investors from personal liability for the loan. Carlson, *supra* note 45, at 81 n.24.

47. *Id.*; see Murdoch, Sartin & Zadek, *supra* note 16, at 3.

48. *Id.* This is typically referred to as "upstreaming."

49. See *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288 (3d Cir. 1986), *cert denied*, 107 S. Ct. 3229 (1987).

50. See *Credit Managers Ass'n v. Federal Co.*, 629 F. Supp. 175 (C.D. Cal. 1985).

51. Baird & Jackson, *supra* note 17, at 851; see also *Tabor Court*, 803 F.2d at 1288.

52. See Baird & Jackson, *supra* note 17, at 851.

53. *Id.*

54. *Id.*; see also 11 U.S.C. § 548 (a)(1) (1982 & Supp. IV 1986); UNIF. FRAUD-

conveyance.⁵⁵ Thus, the security interest granted in the target's assets to secure funds which the target will then transfer to the holding company can be set aside as fraudulent because the debtor receives nothing for granting a security interest for the funds that it is to transfer.

In addition to setting aside the security interest, the trustee may bring back into the debtor's estate the money paid to selling shareholders, absent the applicability of section 548(c) which provides:

Except to the extent that a transfer or obligation is voidable under this section is voidable under section 544, 545 or 547 of this title, a transferee or obligee of such a transfer or obligation that takes for value and in good faith has a lien on or may retain any interest transferred or may enforce any obligation incurred, as the case may be, to the extent that such . . . transferee or obligee gave value to the debtor in exchange for such transfer obligation.⁵⁶

Thus, a selling shareholder who has knowledge that the LBO possibly is void under fraudulent conveyance laws would not be a "good faith" transferee of funds secured by the target's assets.⁵⁷

Other decisions under the UFCA have even more disturbing implications. Specifically, *In re Anderson Industries, Inc.*,⁵⁸ ignored the UFCA⁵⁹ good faith requirement recognized by other courts.⁶⁰ In addition, by application of the constructive fraudulent conveyance provisions, the court held it possible to recover funds paid to any shareholders (no matter how large the number) who

55. Baird & Jackson, *supra* note 17, at 851. A similar method of finding constructive fraud is available in those states not having adopted the UFCA, through the presumption created by "badges of fraud." See cases cited *supra* note 35.

56. 11 U.S.C. § 548(c) (1982 & Supp. IV 1986). Note that the UFCA doesn't have an equivalent section to § 548(c), but the UFCA does require "good faith." UNIF. FRAUDULENT CONVEYANCE ACT § 3, 7A U.L.A. 448 (1918). However, courts have held that good faith is not limited to fair consideration and thus the result should be the same as if § 548(c) was included in UFCA. See *Smith v. Whitman*, 39 N.J. 397, 189 A.2d 15 (1963). Indeed, courts have been willing to construe the multiple transactions as one in order to find a transfer of funds by the debtor corporation directly to the selling shareholders, thus ignoring the actual form of the transaction in which the selling shareholders were actually bought out by the holding company. See *United States v. Gleneagles Inv. Co.*, 565 F. Supp. 556 (M.D. Penn. 1983).

57. See *Gleneagles*, 565 F. Supp. at 575. This is basically a tracing rule which follows the fraudulently conveyed funds until they get to a good faith transferee; *cf.* *World Broadcasting Sys. v. Bass*, 160 Tex. 261, 328 S.W.2d 863 (1959) (court did not even bother tracing the fraudulently conveyed funds through to selling shareholder; rather the court just held the selling shareholders personally liable for outstanding debts of the corporate debtor to the extent that the assets were "appropriated" by the selling shareholders); see also *Kupetz v. Continental Ill. Nat'l Bank & Trust Co.*, 77 Bankr. 754 (Bankr. C.D. Cal. 1987) (court held that shareholders were acting in good faith because they believed that buyer of their company in an LBO had sufficient financial backing to run the company).

58. 55 Bankr. 922 (Banker. W.D. Mich. 1985); see also *McCluer v. White*, 338 Mo. 1017, 93 S.W.2d 696 (1936); *May v. Gibler*, 319 Mo. 672, 4 S.W.2d 769 (1928).

