Are affiliate guarantees at risk of being fraudulent conveyances?

- **Downstream guarantee** - when a parent guarantees debt of its subsidiary.
  - In the case of downstream guarantees (particularly of wholly owned subsidiaries), a parent corporation's effort to protect its investment in a subsidiary has been recognized as providing substantial consideration in return for the obligation incurred. Thus a downstream guarantee may not be avoidable as a fraudulent conveyance.
  
  Commercial Bankruptcy Litigation § 11:39

- **Upstream guarantee** - when a subsidiary guarantees the debt of its parent.
  - Have been challenged as fraudulent conveyances due to lack of reasonably equivalent value.

- **Cross stream guarantee** - when brother/sister entities guarantee each other's debt. (Cross-collateralization.)
Constructive Fraudulent Transfers under the Bankruptcy Code

The Bankruptcy Code defines a “constructively” fraudulent conveyance as any “transfer” of an interest in property of the debtor, “or any obligation, . . .incurred by the debtor” within two years before the bankruptcy filing—

where the debtor “received less than a reasonably equivalent value in exchange for such transfer or obligation; and

where the transferor was insolvent or became insolvent as a result of such transfer or obligation, was left with unreasonably small capital, or was unable to pay its debts as they became due.


Value and reasonably equivalent value

- Value is defined as “property, or satisfaction or securing of a present or antecedent debt of the debtor. . .” 11 U.S.C. § 548(d)(2).

- Generally, to the extent the debtor receives the actual loan proceeds, then property has been given.
  - “Such concrete benefits [that constitute reasonably equivalent value] include (1) the proceeds of the loan, (2) debt relief, (3) the acquisition of inventory and (4) tax benefits.”

- There is no statutory test for reasonably equivalent value. Many courts use a “totality of circumstances” approach and focus on the (1) fair market value of the benefit received, (2) the existence of an arms length transaction and (c) the transferee’s good faith.
Traditional rule:
guarantee of affiliate may lack reasonably equivalent value.

- Guarantees may be at risk of being a fraudulent conveyance.  

- "[I]f the debt secured by the transaction is not the debtor's own, then his giving of security will deplete his estate without bringing in a corresponding value from which his creditors can benefit, and his creditors will suffer just as they would if the debtor had simply made a gift of his property or obligation. Accordingly, courts have long recognized that 't[ransfers made to benefit third parties are clearly not made for a 'fair consideration,' and, similarly, that 'a conveyance' by a corporation for the benefit of an affiliate [should not] be regarded as given for fair consideration as to the creditors of the conveying corporation."
  – Rubin, 661 F.2d at 991.

- But Rubin also recognized that indirect economic benefit "could be enough to establish fair consideration," but remanded for further examination of issue of benefit.

Traditional rule (continued)

- “The traditional view is that unless specific consideration is given, "[t]ransfers made to benefit third parties are clearly not made for 'fair' consideration.” 4 Collier on Bankruptcy, ¶ 67.33 at 514.1 (14th ed. 1978). Accordingly, intercorporate guarantees raise fraudulent conveyance problems because the guarantor often receives no direct benefit in exchange for the obligation incurred on behalf of its affiliate. See generally Blumberg, The Law of Corporate Groups, Problems in the Bankruptcy or Reorganization of Parent and Subsidiary Corporations, Including the Law of Corporate Guaranties (Little, Brown and Company 1985).”
Modern trend: 
Indirect benefit can satisfy test of reasonably equivalent value

• Some cases have held that indirect benefit and not “property” can satisfy the test of “reasonably equivalent value.”
• A frequently cited case, stated that indirect benefit could sustain a guaranty, court found that In re Image Worldwide, Ltd. 139 F.3d 574, 578 (7th Cir. 1998) there was an insufficient showing of indirect benefit on the facts before it, stating:

"Intercorporate guarantees are a routine business practice, and their potential voidability creates a risk for unwary lenders. . . However, requiring a direct flow of capital to a cross-guarantor to avoid a finding of a fraudulent transfer is "inhibitory of contemporary financing practices, which recognize that cross-guarantees are often needed because of the unequal abilities of interrelated corporate entities to collateralize loans. . . In recognition of this economic reality, courts have loosened the old rule that transfers primarily for the benefit of a third party invariably give no consideration to the transferor."

Thus, even when there has been no direct economic benefit to a guarantor, courts performing a fraudulent transfer analysis have been increasingly willing to look at whether a guarantor received indirect benefit from the guarantee if there has been an indirect benefit. One theme permeates the authorities upholding guaranty obligations; that the guaranty at issue was the result of an arms length negotiations at a time when the common enterprise was commercially viable."

Examples of indirect benefit in guarantee context.

• "In determining reasonably equivalent value, “indirect benefits may also be taken into account.” In re Image Worldwide, Ltd., 139 F.3d 574, 578 (7th Cir.1998). "The most straightforward indirect benefit is when the guarantor receives from the debtor some of the consideration paid to it." Id. at 579. Indirect benefits can also be realized when "the loan strengthened the corporate group as a whole, so that the guarantor corporation would benefit from ‘synergy’ within the corporate group." Id. at 578–79. Indirect benefits can also include intangibles, such as goodwill, and an increased ability to borrow working capital. Id. "[I]ndirect benefits to a guarantor [also] exist when ‘the transaction of which the guaranty is a part may safeguard an important source of supply, or an important customer for the guarantor. Or substantial indirect benefits may result from the general relationship.’" Id. (citation omitted).