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# Revisiting the Proper Limits of Fraudulent Transfer Law

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# REVISITING THE PROPER LIMITS OF FRAUDULENT TRANSFER LAW

by  
Jack F. Williams\*

*The delightful quality of fraud lies in its infinite variety . . . .*<sup>1</sup>

## INTRODUCTION

The difficulty of attempting to apply fraudulent transfer law to modern transactions is the struggle of "apply[ing] a law with its origins in 16th century England to a financial transaction [a leveraged buyout] which did not exist on a large scale until the late 1980s."<sup>2</sup> Although a part of the rich fabric of English common law at least since 13 Statute Elizabeth<sup>3</sup> and *Twyne's Case*,<sup>4</sup> fraudulent transfer law has undergone a revival in its application to modern transactions. What can be gleaned from this evolving body of law is that modern fraudulent transfer cases are often difficult to understand.<sup>5</sup> Like the study of equity jurisprudence,

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<sup>1</sup> G. GLENN, *FRAUDULENT CONVEYANCES AND PREFERENCES* § 325a, at 566 (rev. ed. 1940).

<sup>2</sup> *Credit Managers Ass'n v. Federal Co.*, 629 F. Supp. 175, 179 (C.D. Cal. 1985) (footnote omitted) (analysis of leveraged buyout as fraudulent transfer).

<sup>3</sup> Statute of Elizabeth, 13 Eliz., ch. 5 (1571), *repealed by* The Law of Property Act, 15 Geo. 5, ch. 20, § 172 (1925). The Act was penal in nature, with the English Crown receiving as a penalty one-half of all property recovered. See Markell, *Toward True and Plain Dealing: A Theory of Fraudulent Transfers Involving Unreasonably Small Capital*, 21 IND. L. REV. 469, 473 & n.19 (1988). The Act prohibited conveyances made with the "intent to delay, hinder or defraud creditors and others of their just and lawful actions." 13 Eliz., ch. 5, § 1 (1571).

<sup>4</sup> *Twyne's Case*, 76 Eng. Rep. 809 (Star Ch. 1601).

<sup>5</sup> See generally Sherwin, *Creditors' Rights Against Participants in a Leveraged Buyout*, 72 MINN. L. REV. 449 (1988); Carlson, *Leveraged Buyouts in Bankruptcy*, 20 GA. L. REV. 73 (1985); Baird & Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829 (1985).

just when you believe you are on the verge of grasping the central theme, you run smack into a countervailing principle that shakes the foundation of your knowledge. And like the wide-eyed child who sees ghosts everywhere once the lamps are dimmed, you seem to encounter fraudulent transfer risks at many corners in the negotiation and construction of modern transactions.<sup>6</sup>

The purpose of this article is to distill the large body of fraudulent transfer law with an eye toward mapping its contours, both positively and normatively. While mapping the contours, the article attempts to define the proper limits of fraudulent transfer law and, in the process, remain faithful to its basic tenets. It is this task that has captured the attention of commentators and courts alike.<sup>7</sup> In attempting to bring order to this area of the law, the article necessarily stands on the theoretical scaffolding constructed by the courts and commentators to see past the morass of confused cases to a workable model that reunites fraudulent transfer law with its equitable roots.

## I. PURPOSES OF FRAUDULENT TRANSFER LAW

Sections 548(a) and 544(b) (incorporating state fraudulent transfer law) of the Bankruptcy Code<sup>8</sup> recognize the power of the trustee to challenge transfers or obligations incurred as fraudulent transfers. Section 548(a) provides:

(a) 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—

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<sup>6</sup> See 11 U.S.C. § 548 (1988); see also 11 U.S.C. § 544(b) (1988) (incorporates state fraudulent transfer law in bankruptcy). Although this article will pay appropriate homage to the Uniform Fraudulent Conveyance Act (hereinafter UFCA) where appropriate, it will specifically address the concerns generated by the Uniform Fraudulent Transfer Act (hereinafter UFTA).

