One-and-a-Half Badges of Fraud

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Loan documents have long used savings clauses as a way to minimize a lender's exposure to a fraudulent conveyance attack. No one thinks of them as a primary line of defense, but many assume that they provide a significant measure of protection. The bankruptcy court in *TOUSA*, however, found savings clauses unenforceable, and some have feared that others will follow suit.[1] In this paper, I argue that savings clauses are unlikely to provide much comfort to secured lenders. The problem is not that the theory underlying savings clauses is suspect, but rather that the domain in which they operate proves vanishingly small. Those cases in which lenders find themselves exposed to fraudulent conveyance liability are only rarely ones in which a savings clause is of much use.

Savings clauses matter only when the value the lender extends never goes to the debtor and the lender knows it. If value goes to the debtor, there would be reasonably equivalent value and a constructive fraudulent conveyance attack would not be available. If the lender does not know and has no reason to know that the money will go to someone other than the debtor, the recharacterization that makes the action against the lender possible is unavailable. Savings clauses are irrelevant.

But when a lender knows that value is not going to its debtor, it must be on guard that the transaction is an "actual intent" fraudulent conveyance. If the transaction bears additional badges of

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[1] In re TOUSA, Inc., 422 Bankr. 783 (Bankr. S.D. Fla. 2009). In addition, the bankruptcy court expressed doubts about the efficacy of savings clauses in Official Committee of Unsecured Creditors v. Credit Suisse First Boston (In re Exide Technologies Inc.), 299 Bankr. 732, 750-52 (Bankr. D. Del. 2003). A comprehensive exploration of the case and the role of savings clauses can be found in Jessica D. Gabel, *The Terrible TOUSAs: Opinions Test the Patience of Corporate Lending Practices*, 27 EMORY BANKR. DEV. J. 415 (2011). For a characteristically insightful theoretical analysis of this problem, see George G. Triantis, *A Tussle with TOUSA: Avoiding Fraudulent Transfers in Intercorporate Guaranties*, in ANNUAL REVIEW OF INSOLVENCY LAW (2009).

fraud, the lender is at risk. The savings clause does no good. Part I of this paper suggests that finding these additional badges is not likely to be hard in the relevant terrain—where the value never goes to the debtor and the transaction leaves the debtor infinitesimally close to insolvency. A few ill-considered emails among the debtor's underlings may be enough to make the transaction voidable, even if the lender has never met them and never had anything to do with them.

Part II of the paper looks at how savings clauses operate in the context of upstream guarantees, one environment in which they commonly appear. Here the value of the savings clause is small because of the narrow window in which they operate. The value transferred to the lender must be discounted by the likelihood it will be called upon. The amount of the transfer is far less than the face amount of the guarantee, and savings clauses matter only if this discounted amount happens to spell the difference between solvency and insolvency.

Part III suggests that, even in environments where they matter, the usefulness of savings clauses will turn in large measure on the willingness of courts to interpret them flexibly. Courts, however, are likely to insist that those who use savings clauses cut square corners. Uncertainties in how they operate may restrict their usefulness, especially in the context of guarantees.

I. SAVINGS CLAUSES AND "CONSTRUCTIVE" FRAUD

Most discussions of fraudulent conveyance law draw a sharp distinction between "constructive" fraudulent conveyances (transfers for less than reasonably equivalent value) and "actual intent" fraudulent conveyances. The former tag even those who act with perfect innocence, while the second reaches bad actors. This is not quite right.

Modern fraudulent conveyance law can be traced back to *Twyne's Case*. The story is a familiar one to financial lawyers. In 1600 or thereabouts a Hampshire farmer named Pierce conveyed his sheep to a man named Twyne. Twyne allowed Pierce to remain in possession of the sheep, to shear them, and to mark them as his own. A creditor of Pierce's reduced his claim to judgment and had the sheriff try to levy on the sheep that were still in Pierce's hands even though they had been sold to Twyne.