59. See *supra* note 56.

60. *Id.*

sold their stock in the LBO of a large publicly held corporation if the corporation became insolvent.⁶¹ This holding is incorrect in that it ignores the explicit good faith requirement in section 9 of the UFCA.⁶² Most shareholders selling their stock in an LBO of a large publicly held corporation would lack the knowledge necessary to set aside the conveyance. The only likely shareholders that would not have good faith would be large shareholders or other insider shareholders.

THE FAIR CONSIDERATION REQUIREMENT

Herein lies a potential trap for both the creditors who lend the funds to transact the LBO and for the shareholders who sell their stock in the target: the threshold question of whether "fair consideration" was given to the target corporation for its conveyance of a security interest in all its assets.⁶³ The UFCA provides that

[f]air consideration is given for property, or obligation:

- (a) When in exchange for such property, or obligation, as a fair equivalent therefor, and in good faith, property is conveyed or an antecedent debt is satisfied, or
- (b) When such property, or obligation is received in good faith to secure a present advance or antecedent debt in amount not disproportionately small as compared with the value of the property, or obligation obtained.⁶⁴

There are a number of factors that go into determining whether "good faith" under the UFCA existed. Specifically: "1) honest belief in the propriety of the activities in question; 2) no intent to take unconscionable advantage of others; and 3) no intent to, or knowledge of the fact that the activities in question will hinder, delay, or defraud others."⁶⁵ In deciding whether "fair consideration"

61. *In re Anderson*, 55 Bankr. at 926. The court did, however, acknowledge the complexity involved in such an undertaking. *Id.*

62. UNIF. FRAUDULENT CONVEYANCE ACT § 9, 7A U.L.A. 577 (1918), provides:

- (1) Where a conveyance or obligation is fraudulent as to a creditor, such creditor, when his claim has matured, may, as against any person except a purchaser for fair consideration without knowledge of the fraud at the time of the purchase, or one who has derived title immediately from such a purchaser,
 - (a) Have the conveyance set aside or obligation annulled to the extent necessary to satisfy his claim, or
 - (b) Disregard the conveyance and attach or levy execution upon the property conveyed.
- (2) A purchaser who without actual fraudulent intent has given less than a fair consideration for the conveyance or obligation, may retain the property or obligation as security for repayment.

63. *Id.*; see also *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288 (3d Cir. 1986), *cert. denied*, 107 S. Ct. 3229 (1987).

64. UNIF. FRAUDULENT CONVEYANCE ACT § 3, 7A U.L.A. (1918); see *Running v. Widde*, 52 Wis. 2d 254, 190 N.W.2d 169 (1971) (definition of fair consideration should be construed in favor of creditors).

65. *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288, 1296 (3d Cir. 1986), *cert. denied*, 107 S. Ct. 3229 (1987); *Running v. Sparkman & McClean Co. v.*

was given, courts look at the particular circumstances surrounding the questionable transfer.⁶⁶ A Pennsylvania court held in a LBO bankruptcy that the initial question in determining whether there was "fair consideration" was whether the lender lent the proceeds in good faith.⁶⁷ The next inquiry is "whether the obligation received [by the lender] was the fair equivalent of the loan[] to the borrowing compan[y]."⁶⁸

Similarly, the Bankruptcy Code requires that the debtor receive "reasonably equivalent value in exchange for such transfer or obligation."⁶⁹ Moreover, the concept of "reasonable equivalence" was derived from the UFCA. Thus, precedents from the UFCA are highly persuasive under the Bankruptcy Code.⁷⁰

*Rubin v. Manufacturers Hanover Trust Co.*⁷¹ provided a particularly helpful explanation of the bases which underlie the "reasonably equivalent" requirement. The court stated:

if the debtor receives property or discharges or secures an antecedent debt that is substantially equivalent in value to the property given or obligation incurred by him in exchange, then the transaction has not significantly affected his estate and his creditors have no cause to complain. By the same token, however, if the benefit of the transaction to the debtor does not substantially offset its cost to him, then his creditors have suffered, and in the language of [§ 548(a)(2)(A)], the transaction was not supported by "fair" consideration.⁷²