<sup>7</sup> See, e.g., Sherwin, *supra* note 5; Smyser, *Going Private and Going Under: Leveraged Buyouts and the Fraudulent Conveyance Problem*, 63 IND. L.J. 781 (1988); Carlson, *supra* note 5; Baird & Jackson, *supra* note 5.

<sup>8</sup> Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified at 11 U.S.C. §§ 101-1330), as amended by Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333 (codified as amended in various sections of 11 U.S.C. and 28 U.S.C.); Bankruptcy Judges, United States Trustee and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, 100 Stat. 3114 (codified as amended in various sections of 11 U.S.C. and 28 U.S.C.); and, Retiree Benefits Bankruptcy Protection Act of 1988, Pub. L. No. 100-334, 102 Stat. 610 (codified as amended in various sections of 11 U.S.C.) [hereinafter "Bankruptcy Code" or "Code"].

- (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, indebted; or
- (2) (A) received less than a reasonably equivalent value in exchange for such transfer or obligation; and
  - (B) (i) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;
  - (ii) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or
  - (iii) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured.<sup>9</sup>

Section 544(b) authorizes the trustee to avoid any transfers by the debtor that an unsecured creditor with an allowable claim<sup>10</sup> could avoid under state fraudulent transfer law.<sup>11</sup> Under Section 544(b), the trustee's cause of action rises and falls under state law; therefore, one must acquaint oneself with the elements of state fraudulent transfer law. Although the UFTA<sup>12</sup> is similar in many respects to Section 548, some states such as New York<sup>13</sup> still operate under the UFCA<sup>14</sup> and some states like Texas<sup>15</sup> have adopted nonuniform amendments to the UFTA.<sup>16</sup>

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<sup>9</sup> 11 U.S.C. § 548 (1988).

<sup>10</sup> See 11 U.S.C. § 502 (1988) (allowance of claims).

<sup>11</sup> 11 U.S.C. § 544(b) (1988). Section 544(b) provides:

(b) The trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under section 502(e) of this title.

*Id.*

<sup>12</sup> 7A U.L.A. 639 (1985). For a thorough review of the UFCA and UFTA, see Kennedy, *The Uniform Fraudulent Transfer Act*, 18 U.C.C. L.J. 195, 211-12 (1986); Alces & Dorr, *A Critical Analysis of the New Uniform Fraudulent Transfer Act*, 1985 UNIV. OF ILL. L. REV. 527; Vener, *Transfers and Frauds of Creditors Under the Uniform Acts and the Bankruptcy Code*, 92 COMM. L.J. 218 (1987); Shupack, *Confusion and Policy and Language in the Uniform Fraudulent Transfer Act*, 9 CARDOZO L. REV. 811 (1987).

<sup>13</sup> N.Y. DEBT. & CRED. LAW §§ 270-81 (McKinney 1990).

<sup>14</sup> 7A U.L.A. 427 (1918).

<sup>15</sup> TEX. BUS. & COM. CODE ANN. § 24.001-.013 (Vernon 1987).

<sup>16</sup> See generally Dole & Teofan, *The Nonuniform Texas "Uniform" Fraudulent Transfer Act*, 42 SW. L.J. 1029 (1989).

Although beyond the scope of this article, one issue that has so far avoided the collective eye of

Section 548 grants to the trustee the power to avoid fraudulent transfers accomplished with either actual or constructive fraudulent intent.<sup>17</sup> One must, of course, start with the actual language of Section 548<sup>18</sup> in assessing whether a particular transfer is fraudulent. Courts, however, also tend to explore the multitude of purposes behind Section 548 in de-

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scholars in this area is the conflict of laws issues generated by even a simple fraudulent transfer case. For example, Fred Sanford owns a very successful junk yard business located in California. The business is a Delaware corporation eligible to conduct business in California. Most of Fred Sanford's creditors are residents of California. Fred has a dedicated employee, Lamont, who is interested in purchasing the business. Unfortunately, Lamont does not have the money to purchase the business outright nor even to put forth a substantial down payment. Fred wants to retire and likes Lamont; consequently, Fred and Lamont seek lenders willing to fund Lamont's purchase of the business. They find a bank in Texas willing to provide 70% of the purchase price for a lien on all the business' assets. The loan and security documents conspicuously state Texas law will control all issues arising under or related to the transaction. The remaining 30% of the purchase price is provided by an insurance company in return for the issuance of high-risk bonds. The documents here also provide that Texas law will apply.