A fight of some kind ensued, and Edward Coke, then the Queen's attorney general, brought a criminal action against Twyne, the buyer of the sheep, in the Star Chamber.[2] The court in *Twyne's Case* found the transfer of the sheep voidable, not because one could prove that Pierce acted with actual fraudulent intent but because *badges of fraud* were associated with the transaction. A transfer of ownership without a simultaneous transfer of possession was inherently suspect. As the doctrine developed, the badges of fraud ceased to be merely proxies for fraud that was hard to prove and instead covered transactions that, although perhaps not fraudulent, were ones to which creditors would object nevertheless.[3]

As fraudulent conveyance law evolved, two badges of fraud gained particular prominence: transfers made while insolvent and transfers for less than reasonably equivalent value. Courts regularly voided transfers that possessed these two features. They saw no need to look for other signs of mischief. Many suspect transactions share these two badges, and innocent ones rarely do. A constructive fraudulent conveyance is merely an actual intent fraudulent conveyance that has two badges so important that there is no need to make further inquiry.

Because the "constructive" fraudulent conveyance is merely a subset of "actual intent" fraudulent conveyances, the savings clause has only limited effectiveness. Many transactions tagged as "constructive" fraudulent conveyances today are ones that could be set aside as an actual intent fraudulent conveyance. There are enough additional badges, but there is no need to stop and identify them. Even when it is completely effective, a savings clause has the effect

[2] Twyne's Case, 3 Coke 80b, 76 Eng. Rep. 809 (Star Chamber 1601). The Star Chamber was a court largely reserved for treason trials and other crimes against the state. The Elizabethan fraudulent conveyance statute provided that a share of any assets recovered went to the Crown. The Crown had always enjoyed substantial revenue from those convicted of treason and felony, and fraudulent conveyance law was a useful tool in preventing traitors and felons from putting their property beyond its reach. These concerns may explain why a case involving a creditor levying on sheep was litigated here. See GARRARD GLENN, FRAUDULENT CONVEYANCES AND PREFERENCES §§61–61e (rev. ed. 1940).

[3] As Justice Cardozo explained in Shapiro v. Wilgus, 287 U.S. 348, 354 (1932), "A conveyance is illegal if made with an intent to defraud the creditors of the grantor, but equally it is illegal if made with an intent to hinder and delay them."

only of partially removing one of two badges of fraud. Rather than save a transaction, a savings clause merely requires those bringing the action to find additional badges.

We forget at our peril that "actual intent to hinder, delay, or defraud" is a term of art. When the transaction offers the debtor no reasonably equivalent value and, by operation of the savings clause, leaves the debtor in a hair's breadth of being insolvent, it simply does not take much to put the transaction over the line.

Consider first the operation of a savings clause with an unrealistically simple example. Firm approaches Bank and asks Bank to give $100 to Firm's Shareholder in return for Firm's promise to pay it $100 with interest. To support the obligation, Firm also gives Bank a security interest in all of its assets. Bank acts in complete good faith. Nevertheless, it is giving nothing *to Firm* in exchange for the obligation that Firm is incurring and the lien it is granting. For this reason, the transaction would be voidable if incurring the $100 obligation renders Firm insolvent.

The savings clause protects Bank by providing that the obligation and the lien are effective only to the extent that they do not become unenforceable under applicable law. If it happens that Firm is solvent only to the extent of $90, then $10 of the obligation and the lien supporting it disappear. By virtue of the savings clause, Firm incurred only an obligation to pay $90. Because this obligation did not render it insolvent, the trustee cannot avoid this transaction as a "constructive" fraudulent conveyance.

But the avoidance risk remains. The absence of a business justification has long been a common hallmark of transactions that are ultimately found to have sufficient badges of fraud to make them fraudulent conveyances.[4] Even transactions that merely make the debtor's assets less liquid can be a fraudulent conveyance if the purpose was to hinder creditors.[5] It exists whenever a transaction serves to keep creditors in the dark.