Significantly, *Rubin* involved a trustee's attempt to recover the value of collateral the bankrupt corporation gave a bank to guarantee loans made to the bankrupt's affiliate companies.⁷³ The court held that in such a three-party transaction, a corporation's guarantee to benefit a corporate affiliate does not

Derber, 4 Wash. App. 341, 481 P.2d 585 (1971)); see also *Chorost v. Grand Rapids Factory Showrooms*, 77 F. Supp. 276, 281 (D.N.J. 1948), *aff'd*, 172 F.2d 327 (3d Cir. 1949) (good faith requires "lack of knowledge of such facts as would put reasonably prudent person on inquiry" of the possibility of fraudulent conveyance laws avoiding the transaction.).

66. *Halsey v. Winant*, 258 N.Y. 512, 180 N.E. 253 (1932).

67. *United States v. Gleneagles Inv. Co.*, 565 F. Supp. 556, 574 (M.D. Penn. 1983).

68. *Id.*; see also *Neal v. Clark*, 75 Ariz. 91, 251 P.2d 903 (1953); *First Nat'l Bank v. Hoffines*, 429 Pa. 109, 239 A.2d 458 (1968).

69. 11 U.S.C. § 548(a)(2)(A) (1982 & Supp. IV 1986). "Value" is defined as "property, or satisfaction of 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." *Id.* § 548(d)(2)(A); see also *Rubin v. Manufacturers Hanover Trust Co.*, 661 F.2d 979 (2d Cir. 1981); *In re Roco Corp.*, 21 Bankr. 429 (Bankr. 1st Cir. 1982).

70. D. COWANS, *COWANS BANKRUPTCY LAW AND PRACTICE* § 10.9, at 185 (1986).

71. 661 F.2d 979 (2d Cir. 1981).

72. *Id.* at 991.

73. *Id.*

result in fair consideration to such corporation when it received no benefit from having done so.⁷⁴

Accordingly, when the target firm in an LBO conveys a security interest in its assets for a loan whose proceeds are to be transferred to a holding company (and for all intents and purposes to the selling shareholders), the costs to the target are not "substantially offset" by the benefits of the transaction.⁷⁵ Notwithstanding this, other courts have adopted a more liberal interpretation of "fair consideration" in light of modern corporate practices. For instance, in *Telefest, Inc. v. VU-TV, Inc.*,⁷⁶ the court held that when a "debtor and the third party are so related or situated that they share an 'identity of interests,' because what benefits one, will in such case, benefit the other to some degree."⁷⁷ Nevertheless, the same opinion stated that:

The ultimate question then becomes one of determining the value of this vicarious benefit and testing it by the measure of "reasonably equivalent" for the property transferred by the insolvent debtor. When the consideration for a transfer passes to the parent corporation of a debtor/subsidiary making the transfer . . . the benefit to the debtor may be presumed to be nominal, in the absence of proof of a specific benefit to it.⁷⁸

Applying this to the context of an LBO (which of course is a three-party transaction)⁷⁹ indicates that a court could find a lack of fair consideration when the target grants a security interest to the lender. In a technical sense, the target receives no benefit when it grants the security interest for proceeds which are upstreamed to the holding company.⁸⁰

74. *Id.* The court did point out that the benefit received by the guaranteeing corporation need not be direct. "If the consideration given to the third party 'ultimately landed in the debtor's hands' or otherwise conferred an economic benefit upon the debtor in an amount that approximately benefits the value of the thing given up, then the fair consideration requirement has been met." *Id.* at 991, 992 (citing *Klein v. Tabatchnick*, 610 F.2d 1043 (2d Cir. 1979)); see *Williams v. Twin City Co.*, 251 F.2d 678 (9th Cir. 1958); *McNellis v. Raymond*, 287 F. Supp. 232 (N.D.N.Y. 1968)); see also *In re O.P.M. Leasing Serv., Inc.*, 28 Bankr. 740 (Bankr. S.D.N.Y. 1983); *In re Royal Crown Bottlers, Inc.*, 23 Bankr. 28 (N.D. Ala. 1982).