Two years after the transaction, the highly leveraged business defaults and seeks protection under the Bankruptcy Code by filing a Chapter 11 petition. The debtor-in-possession then commences an adversary proceeding under § 544(b) of the Code, which incorporates state fraudulent transfer law, because of the inability to satisfy the one-year reach back period under § 548. Which state law applies? Delaware, the place of incorporation? California, the location of the business and its assets and of the perfection of the Texas bank's lien in the assets? Texas, the location of one of the debtor's largest creditors and the jurisdiction identified in loan and security documents as controlling on issues arising from the transfer?

Lest the patient reader believe this to be more an academic issue than a practical one, let me make just a few points. Delaware has enacted the UFCA. DEL. CODE ANN. tit. 6, §§ 1301-12 (1953). Consequently, Delaware law would require the trustee to prove lack of fair consideration (an exchange for less than fair value coupled with lack of good faith) as a precondition to avoiding the transfers. See generally *Cooch v. Grier*, 30 Del. Ch. 255, 59 A.2d 282 (1948) (fair consideration required). California has enacted the UFTA. CAL. CIV. CODE § 3439.0-.12 (West 1986). Texas, too, has enacted the UFTA, TEX. BUS. & COM. CODE ANN. § 24.001-.013 (Vernon 1987), but with substantial non-uniform amendments, including a non-exclusive definition of reasonably equivalent value. TEX. BUS. & COM. CODE ANN. § 24.004(b) (Vernon 1987). Thus, which state's law will apply, like in many other areas of the law, will have substantive and strategic significance.

Again, to bring home this point is the recent preliminary analysis of the choice of law issues in the fraudulent transfer context by Professor Barry Lewis Zaretsky, examiner in the Revco bankruptcy. See "Preliminary Report of Examiner Professor Barry Lewis Zaretsky" in *In re Revco D.S., Inc.*, 118 Bankr. 468, 477 (Bankr. N.D. Ohio 1990). Professor Zaretsky's analysis of the choice of law issues generated by the Revco leveraged transaction is thorough and illuminating. *Id.* at 500-04.

<sup>17</sup> For a thorough account of the common law history of fraudulent transfers, see 1 G. GLENN, *supra* note 1, at §§ 58-62b. For an analysis of some of the policy goals embodied in fraudulent transfer laws, see Clark, *The Duties of the Corporate Debtor to Its Creditors*, 90 HARV. L. REV. 505 (1977). For an introduction to fraudulent transfer laws, see D. EPSTEIN & J. LANDERS, *DEBTORS AND CREDITORS: CASES AND MATERIALS* 120-27, 490-92 (2d ed. 1982).

<sup>18</sup> "Since Code § 548 is largely derived from § 67(d) of the Bankruptcy Act of 1898, . . . case law under the former statute is a useful tool in construing [the present statute's] meaning and intended purpose." *Carr v. Demusis (In re Carr)*, 34 Bankr. 653, 656 (Bankr. D. Conn. 1983) (footnote omitted), *aff'd*, 40 Bankr. 1007 (D. Conn. 1984).

termining whether the transfer before them should be avoided. This, therefore, is where our inquiry must begin.