To know whether a transaction has sufficient badges, we need to look at the particulars of the transaction. Assume, for example, that in our hypothetical, completely unbeknownst to Bank, Shareholder, the owner of Firm, confided in an email to a friend, "For the

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[4] *See, e.g.*, Clow v. Woods, 5 Sergeant & Rawle 275 (Pa. 1819).

[5] *See, e.g.*, Empire Lighting Fixture Co. v. Practical Lighting Fixture Co., 20 F.2d 295, 297 (2d Cir. 1927) (L. Hand, J.).

last year, you worried that Firm might implode, but you can rest easy. I've got my nuts out of this fire. The people you should feel sorry for now are Firm's creditors. The poor, dumb sons of bitches."

This email is likely enough to allow the trustee to recover the $100 from Shareholder. Even though Firm never gave anything directly to Shareholder, a court will recharacterize this transaction as one in which Bank first lent $100 to Firm and Firm then gave it to Shareholder. Firm's trustee can bring the action against Shareholder to recover what is a virtual transfer. Courts look to substance.[6] They routinely collapse the various steps. The issue of collapsing various transactions usually arises in the context of a leveraged buyout,[7] but the principles animating these opinions apply whenever shareholders orchestrate a transaction in which value flows from the corporation to them.[8]

The simple three-party case in which the money ultimately rests with Shareholder is one that has been heavily litigated for decades. Collapsing the transaction to ensure that those in Shareholder's position are held liable is routine once the predicate facts are made out. But once the trustee has the ability to recover the money from Shareholder, the trustee can bring the action against Bank as well. Moreover, this will be the trustee's first instinct. Avoiding an obligation is much easier than bringing a cause of action.

It matters not that Bank was as in the dark as anyone. Bank made a transfer directly to Shareholder. When Firm promised to repay it, Firm incurred an obligation without receiving anything in return. As long as the debtor engaged in an "actual intent" fraudulent conveyance, Bank is liable. Only the intentions of the debtor are relevant in determining whether a transaction is a fraudulent conveyance in the first instance. Good faith is a defense available

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[6] *See, e.g.*, Wiebolt Stores, Inc. v. Schottenstein, 94 Bankr. 488, 502 (N.D. Ill. 1988) ("[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.").

[7] *See, e.g.*, Rosener v. Majestic Management, Inc. (In re OODC, LLC), 321 Bankr. 128, 138 (Bankr. D. Del. 2005).

[8] *See* Boyer v. Crown Stock Distribution, Inc., 587 F.3d 787, 793 (7th Cir. 2009) ("Now whether one calls it an LBO or not is not critical. . . . [I]f the dividend was part and parcel of the transaction that fatally depleted new Crown's assets, it was part and parcel of a fraudulent conveyance.").

to those who receive a fraudulent conveyance, but it is available only to the extent the transferee gave value to the debtor. In this case, the debtor is Firm, and Bank gave no value *to it*.

In the typical case, Bank will give cash to Firm and then Firm will send it upstream to Shareholder. Bank can try to argue that it did give value to Firm on the grounds that Firm received value in the first instance. Whether this argument works turns on whether, from Bank's perspective, the transaction had two steps or only one. No action should lie against Bank if it gave $100 to Firm and had no reason to believe that Firm would pass the money on to Shareholder. Lenders are generally not responsible for what their debtor does with the money they lend. Everything turns on whether Bank can keep the two steps of the transaction—the loan from it to Firm and the dividend of the loan proceeds to Shareholder—from being collapsed together.

If Bank knows that Firm will use the loan to make a dividend, then this transaction is the same as one in which Bank conveys the money directly to Shareholder. Collapsing the transactions turns on whether Bank knows that the transaction is one in which value is ultimately ending up in Shareholder's hands, not on whether it believes the circumstances make the dividend reasonable.