75. See *Rubin*, 661 F.2d 979 (2d Cir. 1981); see also *Tabor Court*, 803 F.2d 1288 (3d Cir. 1986), cert. denied, 107 S. Ct. 3229 (1987). In Missouri, "[i]t is well settled that a conveyance by a debtor of all or nearly all of his property gives rise to an inference of fraudulent intent." *Lindell Trust Co. v. Commonwealth Land Title Ins. Co.*, 611 S.W.2d 283, 288 (Mo. Ct. App. 1981) (citing *Harrison v. Harrison*, 339 S.W.2d 509 (Mo. Ct. App. 1960)). But see *McCluer v. White*, 338 Mo. 1017, 1024, 93 S.W.2d 696, 700 (1936). "If at the time of making the conveyance the grantor retained ample means to pay his debts . . . [then] the conveyance is valid". *Id.*

76. 591 F. Supp. 1368 (D.C.N.J. 1984)

77. *Id.* at 1378 (quoting *In re Royal Crown Bottlers Inc.*, 23 Bankr. 28 (N.D. Ala. 1982)).

78. *Id.*

79. The three parties: (1) the target company; (2) the LBO investors; and (3) the lender.

80. Note that the upstreamed proceeds to the holding company are used to pay off the unsecured loan which was used to cash out the selling shareholders.

Using "identity of interests" reasoning, the holding company and target are closely related. The holding company merely serves as a vehicle to facilitate the LBO of the target. The target "benefits" in that the "new" target is a privately-held corporation not subject to expensive SEC reporting requirements.⁸¹ In addition, most post-LBO companies strive to increase profits by cutting costs, closing unprofitable operations and eliminating expensive corporate perks for management.⁸² Thus in an LBO transaction, one can argue that the holding company provides adequate consideration by trying to save a failing company or increasing profits of a stable company. Notwithstanding this logic, *Credit Managers Association v. The Federal Co.*⁸³ stated that, because of the very nature of an LBO, the target probably never receives fair consideration (under the confines of the Bankruptcy Code and the UFCA) for the obligation it assumes.⁸⁴

Nevertheless, a later decision that relied heavily on *Credit Managers* lends support to shareholders who ultimately received the proceeds that were part of an alleged fraudulent conveyance. In *Kupetz v. Continental Illinois National Bank & Trust Co.*,⁸⁵ the bankruptcy court held that just because the target company did not receive fair consideration when its assets were pledged for the loan that was subsequently upstreamed to the holding company to pay off the unsecured debt does not make the payment to the selling shareholders fraudulent.⁸⁶ Indeed, the court reasoned that the shareholders' selling their stock to the holding company was a "fair transaction" made for fair consideration.⁸⁷ Accordingly, the court held that the shareholders should not be punished for the company's later transactions to which they were not parties.⁸⁸

81. See Anders, *Another Round: Many Firms Go Public Within a Few Years of Leveraged Buyout*, Wall St. J., Jan. 2, 1987, at 1, col. 6.; Baird & Jackson, *supra* note 17, at 853.

82. Anders, *supra* note 81, at 1, col. 6.

83. 629 F. Supp. 175 (C.D. Cal. 1985).

84. *Id.* at 182. The court held as a matter of law that management services provided by an affiliate to the debtor company did not constitute fair consideration for the obligation the debtor received. *Id.* (citing *United States v. Gleneagles Inv. Co.*, 565 F. Supp. at 576); see also *Kupetz v. Continental Ill. Nat'l Bank & Trust Co.*, 77 Bankr. 754 (C.D. Cal. 1987).

85. 77 Bankr. 754 (C.D. Cal. 1987).

86. *Id.*

87. *Id.* at 761. In fact, the LBO investor testified that he thought he was getting a good deal. *Id.* at 764.

88. *Id.* It is possible this case will be limited to its facts. Evidence introduced at trial showed that the selling shareholders were unaware that the target was going to convey a security interest in all its assets in order to obtain financing which was then upstreamed to the holding company in order to retire the unsecured debt taken to buyout the selling shareholders. *Id.* at 758. In contrast, in most LBOs, the selling shareholders are probably well aware of the leveraged nature of the transaction.