The fraudulent transfer is an infringement of the creditor's right to realize upon the available assets of its debtor.<sup>19</sup> The law imposes a substantive prohibition—the debtor may not dispose of its property with the intent, actual or implied by law, of placing the property beyond the reach of its creditors.<sup>20</sup> “A debtor cannot manipulate his affairs in order to shortchange his creditors and pocket the difference. Those who collude with a debtor in these transactions are not protected either.”<sup>21</sup>

Although most commentators agree that the thrust of fraudulent transfer law is to protect the unjust diminution of the debtor's estate, the authorities appear confused about where the proper limits of fraudulent transfer law should be drawn.<sup>22</sup> Nowhere are the appropriate limits more greatly debated than in the context of the application of fraudulent transfer laws to the leveraged buyout.<sup>23</sup>

In their seminal article, Professors Douglas Baird and Thomas Jackson criticized the application of fraudulent transfer law to leveraged buyouts on the ground that these statutes should apply to invalidate only sham transactions and gratuitous transfers.<sup>24</sup> Thus, according to Professors Baird and Jackson, fraudulent transfer law should not upset any arm's length transaction, regardless of whether the transaction harms creditors.<sup>25</sup> Consequently, Professors Baird and Jackson conclude that leveraged buyouts should be categorically excluded from fraudulent trans-

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<sup>19</sup> See 1 G. GLENN, *supra* note 1, § 1. Not all infringements upon the creditor's right to realize upon the available assets of the debtor are proscribed. For example, the fresh start policy may remove assets from the creditor. See 11 U.S.C. § 522 (1988 & Supp. 1991); see also Jackson, *Avoiding Powers in Bankruptcy*, 36 STAN. L. REV. 725, 725 n.1 (1984) (At times, an individual debtor can avoid, for his own benefit, property interests held by entities other than himself which are similar to his own interests.).

<sup>20</sup> See Cook, *Fraudulent Transfer Liability Under the Bankruptcy Code*, 17 HOUS. L. REV. 263, 266 (1980).

<sup>21</sup> Baird & Jackson, *supra* note 5, at 829-30 (1985).

<sup>22</sup> See generally *supra* notes 5 and 7.

<sup>23</sup> In its simplest form, a leveraged buyout is one where a group of investors, with little or no funds, purchases the shares of a target corporation, borrowing the purchase price from a lender who in turn takes a security interest in all the target's assets. Because the purchase price is retained by old shareholders while the assets are fully encumbered by the new lender, unsecured creditors of the target may lose the value of the target's assets upon liquidation. For a readable discussion of leveraged buyouts, see Thompson, *Engineering Your Own LBO*, U.S. NEWS & WORLD REPORT, Jan. 30, 1989, at 74-76. For a more complete discussion of various forms of leveraged buyouts, see Carlson, *supra* note 5, at 80-83.

<sup>24</sup> Baird & Jackson, *supra* note 5, at 840.

<sup>25</sup> *Id.* at 833-35, 854.

fer analysis because "[a] firm that incurs obligations in the course of a buyout does not seem at all like the Elizabethan dead beat who sells his sheep to his brother for a pittance."<sup>26</sup> With this statement, Professors Baird and Jackson show their hand: they view fraudulent transfer law through an historical lens for the purposes not merely of gaining insight into its application, but also of providing limits to its application. Their view regarding the categorical exclusion of leveraged buyouts from fraudulent transfer analysis is wholly consistent with the historical view that fraudulent transfer laws were initially passed to prevent collusive transfers between individual debtors and their families and friends.<sup>27</sup> Unfortunately, their view fails to appreciate several centuries of case law that has time after time focused its efforts on protecting unsecured creditors from the unjust diminution of their debtor's estate.

Professors Baird and Jackson correctly note that fraudulent transfer law is a per se rule whose purpose is to "provide all the parties [to a transaction] with the type of contract that they would have agreed to if they had the time and money to bargain over all aspects of their deal."<sup>28</sup> A per se rule operates to constrain the conduct of parties to a credit transaction in addition to whatever specific terms they may choose to include in the contract relating to the transaction.<sup>29</sup>

Professors Baird and Jackson conclude that parties to a commercial transaction would not generally include a fraudulent transfer provision in spite of the potential for injury to creditors resulting from leveraged buyouts.<sup>30</sup> According to Professors Baird and Jackson, under ideal negotiating circumstances, creditors do not seek to protect themselves against all debtor transactions that could potentially injure creditors, but only against those transactions that almost always result in injury, such as gratuitous or sham transfers. Consequently, creditors would not seek a contractual provision restricting a debtor's ability to engage in leveraged buyouts because creditors do not perceive such transactions as injurious to their interest.<sup>31</sup>

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<sup>26</sup> *Id.* at 852.