Whenever Bank needs to invoke a savings clause, it will find itself on the precipice. Bank will find itself at best a badge of fraud or two short of being subject to a fraudulent conveyance attack. Even if Bank's motives are pure, as long as it knows that value is not ending up with Firm—or simply not enough value—it is at risk. The inquiry into whether a transaction is an "actual intent" fraudulent conveyance turns on the motivations and the conduct of the debtor. It is has nothing to do with Bank's motives or its knowledge of the underlying transactions.

The typical leveraged buyout may seem quite removed from the traditional actual intent fraudulent conveyance in which shareholders are looting the firm in the dark of night. The conventional wisdom, however, likely underestimates the realm of the "actual intent" fraudulent conveyance. The opinions in which appellate judges who do not know any better equate "actual intent" fraudulent conveyances with transactions involving bad behavior give a false sense of comfort.

When value is taken out of a firm and leaves it at the very edge of solvency, the trustee needs to find little more than a few emails.

Of course, those involved in large-scale corporate transactions should know better than to write emails reveling in their mischief, but, as cases such as *TOUSA* illustrate, people can be astonishingly loose-tongued.[9] The emails do not even need to be from the principals. An ill-considered text message from a paralegal wannabe to a friend or co-worker is enough as long as he is close enough to the action. It might seem that the misdeeds of Firm should not tag lenders of new money when, notwithstanding their due diligence, they had no inkling that anything was amiss. But this critique of existing fraudulent conveyance law stands quite apart from whether savings clauses do any heavy lifting.

Savings clauses might seem valuable in cases where the lenders are confident that nothing is amiss, but are worried about being second-guessed after the fact. They are financing a completely sensible leveraged buyout, and they use savings clauses to protect themselves from Monday-morning quarterbacking. The only risk is that a dividend will be found a constructive fraudulent conveyance because a judge will later conclude, erroneously, that the debtor was insolvent at the time of the transaction. Savings clauses do help to protect against this type of judicial error, but it is easy to exaggerate this risk.

Whether a company is insolvent at any given moment depends on what is known at that time, not on what is known in hindsight.[10] Today's bankruptcy judges understand this. Those who worked for Iridium were nicknamed "Iridiots" after the fact. The idea that millions would buy brick-sized telephones that worked only outdoors seemed ludicrous almost as soon as the product hit the marketplace. Nevertheless, the judge quickly found that the enterprise solvent when it was launched. It was enough that fully informed investors were willing to invest in the firm's equity and buy its debt at par.[11]

Of course, managers cannot conceal the financial condition of the business, issue a dividend before the bad news comes, and then

[9] *See* In re TOUSA, Inc., 422 Bankr. 783, 794 (Bankr. S.D. Fla. 2009) (email by CFO characterizing transaction with a compound noun, the first half of which was "cluster").

[10] *See* Lippe v. Bairnco Corp., 249 F. Supp. 2d 357 (S.D.N.Y. 2003).

[11] Statutory Committee of Unsecured Creditors v. Motorola, Inc. (In re Iridium Operating LLC), 373 Bankr. 283 (Bankr. S.D.N.Y. 2007).

assert that the business was solvent on the basis of market data.[12] But it is exactly when managers do this that it will be easier to find other badges of fraud. Once again the savings clause will not do any good regardless of solvency. If the managers actively mislead creditors while shoveling assets to shareholders, the transaction is likely to be voidable whether the firm is solvent or not.

Savings clauses originated in an era in which many bankruptcy judges lacked the sophistication of those who sit on the bench now. Modern bankruptcy judges completely understand that the solvency of a debtor completely turns on what is known at the time. They know not to think that was is obvious after the fact was obvious at the time. The change in the legal environment means that even the judges naturally inclined to second-guessing will have to explain why people in the past were fooled. At this point, they need catalogue the misdeeds that led to people being misled. Once they do this, fairly or unfairly, they will have identified misdeeds necessary to constitute the badges of fraud that put the transaction over the line quite apart from insolvency.