FINANCIAL CONDITION

If the court decides that less than reasonably equivalent value was given⁸⁹ in a leveraged buyout transaction, its next inquiry under the Bankruptcy Code is determining whether the debtor was insolvent or became insolvent as a result of the transfer,⁹⁰ was left with unreasonably small capital after the transfer,⁹¹ or was left with debts that the debtor would be unable to pay.⁹²

Likewise, the UFCA provides similar bases for finding constructive fraud once the court finds that the debtor made a conveyance without receiving fair consideration.⁹³ UFCA section 4 provides one test of financial condition: "[e]very 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 his actual intent if the conveyance is made or the obligation is incurred without fair consideration."⁹⁴

Further, the UFCA provides that a debtor is insolvent "when the present fair salable value of his assets is less than the amount that will be required to pay his probable liability on his existing debts as they become absolute and matured."⁹⁵ Unfortunately, this test still does not necessarily make it clear just when a debtor is rendered insolvent. For example, in *United States v. Gleneagles Investment Co.*⁹⁶ (a LBO bankruptcy case) the court held that "present, fair, salable value" as used in the Pennsylvania UFCA definition of insolvency means "the value which can be obtained if the assets are liquidated with reasonable promptness in an arms-length transaction in an existing and not theoretical market."⁹⁷ Moreover, the *Gleneagles* court stated that:

[i]f a debtor has a deficit net worth, then the present salable value of his assets must be less than the amount required to pay the liability on his debts as they mature. A debtor may have substantial paper net worth including assets which have a small salable value, but which if held to a subsequent date could have a much higher salable value. Nevertheless, if the *present* salable value of his assets are [sic] less than the amount required to pay existing debts as they mature, the debtor is insolvent.⁹⁸

89. For this Comment's purposes, "fair consideration" as used in the UFCA will be the functional equivalent of "less than reasonably equivalent value" as used in the Bankruptcy Code.

90. 11 U.S.C. § 548(a)(2)(B)(ii) (1982 & Supp. IV 1986).

91. *Id.*

92. *Id.* § 548(a)(2)(B)(iii).

93. UNIF. FRAUDULENT CONVEYANCE ACT §§ 4-6, 7A U.L.A. (1918).

94. *Id.* § 4; see *In re Knox Kreations, Inc.*, 474 F. Supp. 567, 571 (E.D. Tenn. 1979); *Gleneagles*, 565 F. Supp. at 573.

95. UNIF. FRAUDULENT CONVEYANCE ACT § 2(1), 7A U.L.A. 442 (1985).

96. 565 F. Supp. 556 (M.D. Penn. 1983).

97. *Id.* at 578; see also *Hyde Prop. v. McCoy*, 507 F.2d 301, 307 (6th Cir. 1974).

98. 565 F. Supp. at 578 (citing *Lerrimer v. Feeney*, 411 Pa. 604, 609, 192 A.2d

This rigid approach to insolvency necessarily results in many LBO target companies being considered insolvent because the post-transaction company is structured primarily with debt.⁹⁹ As discussed above, LBO investors plan to increase the profitability of their investment by increasing the value of the company.¹⁰⁰

Regardless of *Gleneagles*, other courts have taken a more realistic approach to the issue of insolvency.¹⁰¹ For example, in *Telefest, Inc. v. VU-TV, Inc.*¹⁰² the court held that just because the debtor's liabilities exceed assets it does not necessarily mean that the corporation is insolvent.¹⁰³ If the debtor corporation is "actively pursuing its regular business with a reasonable expectation that business conditions will improve and that it will be re-established on a sound financial basis" then it is quite possible that the debtor corporation was solvent at the time of the alleged fraudulent transaction and remained so thereafter.¹⁰⁴

Missouri courts apply similar reasoning. Essentially, if at the time of the conveyance the debtor retained "ample means" to pay his debts as they come due, then the debtor is not insolvent for fraudulent conveyance purposes.¹⁰⁵

The holding in *Credit Managers Association v. The Federal Co.*,¹⁰⁶ illustrates another test of financial condition available to set aside a fraudulent conveyance: the transfer is considered fraudulent if it left the debtor with "unreasonably small capital" to continue business.¹⁰⁷ Specifically, the relevant provision provides that:

[e]very conveyance made without fair consideration when the person making it engaged or is about to engage in a business or transaction for which the property remaining in his hands after the conveyance is an unreasonably small capital, is fraudulent as to creditors and as to other persons who become creditors during the continuance of such business or transaction without regard to his actual intent.¹⁰⁸