<sup>27</sup> *Id.* at 829-32.

<sup>28</sup> *Id.* at 835-36.

<sup>29</sup> *Id.* at 836.

<sup>30</sup> *Id.* at 853-54.

<sup>31</sup> *Id.*; see Burns, *The Fraudulent Conveyance Laws and the LBO Lender*, 94 COMM. L.J. 268, 304 (1986). Baird's and Jackson's major premise, that creditors would include fraudulent transfer protection if they truly thought it important, is weakened by a number of factors. The premise ignores the host of nonconsensual creditors like taxing authorities, tort claimants, and government environmental and pension fund claimants, historically vulnerable to the fraudulent transfer. See United

In a thoughtful and well-reasoned article, Professor Kathryn Smyser persuasively disagrees with Professors Baird and Jackson.<sup>32</sup> She recognizes that leveraged buyouts adversely affect existing creditors of a company by reducing the assets available for the satisfaction of the obligations owed to them. Furthermore, she understands, like Baird and Jackson, the application of fraudulent transfer law to leveraged buyouts where actual fraud existed, and, more importantly, where the debtor received less than reasonably equivalent value (fair consideration under the UFCA) at a time when it was in a precarious financial condition.<sup>33</sup>

Professor Smyser correctly states that the Baird and Jackson observation regarding per se rules "misperceives the relationship between 'per se' rules such as fraudulent conveyance laws and specifically negotiated contractual provisions."<sup>34</sup> She also remarks: "Creditors negotiate specific contractual protection, and incur the costs associated with this process, only when they assume that the applicable law—that is, the relevant body of per se rules—does not protect them against a particular risk. To do otherwise would be inefficient and redundant."<sup>35</sup>

In condemning the application of fraudulent transfer law to leveraged buyouts, Professors Baird and Jackson paint with broad strokes. As Professor Smyser cogently observes, fraudulent transfer analysis contains two sets of limiting circumstances in the first instance—the requirements of a precarious financial condition and the lack of reasonably equivalent value.<sup>36</sup> As discussed below, not all transactions that result in a diminution of the debtor's estate are condemned by fraudulent transfer law. First, fraudulent transfer law applies only to transfers made when a debtor's financial circumstances are exceptionally precarious or become so as a result of the transfer.<sup>37</sup> Second, fraudulent transfer law applies only to transfers made under circumstances where the debtor receives less than

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States v. Tabor Court Realty Corp., 803 F.2d 1288, 1297 & n.2 (3d Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987). Moreover, a fraudulent transfer restriction would be in the nature of a negative covenant, the value of which is often questionable, or an event of default under the collateral documents. Those creditors with sufficient economic power to extract such a condition are more likely to take a security interest to protect themselves. See Note, *Fraudulent Conveyance Law & Leveraged Buyouts*, 87 COLUM. L. REV. 1491, 1512 (1987).

<sup>32</sup> See Smyser, *supra* note 7, at 791.

<sup>33</sup> *Id.*

<sup>34</sup> *Id.*

<sup>35</sup> *Id.* at 789.

<sup>36</sup> *Id.* at 791.

<sup>37</sup> *Id.* at 792.



reasonably equivalent value in exchange for the property transferred.<sup>38</sup> Both requirements must exist at the time of the challenged transfer. Without them, no fraudulent transfer exists. Professor Smyser asserts: "These limitations cannot be overlooked in speculating about what types of per se rules restricting debtor conduct creditors may favor."<sup>39</sup>

Although it seems apparent why fraudulent transfer law would require lack of reasonably equivalent value as a precondition to the successful challenge of a transfer, why do the statutes also require insolvency as a precondition? Here, the commentators are generally in agreement.

