

# CORPORATE GROUP JOINT BORROWERS AND FRAUDULENT CONVEYANCES

By Ernest A. Goetz, Jr. and Kenneth A. Hoffmann

**INTRODUCTION.** In deciding whether to extend credit, lenders often disregard the legal separateness of the entities in a corporate group in order to underwrite a credit facility based on the strength of the corporate group as a whole. In doing so, lenders usually require all of the members of the corporate group to provide some form of credit support, either by spreading the repayment obligations among the members of the corporate group on a joint and several basis or requiring a guarantee and/or security from all of the members of the corporate group.

Lenders should use caution when underwriting on the basis of the corporate group. In a prior article entitled "Co-Borrowers or Sureties", we explored the suretyship defenses involved in multiple-borrower loan structures and discussed ways to avoid inadvertent discharge of co-borrowers.

This article focuses on the fraudulent transfer law implications involved in co-borrower transactions. While a lender may prefer a co-borrower structure over a borrower and guarantor structure, or vice versa, such variation in structure may prove virtually irrelevant in the context of minimizing fraudulent transfer risks.

**CONSTRUCTIVE FRAUDULENT TRANSFERS.** If a corporate entity provides credit support for another member of a corporate group, whether as a co-borrower or as a guarantor, whereby such member becomes obligated or pledges collateral may be subject to avoidance as a fraudulent transfer. Fraudulent transfer laws are intended to protect a debtor's creditors. They do not provide special treatment for a lender which provides credit to a corporate group in good faith reliance in what may ultimately be deemed a fraudulent transaction.

In the prior article, we explored the situation in which a subsidiary is either a co-borrower or a guarantor and, in either case, is not utilizing the proceeds of the loan for its own purposes. A lender, however, will often require the subsidiary to be a co-borrower or guarantor in order to take a security interest in the subsidiary's assets to enhance the credit. Whether the subsidiary signs as a co-borrower or a guarantor, the potential effect of fraudulent transfer law on the subsidiary and its creditors is the same.

If the subsidiary does not receive any of the proceeds of or any direct benefit from the loan, its repayment obligation and/or security interest may be avoided, regardless of fraudulent intent. This type of fraudulent transfer is commonly referred to as a "constructive fraudulent transfer".

In a bankruptcy context, a creditor of the debtor, or a bankruptcy trustee can have a transaction avoided as a constructive fraudulent transfer. Solely between a lender and

its debtor, however, a transaction that is constructively fraudulent is still enforceable. If a lender concludes that the risk of the borrower or the guarantor being the subject of a bankruptcy proceeding is minimal, it may consider the risk of fraudulent transfer acceptable.

Under the Federal Bankruptcy Code, an obligation incurred or a pledge of collateral (a "transfer") made within one year of the date of a debtor's bankruptcy is considered constructively fraudulent and can be avoided if (1) the debtor received "less than a reasonably equivalent value" for such obligation or transfer, and (2) was insolvent at the time of the transaction or rendered insolvent as a result of such transaction, was left with "unreasonably small capital", or intended to incur debts that would be beyond its ability to pay as such debts matured. A transaction will be deemed constructively fraudulent if it fails both prongs of the test. State bankruptcy laws usually have a similar test, with some nuances.

Intercorporate guarantees (including guarantors disguised as co-borrowers) are subject to scrutiny under constructive fraudulent transfer law. Guarantees from a subsidiary of the obligations of its parent ("upstream guarantees") and guarantees by an affiliate of the obligations of another affiliate ("cross-stream guarantees") where the subsidiary or affiliate receives little or no direct benefit for its guarantee are particularly suspect.

In determining "reasonably equivalent value" for the first prong of the test, it is not necessary for the value received to be equal to the value given or that the value received be a direct benefit. Indirect, intangible economic benefits may be a source of reasonably equivalent value, so long as these benefits confer a "realizable commercial value on the debtor reasonably equivalent to the realizable commercial value of the assets transferred." Whether indirect benefits exist and qualify as "reasonably equivalent value" in any transaction alleged to be constructively fraudulent is a question of fact, considering all of the circumstances of the transaction in a light most favorable to the debtor's creditors.

The guarantor's lack of receipt of reasonably equivalent value for its guarantee is not, by itself, sufficient to render the guarantee constructively fraudulent. In addition, one or more of the financial conditions of the second prong of the test must also be present at the time or occur as a result of the transaction. As in the case of determining the existence of "reasonably equivalent value," the determination of whether one of the triggering financial conditions required by the applicable constructive fraudulent transfer law is present or occurs is a factual question. Unfortunately for the lender, its evaluation of these factual issues will also be subject to later review by a court. The court, however, unlike the lender will have the benefit of hindsight.