99. See *Credit Managers Ass'n v. Federal Co.*, 629 F. Supp. 175, 178 (C.D. Cal. 1985).

100. See *Anders*, *supra* note 81, at 1, col. 6.

101. See, e.g., *Freehling v. Michigan Repacking & Produce Co.*, 426 F.2d 989, 990 (5th Cir. 1970); *Telefest, Inc. v. VU-TV, Inc.*, 591 F. Supp. 1368, 1375-76 (D.N.J. 1984); *Hersh v. Levinson Bros.*, 117 N.J. Eq. 131, 136, 171 A. 736, 739 (1934).

102. 591 F. Supp. 1368 (D.N.J. 1984).

103. *Id.* at 1376.

104. *Id.* Creditor sought to have a security agreement given on the assets of a subsidiary of the debtor set aside as a fraudulent conveyance. *Id.* at 1371.

105. See *McCluer v. White*, 338 Mo. 1017, 1024; 93 S.W.2d 696, 700 (1936); see also *May v. Gibler*, 319 Mo. 672, 677, 4 S.W.2d 769, 771 (1928). Note that this reasoning is the functional equivalent of the second and third tests of financial condition as discussed *infra* text accompanying note 131.

106. 629 F. Supp. 175 (C.D. Cal. 1985).

107. UNIF. FRAUDULENT CONVEYANCE ACT § 5, 7A U.L.A. 504 (1918); 11 U.S.C. § 548(a)(2)(B)(ii) (1982 & Supp. IV 1986).

108. UNIF. FRAUDULENT CONVEYANCE ACT § 5, 7A U.L.A. 504 (1918).

Thus, if the holding company did not give fair consideration, and the surrounding facts indicate the post-LBO target was left insufficiently capitalized, then courts under this test consider the LBO transaction fraudulent.¹⁰⁹ Although several factors enter into the question, *Credit Managers* deemed the projected cash flows at the time of the LBO transaction as most important.¹¹⁰ The court reasoned that the cash flow projections show the target company's ability after the LBO to meet its obligations as they would become due.¹¹¹ Moreover, the issue of proper cash flow analysis turns not on whether the analysis turned out to be correct; rather, it depends on whether the projection was "reasonable and prudent at the time it was made."¹¹²

As *Credit Managers* illustrates, the financial condition test of adequate capitalization¹¹³ is similar to the requirement that the parties believe that the transaction will not cause the debtor to incur "debts that would be beyond the debtor's ability to pay as such debts matured."¹¹⁴ Indeed, *Credit Managers* states that the determination of whether the post-LBO company will be adequately capitalized depends on whether the projections made at the time of the LBO indicated that the business could continue to operate and to meet its debt servicing requirements.¹¹⁵ But, the adequate capitalization requirement "does not require that [debtor] companies be sufficiently capitalized to withstand any and all setbacks to their business."¹¹⁶ It only requires that capitalization not be "unreasonably small."¹¹⁷

As a result, if there was a reasonable expectation at the time of the LBO transaction that the target would be able to meet its operating expenses, it would be adequately capitalized. Nevertheless, if the LBO company subsequently becomes bankrupt, courts can make a hindsight determination based solely on insolvency.¹¹⁸ If the court follows the *Gleneagles* definition of insolvency, which is based on net worth calculated with liquidation or "fire-sale" asset values, then the LBO runs a much greater chance of being found to have occurred while the target was insolvent or to have caused the target's insolvency.¹¹⁹ But this is an illogical way to value assets. At the time of the LBO,

109. *Credit Managers*, 629 F. Supp. at 182.

110. *Id.* at 183.

111. *Id.* The cash flow analysis in *Credit Managers* showed that at the time the LBO was transacted, the target company was expected to "have sufficient funds to carry on its operations." *Id.*

112. *Id.* at 184. This determination is based on projected sales, gross profit margins and inventory turnover, accounts receivable collection periods, and certain balance sheet financial ratios. *Id.* at 184, 188. In this case, the court held the projections were reasonable at the time made. Nevertheless, with the benefit of hindsight, events such as a strike by the target's employees helped to make the cash projections incorrect.