II. SAVINGS CLAUSES AND GUARANTEES

Apart from leveraged buyouts, savings clauses loom largest in loans to corporate groups in which many individual subsidiaries become joint and severally liable for the debts of the group. The greater the danger that these transactions will be subject to a fraudulent conveyance attack, the more valuable the savings clause. This danger, however, is again easy to overstate. As long as each subsidiary can show that they received reasonably equivalent value in exchange for issuing the guarantee, they are immune from a "constructive fraud" fraudulent convenience attack, the only kind where savings clauses do any good.

The Eleventh Circuit's opinion in *TOUSA* rejected the presence of reasonably equivalent value, but the articulated benefit (putting off an inevitable bankruptcy for a few months at a cost of hundreds of millions) was plainly insufficient.[13] Among other things, it was based on an idea (that it is better to have restructurings later rather than sooner) that runs contrary to the conventional wisdom. Bankruptcy often comes too late, but rarely too soon. In most cases,

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[12] VFB LLC v. Campbell Soup Co., 482 F.3d 624 (3d Cir. 2007).

[13] In re TOUSA, Inc., 680 F.3d 1298, 1313 (11th Cir. 2012).

a much better story can be told and little more than a plausible story is going to be required. "Reasonably equivalent" value does not require precise calculation. It merely needs to point to some concrete benefit of the sort that a reasonable person without creditors would expect in return for the burdens it was taking upon.

As long as the lender can make a respectable argument that the subsidiaries guaranteeing the loan are receiving some indirect benefit from the loan, there is reasonably equivalent value. When the corporate group operates as a single economic entity, this is not hard. The synergy of the corporate group itself makes essential borrowing by any one component something that is valuable to all the other related entities.[14]

In *TOUSA*, the perilous condition of the business made it highly likely that the guarantee would be triggered.[15] In the typical case, the chance that the debtor will be called upon to honor the guarantee is quite small. This makes a big difference. The lower the probability is, the smaller the size of the transfer to the lender and the smaller the indirect benefit that needs to be found to justify it.[16]

Assume that Bank is making a $100 loan to Parent. There is a one-in-ten chance that Parent will prove worthless and unable to pay back any of the loan. When Subsidiary guarantees the loan and gives Bank a senior lien on all its assets it is making a transfer of $10. The intuition behind that idea that the face amount of the guarantee needs to be discounted is straightforward.[17] Instead of

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[14] It is essential, however, that the benefits, when they come indirectly, are "fairly concrete." A standard that is too low permits diversions of value by those who possess a modicum of imagination. In re Image Worldwide, Ltd., 139 F.3d 574 (7th Cir. 1998).

[15] In re TOUSA, Inc., 680 F.3d 1298, 1313 (11th Cir. 2012) (collapse of TOUSA "as foreseeable as the bombing of Nagasaki after President Truman's ultimatum").

[16] As Judge Sontchi observed in In re Capmark Financial Group Inc., 438 Bankr. 471 (Bankr. D. Del. 2010), a case that also dealt with a savings clause, "The well-settled jurisprudence shows that guarantees are liquidated based upon their probabilities of being called." Both the Third and the Seventh Circuit have spoken to the question. *See, e.g.*, Mellon Bank v. Official Comm. of Unsecured Creditors of R.M.L., Inc. (In re R.M.L. Inc.), 92 F.3d 139, 156 (3d Cir. 1996); In re Xonics Photochemical, Inc., 841 F.2d 198, 199–200 (7th Cir. 1988)."

[17] Dean Rasmussen argued for focusing on value at the time of transfer many years ago while still in law school. See Comment, *Guarantees*

giving Bank its guarantee, Subsidiary in theory could have given $10 in cash to Bank and Bank could have used the money to find a third party to guarantee Parent's loan.

Of course, there are many reasons why such third parties might be hard to find, but the thought experiment makes plain the stakes. When it received Subsidiary's promise, Bank is getting something that is worth only $10. Subsidiary's guarantee brings it no benefit in the vast majority of cases when it is never called upon. The effective cost to the other creditors of Subsidiary has to take account of good states of the world, the ones in which incurring the obligation has utterly no effect on the creditors.