Limiting the application of fraudulent conveyance statutes to circumstances of insolvency reflects a logical assessment of a change in circumstances which transforms the inherent conflict of interest between debtor and creditor present from the outset of every credit transaction into a much more serious conflict. The use of insolvency as a trigger for liability in the fraudulent conveyance statutes represents a determination that under circumstances of insolvency the risk of misconduct by those in control of a corporate debtor becomes so great that it is appropriate to afford creditors the benefit of a per se rule restricting the corporation's conduct. . . . The insolvency threshold limits the application of fraudulent conveyance statutes to precisely those extraordinary circumstances in which creditors are likely to oppose the challenged conveyance before it is made.<sup>40</sup>

Section 548 transcends the dispute between a debtor and a creditor; it brings into focus the claims of a debtor's other creditors that they have been collectively deprived of recourse to a debtor's asset.<sup>41</sup> Thus, while preference law under Section 547<sup>42</sup> enforces the bargain (usually implied by law) among the creditors to resort to collective creditor action in bankruptcy,<sup>43</sup> fraudulent transfer law enforces the bargain between the debtor

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<sup>38</sup> *Id.*

<sup>39</sup> *Id.* at 791. Notwithstanding the almost unanimous judicial rejection of the Baird and Jackson view, Professor Zaretsky in his preliminary examiner's report pays it considerable (I believe too much) deference. See *In re Revco D.S., Inc.*, 118 Bankr. 468 (Bankr. N.D. Ohio 1990).

<sup>40</sup> Smyser, *supra* note 7, at 795 (footnote omitted).

<sup>41</sup> See *Lawyers Title Ins. Corp. v. Madrid (In re Madrid)*, 21 Bankr. 424, 428 (Bankr. 9th Cir. 1982) (Volinn, J., dissenting), *aff'd on other grounds*, 725 F.2d 1197 (9th Cir.), *cert. denied*, 469 U.S. 833 (1984).

<sup>42</sup> 11 U.S.C. § 547(b) (1988).

<sup>43</sup> The legislative history for § 547 states:

The purpose of the preference section is two-fold. First, by permitting the trustee to avoid prebankruptcy transfers that occur within a short period before bankruptcy, creditors are discouraged from racing to the courthouse to dismember the debtor during his slide into bankruptcy. The protection thus afforded the debtor often enables him to work his way out

and its creditors.<sup>44</sup> Fraudulent transfer law protects creditors against misbehavior (actual or implied by law) by their debtor.<sup>45</sup> Professor Jackson remarked:

The rough contours of fraudulent conveyance law are easy to establish. Classic fraudulent conveyance law is concerned with a debtor who manipulates his assets so as to keep them from his creditors. When a debtor is insolvent and must hand his assets over to his creditors, he has an incentive to hide his assets, to gamble them away, or to cut the best possible deal with a friend (whether or not the friend is a creditor). These types of actions form the core behavior that classic fraudulent conveyance law is designed to prevent. Actions taken to 'hinder, delay, or defraud' one's creditors are, therefore, fraudulent.<sup>46</sup>

Blocking a debtor's attempt to place assets out of the reach of its creditors with the actual intent to hinder, delay, or defraud was the original goal of fraudulent transfer law.<sup>47</sup> Commentators are nearly unanimous in the view that creditors' collection law (including bankruptcy) should contain a prohibition against actual fraudulent transfers.<sup>48</sup> The de-

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of a difficult financial situation through cooperation with all of his creditors. Second, and more important, the preference provisions facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor. Any creditor that received a greater payment than others of his class is required to disgorge so that all may share equally.

H.R. REP. NO. 595, 95th Cong., 1st Sess. 177-78, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6138.

<sup>44</sup> See Jackson, *supra* note 19, at 726, 777 (fraudulent transfer law adjusts rights of creditors vis-à-vis the debtor); Clark, *supra* note 17, at 554-60.