113. 11 U.S.C. § 548(a)(2)(B)(ii) (1982 & Supp. IV. 1986).

114. *Id.* § 548(a)(2)(B)(iii).

115. *Credit Managers*, 629 F. Supp. at 187.

116. *Id.*

117. *Id.*

118. See 11 U.S.C. § 548(A)(2)(B)(i) (1982 & Supp. IV 1986).

119. See *United States v. Labor Court Realty Corp.*, 803 F.2d 1288 (3d Cir.

the parties based the stock price on the fair market value of the company as normally used in the business context.¹²⁰ Consequently, it seems unfair to later judge the solvency of the target by the harsher test of rapid sale market value.¹²¹

The preeminent case regarding LBO transactions and fraudulent conveyances is *United States v. Tabor Court Realty Corp.*¹²² The facts and circumstances of the case are exceedingly complicated, involving dozens of parties and separate cases which were consolidated on appeal.¹²³ The LBO in the *Gleneagles* decisions and reviewed in *Tabor* was found to be fraudulent on several bases. First, the security interest granted in the target was invalid under the intentional fraud sections of the UFCA.¹²⁴ Moreover, the *Tabor* court invalidated the mortgages under the UFCA constructive fraud provisions.¹²⁵

1986), *cert. denied*, 107 S. Ct. 3229 (1987).

120. Black's Law Dictionary defines "fair market value" as:

The amount at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. By fair market value is meant the price in cash, or its equivalent, the property would have brought at the time of taking, considering its highest and most profitable use, if then offered for sale in the open market, in competition with similar properties at or near the location of the property taken, *with a reasonable time allowed to find a purchaser.*

BLACK'S LAW DICTIONARY 537 (5th ed. 1979) (emphasis added); *see also* Hyde Prop. v. McCoy, 507 F.2d 301 (6th Cir. 1974). "Essentially the statutory provision [the UFCA] anticipates a voluntary, open market sale of all of an individual's assets." *Id.* at 307.

121. As National Commercial Finance Ass'n, Inc. argued in its amicus curiae brief in *Tabor*, the district court in *Gleneagles* incorrectly interpreted the word "present" as used in UFCA § 2. *Gleneagles*, 565 F. Supp. at 578. "Present fair salable value" is interpreted to mean the value that could be received if the "assets are liquidated with reasonable promptness in an arms-length transaction in an existing and not theoretical market." *Id.* In contrast, "[p]roper application . . . requires the valuation of an asset at its present value, provided it can be liquidated within a reasonably immediate period of time - not its value if liquidated immediately." *Tabor*, 803 F.2d at 1303 (quoting from appellant's brief at 37); *see also In re Bichel Optical Laboratories, Inc.*, 299 F. Supp. 545, 548 (D. Minn. 1969); *Tumarkin v. Gallay*, 127 F. Supp. 94, 96 (S.D.N.Y. 1954).

122. 803 F.2d 1288 (3d Cir. 1986), *cert. denied*, 107 S. Ct. 3229 (1987). This was the first case involving "significant application of the UFCA to leveraged buyout financing." *Id.* at 1291.

123. *Id.* The district court made 481 findings of facts and issued three separate published opinions. For an in-depth analysis of the *Gleneagles* decisions, see Murdoch, Sartin & Zadek, *supra* note 16.

124. *Tabor*, 803 F.2d at 1304, 1305; *see* UNIF. FRAUDULENT CONVEYANCE ACT § 7, 7A U.L.A. 509 (1918), which provides that "[e]very conveyance made and every obligation incurred with actual intent, as distinguished from intent presumed in law, to hinder, delay, or defraud either present or future creditors, is fraudulent as to both present and future creditors."

125. 803 F.2d at 1296, 1297; *see also* UNIF. FRAUDULENT CONVEYANCE ACT

As Professor Carlson pointed out, the lender involved in *Gleneagles* was not exactly deserving of sympathy.¹²⁶ Indeed, evidence surrounding the loan to the target company indicated that the lender did not expect the target company to survive.¹²⁷ Moreover, the selling shareholders settled out of court, disgorging almost all the proceeds they received from the transaction.¹²⁸ The troubling aspect of *Gleneagles* is not the result, but the way in which the court arrived at its decision. By applying constructive fraudulent conveyance provisions, the court established a dangerous precedent that could punish above-board lenders and selling shareholders should the company subsequently fail.