One can argue, of course, that it is too simple to discount mechanically. The fortunes of Parent and Subsidiary are closely tied to one another. The conditions under which the creditors are most at risk are also those under which the guarantee is most likely to be called upon.[18] But the baseline is the discounted value of the guarantee. It provides a much lower hurdle than the face amount of the guarantee itself.[19]

We need to discount the obligation even further. Even if the indirect benefit of the loan to the corporate group did not provide reasonably equivalent value to a particular entity, whatever value it did receive must be taken into account in assessing whether the transaction rendered it insolvent. If the cost of the guarantee is $10, and a less-than-reasonably-equivalent benefit of $2 was received in return, the balance sheet takes a hit only to the extent of $8. In determining whether the transaction renders Subsidiary insolvent, one has to take into account both the net worth of Subsidiary at the time of the transfer and the indirect benefits the loan produces.

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and Section 548(a)(2) of the Bankruptcy Code, 52 U. CHI. L. REV. 194 (1985).

[18] *See* Richard Squire, *Strategic Liability in the Corporate Group*, 78 U. CHI. L. REV. 605 (2011).

[19] Complications arise if a guarantee is made at one point and extensions of credit are made at later points in time. The moment at which the transfer takes place for fraudulent conveyance purposes may be only at the time the loan is made. See Rubin v. Manufacturers Hanover Trust Co., 661 F.2d 979, 993 n.16 (2d Cir. 1981); Kenneth J. Carl, *Fraudulent Transfer Attacks on Guaranties in Bankruptcy*, 60 AM. BANKR. L.J. 109 (1986).

The imputed cost of the transfer must be reduced for still another reason. Even if called upon to honor the guarantee, Subsidiary can assert whatever rights Bank has against Parent, and it may be able to look for contributions from other subsidiaries. Assume that each of ten subsidiaries guarantees a $100 loan that has a one-in-ten chance of being called upon. None of them receive any value from the loan, but Subsidiary is the only one whose solvency is in question at the time of the guarantee. Under these facts, the only fraudulent conveyance attack is against Subsidiary and it is available only to the extent of $1.

Such refinements do not matter in determining whether a transaction is a fraudulent conveyance, but they are relevant in establishing the savings clause is going to do any significant work. Consider a simple case. Subsidiary guarantees a $100 loan to Parent that has a one-in-ten chance of not being repaid. It receives nothing in return and equitable subrogation and rights of contribution are worthless. Only if the Subsidiary has a net worth between $0 and $10 at the time of the transfer does the savings clause operate at all. If Subsidiary has a net worth of more than $10, the guarantee is not a fraudulent conveyance at all in the absence of other badges of fraud. If Subsidiary is already insolvent, the savings clause does no good.

In short, much of the justification for savings clauses rests on the hope that they will provide security when bankruptcy judges make mistakes. As long as guarantees are properly discounted and indirect benefits are included in the tally, they are not likely to be necessary. Of course, not all bankruptcy judges are equally sophisticated. But if these judges are the ones for whom savings clauses are intended, then one must have faith that they will look favorably upon them. In the next part, I suggest that there are doubts on this score as well.

III. SAVINGS CLAUSES AND CUTTING SQUARE CORNERS

The savings clause is a species of severability clause, and they are commonplace. Legislation routinely provides that other parts of an act remain effective even if particular parts are struck down. Drafters of wills often use them to protect themselves against unwittingly tripping up the rule against perpetuities.[20] Severability

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[20] *See* Cattail Assocs. Inc. v. Sass, 907 A.2d 828, 840 (Md. App. 2006).

clauses also appear in many consumer contracts to minimize the effect of a court striking down a particular clause:

> If any provision of this Agreement shall be held illegal or unenforceable, that provision shall be limited or eliminated to the minimum extent necessary so that this Agreement shall otherwise remain in full force and effect and enforceable.[21]