<sup>45</sup> Or, as Professors Jackson and Scott observe, fraudulent transfer law "responds to the well understood problems of inappropriate self-interested behavior by managers and equity" of the debtor. Jackson & Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155, 170 (1989).

<sup>46</sup> Jackson, *supra* note 19, at 778 (footnote omitted).

<sup>47</sup> In a thoughtful article, Professor McCoid recognizes that this type of transfer has its common law roots in the "voluntary conveyance" and reminds all that the modern law of fraudulent transfer has subtly merged the voluntary conveyance and the transfer for inadequate consideration (the subject of most modern fraudulent transfer cases). See McCoid, *Constructively Fraudulent Conveyances: Transfers for Inadequate Consideration*, 62 TEX. L. REV. 639, 642-49 (1983). See generally 1 G. GLENN, *supra* note 1, §§ 275, 294, 298; O. BUMP, A TREATISE UPON CONVEYANCES MADE BY DEBTORS TO DEFRAUD CREDITORS §§ 57, 247 (rev. 4th ed. 1986).

<sup>48</sup> Cf. Jackson, *supra* note 19, at 779 n.172 (citations omitted):

Had states not adopted fraudulent conveyance laws, a fraudulent conveyance rule in bankruptcy probably would have been preferable to no rule at all, given the inherently insolvency-directed nature of fraudulent conveyance law. Since general fraudulent conveyance laws are a standard feature of all jurisdictions, however, the wisdom of a separate bankruptcy rule is substantially more dubious because of the bankruptcy incentives it creates. . . . Section 548 of the Bankruptcy Code borrows from fraudulent conveyance law, but tinkers

bate, however, begins with constructive fraudulent transfers. What are its limitations? What policy is it intended to foster? What interests is it there to protect?

The purpose of this article is not only to offer a critical analysis of proposed fraudulent transfer policy paradigms, but also to deduce a working hypothesis that the courts and practitioners may employ, much like the navigator with his sextant, to fix their position in the turbulent seas of fraudulent transfer law. The normative question is: what should be the theoretical explanation for invalidation in constructive fraudulent transfer cases? The answer is a reasoned creditors' harm heuristic. Deduced from cases, equity, and legislative history, the reasoned creditors' harm heuristic asks one to view the transaction or proposed transaction from the point of view of the debtor's unsecured creditors. At the time of the transfer, does what is contemplated significantly harm the unsecured creditors at a time when their debtor is in a precarious financial position, that is, is there a diminution of the debtor's estate?<sup>49</sup> If so, is there any reason to ignore fraudulent transfer liability, that is, is the diminution unjust?<sup>50</sup> The first inquiry is more scientific; the second, more artistic.

In its preface explaining the inclusion of a constructive fraud provision, the UFCA states: "There are many conveyances which wrong creditors where an intent to defraud on the part of the debtor does not in fact exist."<sup>51</sup> The note to UFCA Section 3 (defining fair consideration) confirms that injury to creditors was the UFCA's primary concern:

The cases relating to the subject of this section usually deal with the amount of consideration as indicating whether there is a fraudulent intent

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with it in a fashion that is often inexplicable. *Compare* UNIF. FRAUDULENT CONVEYANCE ACT § 1 (1919) (definition of "conveyance") *with* Bankruptcy Code § 548(d) (definition "transfer"). *Compare* UNIF. FRAUDULENT CONVEYANCE ACT § 9(1) (1919) (a wronged creditor cannot recover from a "purchaser for fair consideration without knowledge of the fraud at the time of purchase") *with* Bankruptcy Code § 548(c) (transferee "that takes for value and in good faith has a lien on any interest transferred . . . to the extent that [he] gave value to the debtor"). This process has accelerated with the 1984 amendment.

Many of these distinctions have been eliminated in jurisdictions which have enacted the UFTA. *But see* UFTA §§ 3(b), 6(5)(ii), 8(e)(1), 8(e)(2), 7A U.L.A. 639, 650, 659, 662 (1984).