**CO-BORROWER OR GUARANTOR?** For purposes of fraudulent conveyance issues, a lender's decision to require the subsidiary to sign a note or a guarantee is irrelevant if the facts do not support the structure. Since a lender is relying on the subsidiary's assets, the goal of the lender should be to

minimize or eliminate the fraudulent transfer risk. One way is to "lend to where the assets are". A true co-borrowing arrangement in which both the subsidiary and the parent have the ability to borrow can survive a fraudulent transfer challenge at least to the extent of loans made directly to it as a primary obligor. Whether the subsidiary's ability to borrow constitutes reasonably equivalent value for the guarantee obligations is a question of fact that primarily depends on the business opportunities made available by the loan facility.

If a subsidiary has no true ability to access the benefits of the loan and is merely providing its guarantee and/or collateral for loans made to the parent, the lender should look for ways in which the loan directly or indirectly benefits the subsidiary and document the transaction based upon these benefits. Such benefits are often recited in the form of representations including common ownership or management and the financial interdependence of the companies.

**THE DRAFTING SOLUTIONS.** A lender would be prudent to carefully consider the financial condition triggers of the constructive fraudulent transfer law especially if the existence of reasonably equivalent value for the subsidiary's guarantee or lien on its assets is in doubt.

A lender might consider limiting the subsidiary's guarantee obligations. Two possible limitations for this purpose are limiting a guarantor's liability to an amount that is slightly less than its net worth (a "net worth guarantee") or to an amount not to exceed the amount that can be guaranteed by such guarantor under applicable fraudulent transfer law in the event that a fraudulent transfer claim is asserted (a "savings clause"). The theory behind a net worth guarantee is to make it mathematically impossible for the guarantee to render a guarantor insolvent. We stress the theoretical aspect of this device since it would be difficult to determine such figures to a sufficient degree of accuracy and, as yet, it has not been tested in the courts.

Savings clauses attempt to "save" a transaction that might otherwise be avoided in its entirety as a fraudulent transfer. The advantage of a savings clause over a net worth limitation is that the savings clause limits its applicability to instances where the guarantee is actually found to be constructively fraudulent. It does not limit the amount of the guarantee. However, like net worth guarantees, the efficacy of a savings clause has not yet been determined.

**CONCLUSION.** Disguising an intercorporate guarantee as a co-borrowing arrangement can be merely form over substance. Fraudulent conveyance law applies regardless of the structure and is dependent on a factual analysis. However, if lenders, when structuring loans to corporate groups, keep in mind the fraudulent transfer principles discussed above and the suretyship principles discussed in the prior Co-Borrower/Surety article, the transaction can be documented in a way calculated to achieve the desired result.

**The Following Are Some Suggested Clauses for Inclusion in Documentation:**

*Whereas Clause.* WHEREAS, it is a condition precedent to the borrowings under the Credit Agreement that each Guarantor guarantee the indebtedness and other obligations of the Borrower to the Bank under or in connection with the Credit Agreement as set forth herein. Each Guarantor, as a subsidiary of the Borrower, will derive substantial direct and indirect benefits from the making of the Loan to the Borrower pursuant to the Credit Agreement (which benefits are hereby acknowledged by each Guarantor).

*Limitation of Guaranty.* To the extent that any court of competent jurisdiction shall impose by final judgment, under applicable law, any limitations on the amount of any Guarantor's liability with respect to the Guaranteed Obligations which the Bank can enforce under this Guaranty, the Bank accepts such limitation on the amount of such Guarantor's liability hereunder to the extent needed to make this Guaranty and the Guarantor Documents fully enforceable and nonavoidable.

*Solvency.* Immediately prior to and after and giving effect to the incurrence of any Guarantor's obligations under the Guaranty, such Guarantor is and will be Solvent.

*Consideration.* Each Guarantor has received at least "reasonably equivalent value" (as such phrase is used in §548 of the Bankruptcy Code and in comparable provisions of other applicable law) and more than sufficient consideration to support its obligations hereunder in respect of the Guaranteed Obligations and under any of the Collateral Documents to which it is a party.

**USE OF SUGGESTED CLAUSES**

*You can use suggested clauses in two ways. First, you can use it in a specific transaction with appropriate modifications. Second, you can use it to compare against another similar loan document. In either case, do not use this sample language without appropriate legal advice.*

*This article is not intended to provide legal advice for a specific transaction. If you require further information on any matter contained in this article or would like to discuss a specific transaction, please feel free to contact either **Mr. Goetz or Mr. Hoffmann at (516) 296-7000.***