Such clauses are enforced, but only if they are not seen as part of a larger pattern of sharp practice. It will not save a contract that is usurious on its face, but it will work if the interest rate turned out to be usurious because of a computational error made in good faith.[22]

Severability clauses are most useful when regulators provide a narrow path that must be followed, but then fail to mark it clearly. Without severability clauses, those who are trying to play by the rules must seek other, perhaps much more costly ways, to conform. Hostility to savings clauses may simply complicate contracts and increase costs without providing any benefit to consumers.[23] Nevertheless, there is something unseemly about allowing one party to a contract to skirt on the edge of enforceability. There is little social benefit from allowing the unscrupulous to push up against the very limits of what is permissible. Indeed, it may have the effect of allowing bad actors to trespass at will and face only the risk that they will have to give back ill-gotten gains when they are caught. A merchant can charge a usurious rate of interest, pocket the ill-gotten gains most of the time, and use the severability clause to escape punishment in the few cases in which it is caught.[24]

Savings clauses in the context of fraudulent conveyance law present a somewhat different problem. We worry not that a lender is taking advantage of its debtor, but rather than the two together are undermining the rights of the debtor's existing creditors. It is a

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[21] For a discussion of these severability clauses, see Omri Ben-Shahar, *Fixing Unfair Contracts*, 63 STAN. L. REV. 869, 887 (2011).

[22] Federal Sav. & Loan Ins. v. Kralj, 968 F.2d 500, 506 (1992).

[23] *See* Ben-Shahar, *supra* note 21, at 906.

[24] Swindell v. Federal National Mortgage Association, 409 S.E.2d 892, 896 (N.C. 1991) ("A lender cannot charge usurious rates with impunity by making that rate conditional upon its legality and relying upon the illegal rate's automatic rescission when discovered and challenged by the borrower.").

mistake to assume that creditors have nothing to complain about as long as a transaction stops short of leaving the debtor insolvent.

When Firm remains in business, its value shifts constantly. When Firm has liabilities of $100, creditors do not need to worry whether the assets are worth $250 or only $200. They will be paid in all events. By contrast, creditors are likely to worry a lot when the value of the assets drops and comes close to $100. Whether the value falls slightly below $100 or remains just above it is not the point. The creditors' loans have become much more risky. There is a much greater chance they will not be paid. The interests of creditors are continuously compromised as the solvency/insolvency line comes closer. To be sure, a court might well take the view that creditors must look out for their own interests. If they want protection as Firm's condition worsens, they must bargain for a covenant that allows them to declare a default if the solvency line is approached, but not crossed. At the same time, however, the judge might believe that she is under no obligation to help parties get close to this line.

Those who engage in transactions that come as close as possible to something long considered a badge of fraud should not expect to be given much slack. Those who want savings clauses enforced need to cut square corners. A savings clause, to be effective, has to be clear. This turns out to be easier said than done. I provide two examples of the difficulties. There are undoubtedly others.

In many transactions, there are multiple loans at the same time. It is not unusual for each of the loans to have a savings clause that renders the obligation ineffective to the extent that it, combined with the debtor's obligations, renders the firm insolvent. But how should the losses be allocated when two loans are made at the same time and both contain this language?

Consider the following example. Firm is solvent, but only to the tune of $100. There is a leveraged buyout, and there are two loans, one for $100 and one for $50. Together the two loans render the firm insolvent. Each of the loans has a savings clause. To be effective, the two together need to reduce Firm's obligations by $50, but how much does each give up? The matter would disappear if the two loans were explicit and both adopted the same allocation rule. But what should be done in the face of silence?

The court in *TOUSA* pointed to the absence of an allocation rule as a ground for refusing to enforce a savings clause. From its perspective, it had no obligation to discover a sharing rule when the parties provided none. It might seem that the court was being deliberately obtuse. For bankruptcy lawyers, it is second nature to assume that, everything else being equal, loses are shared pro rata. By this logic, the party that loans $100 should have her claim trimmed back to $67, while the one that loaned $50 should have her claimed trimmed back to $33. But it is not so obvious. One of the parties may have priority over another. One may have been promised payment sooner.