As a result of *Gleneagles*, any LBO should be transacted so as to minimize fraudulent conveyance risk. Both lenders and selling shareholders should strive to ensure the post-LBO company could survive a challenge under state or federal bankruptcy provisions.

Leveraged buyout experts Much and O'Dea assert that one can minimize the risks of constructive fraudulent conveyance laws by undertaking a "two-part capital adequacy analysis at the time of the LBO."¹²⁹ First, she should determine whether there will be a positive net worth after the LBO transaction, *i.e.* a determination of solvency. Much and O'Dea suggest three types of asset valuation. In the first, assets are valued at fair market value¹³⁰ (which ideally would be the price paid for the selling shareholders stock). In the second valuation, assets are valued at an "orderly liquidation."¹³¹ Finally, solvency is determined based on a rapid-sale or liquidation asset values.¹³²

Second, Much and O'Dea suggest that parties to a potential LBO conduct a cash flow analysis to determine whether the post-LBO target company will be able to meet its debt obligations as they become due.¹³³ Cash flow analysis focuses upon the adequacy of the firm's capitalization and whether the target would be able to meet the debt payments and other obligations as they became due.¹³⁴

Attempts to transact a LBO in a way to avoid a later finding of insolvency have recently been dealt a setback. In February 1988, the American

§§ 4-5, 7A U.L.A. (1918).

126. Carlson, *supra* note 45, at 109.

127. *Id.* at 106 (citing *United States v. Gleneagles*, 565 F. Supp. 556, 571, 574-575 (M.D. Penn. 1983)). Professor Carlson argued that the LBO was very close to a looting scheme "whereby the company was liquidated not for the benefit of the creditors, but for the benefit of the equity owners and the secured lender." *Id.*

128. *Tabor*, 803 F.2d at 1300.

129. Much & O'Dea, *LBO's and the Risks of Fraudulent Conveyance*, 9 NAT'L L.J. 36, (1986).

130. *Id.* at 36-37.

131. *Id.*

132. *Id.* at 37. Note that the valuation at the rapid sale value compensates for the possibility that a court will apply the *Gleneagles* rapid sale asset valuation for a solvency determination.

133. *Id.*

134. *Id.* at 38.

Institute of Certified Public Accountants ("AICPA") issued an interpretation statement on standards for attestation engagements titled "Responding to Requests for Reports on Matters Relating to Solvency."¹³⁵ The interpretation precludes accountants from "providing any form of assurance, through examination, review or agreed-upon procedures engagements, that an entity: [1] Is not insolvent thereby; [2] Does not have unreasonably small capital; [or] [3] Has the ability to pay its debts as they mature."¹³⁶

Although this AICPA interpretation is binding on Certified Public Accountants, it probably will not have a great impact on most LBO transactions. Indeed, one possible way around it is to have a valuation company give an opinion on the company's solvency.¹³⁷

CONCLUSION

As the law of fraudulent conveyances stands, companies purchased through a leveraged buyout run the risk of being subject to fraudulent conveyance laws. The *Gleneagles* decisions present troubling problems. Nevertheless, careful planning and documentation of the LBO should minimize risk to arm's-length transactions that are carried out in good faith.

PRICE A. SLOAN

135. The Auditing Standards Division of the American Institute of Certified Public Accountants issued this interpretation. As stated in the interpretation, "[a]n interpretation is not as authoritative as a pronouncement of the Auditing Standards Board, but members should be aware that they may have to justify a departure from an interpretation if the quality of their work is questioned." AICPA, RESPONDING TO REQUESTS FOR REPORTS ON MATTER RELATING TO INSOLVENCY, *inside front cover* (1988).

136. *Id.* at 4. In addition, the interpretation also prohibits any assurances regarding equivalent terms to solvency, e.g., "fair saleable value of assets exceeds liabilities". *Id.* at 5.

137. See Much & O'Dea, *LBO's and the Risks of Fraudulent Conveyance*, 9 NAT'L L.J. 36 (1986).