Moreover, there is no reason to privilege a pro rata sharing rule in this environment. An equally natural and logical sharing rule is one in which the party lending $100 should have its loan scaled back to $75, and the one lending $50 should have its loan scaled back to $25. There is $100 of value that must be divided between the two parties, but one of the lenders is owed only $50 and hence can assert a right to only half of it. It has no claim against the other half. There is $50 to which this lender lays no claim. Hence, the lender that advanced $100 should be able to assert a right to the $50 to which the other lender has no right. Only half of what needs to be divided is disputed, and it makes sense to divide this equally.

Under this line of thought, the lender of $100 should have the half to which the lender of $50 lays no claim, and the balance should be divided equally. The $100 lender therefore receives the uncontested part ($50) plus its share of what is contested ($25). The $50 lender receives only its share of the contested part ($25).

This kind of division might strike bankruptcy lawyers accustomed to pro rata sharing as odd, but this way of interpreting the savings clause is entirely logical. It can be expanded to an arbitrarily large number of parties and yield a unique solution. Moreover, its pedigree is eminently respectable. It is set out in the *Talmud*. Called the "contested-garment" rule, it has been subject to rigorous scrutiny.[25] A court could simply conclude that it was under no obligation to choose among sharing rules when the parties themselves did not.

Of course, after the warning shot in *TOUSA*, one would expect lawyers to respond to this problem, but there are likely other areas of uncertainty. Someone that believes that the savings clause can

[25] *See* Robert J. Aumann & Michael Maschler, *Game Theoretic Analysis of a Bankruptcy Problem from the Talmud*, 36 J. ECON. THEORY 195 (1985).

do heavy lifting must be sure that all the bases are covered. Another place in which savings clauses seem underspecified arises in the context of a guarantee.

Assume once again that Subsidiary guarantees a $100 loan to Parent and incurs a $10 hit as a result. Assume further that Subsidiary receives nothing in return for the loan, that subrogation rights have no value, and that Subsidiary has a net worth of only $5 at the time that it issues the guarantee. Because Subsidiary has made a transfer worth $10 in value, it would be a fraudulent conveyance in the absence of the savings clause. But what exactly is the effect of the savings clause? What does it mean to say that the guarantee is enforceable to the extent that it does not render Subsidiary insolvent? It might seem that the guarantee in effect is a guarantee for only $50, rather than $100, but it is not obvious. If a guarantee of $100 imposes a cost of $10, does it follow that a $50 guarantee imposes one half as large? A judge may reasonably decline to rewrite the contract in this fashion. Valuing actual guarantees is hard enough. Judges are under no obligation to value hypothetical guarantees to which parties may have given no thought. If they want a savings clause to work, the parties themselves need to specify how the obligation is to be scaled back.

IV. CONCLUSION

The challenge of savings clauses is not so much that they do not work, but rather that the domain in which they do work is so small. It might seem that they provide a form of cheap insurance. Even if there are few benefits, the costs are small as well. But there are always downsides. Some courts might (though they should not) infer from the presence of such a clause that the debtor and the lender were thinking about how the transaction might compromise the rights of creditors. Courts might put the presence of such a clause on the scale when assessing whether there were sufficient badges. There are other ways in which the savings clause can make life harder. For example, in one case the existence of a savings clause led a debtor to resist an involuntary petition by arguing (albeit unsuccessfully) that the debts held by the creditors with such clauses subject to a bona fide dispute.[26] If more such cases arise, one should start to ask whether this game is worth the candle. In any event, it

[26] In re Vitro Asset Corp., 2012 WL 6021475 (Bankr. N.D. Tex. 2012).

is a mistake to take much solace from savings clauses, at least in their present form.