<sup>49</sup> *See* General Electric Credit Corp. v. Murphy (*In re Rodriguez*), 895 F.2d 725, 727 (11th Cir. 1990) (reasonably equivalent value requirement exists to protect creditors against depletion of the debtor's estate).

<sup>50</sup> UFTA § 10 recognizes the defenses of estoppel, laches, and waiver. *See* UFTA § 10, 7A U.L.A. 639, 666 (1984); *see also* Kupetz v. Wolf, 845 F.2d 842 (9th Cir. 1988) (court recognized the unfairness of allowing attacks by future creditors on prior transfers).

<sup>51</sup> UFCA, Prefatory Note, 7A U.L.A. 427, 428 (1918).

on the part of the grantor or collusion on the part of the grantee. It is submitted that the real question in such cases is the good faith of the grantee, and whether the consideration given by him is a reasonable equivalent for the property received.<sup>52</sup>

As Professor McCoid observes:

The UFCA was drafted against this varied landscape. . . . [T]he drafter's eye was on the injury to creditors, not the behavior of the transferor or transferee. Creditors suffer an economic loss when their insolvent debtor transfers property for inadequate consideration. The debtor's remaining estate, to which they look for satisfaction, is diminished. Of course, to the extent that consideration is given there is no diminution. This fact presumably accounts for the protection of the transfers provided by section 9(2). The UFCA and corresponding bankruptcy provisions seek to rectify the perceived injury. The impulse to which they respond is very different from that prohibiting transfers with actual fraudulent intent and voluntary conveyances. It is a kind of 'no fault' principle.<sup>53</sup>

The UFTA also suggests that the focus of a constructive fraudulent transfer is on value which, from a creditor's viewpoint, has utility.<sup>54</sup> Section 3 of the UFTA states:

"Value" is to be determined in light of the purpose of the Act to protect a debtor's estate from being depleted to the prejudice of the debtor's unsecured creditors. Consideration having no utility from a creditor's viewpoint does not satisfy the statutory definition.<sup>55</sup>

This analysis is no different if one employs Section 548 of the Bankruptcy Code rather than state fraudulent transfer law under Section 544(b). Courts usually focus on the value received by the debtor, rather than the value given by the transferee.<sup>56</sup> This approach ensures max-

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<sup>52</sup> NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, PROCEEDINGS OF THE TWENTY-EIGHTH ANNUAL MEETING 352 (1918); see McCoid, *supra* note 46, at 644; accord Dole & Teofan, *supra* note 16, at 1029. For a discussion of the transferee's good faith requirement, see generally Note, *Good Faith and Fraudulent Conveyances*, 97 HARV. L. REV. 495 (1983).

<sup>53</sup> McCoid, *supra* note 46, at 655-56.

<sup>54</sup> See Shupack, *Confusion in Policy and Language in the Uniform Fraudulent Transfer Act*, 9 CARDOZO L. REV. 811, 832 (1987).

<sup>55</sup> UFTA § 3, Comment 2, 7A U.L.A. 639, 650-51 (1984).

<sup>56</sup> See, e.g., *Consove v. Cohen (In re Roco Corp.)*, 701 F.2d 978, 982 (1st Cir. 1983) (in analyzing stock redemption under § 548(a)(2), court held that value to be assessed is value received by debtor, not value forfeited by transferee); *Ohio Corrugating Co. v. Security Pac. Bus. Credit, Inc. (In*

imization of the creditors' welfare. One may argue that a strict application of the creditors' harm heuristic may persuade a court to disregard value paid by a transferee initially to third parties. Nonetheless, courts are acknowledging that "indirect benefits" can possibly satisfy the reasonably equivalent value requirement if the value is definite and not illusory.<sup>57</sup> This is correct for the obvious reason—"indirect benefits" are indeed benefits to the debtor and ultimately its creditors, by definition. Although these indirect benefits may not, and often do not, constitute reasonably equivalent value, there is no reason that they should not be quantified and considered.

To understand that the essence of fraudulent transfer law is to protect creditors from the unjust diminution of the debtor's estate requires one to accept a fundamentally sound, yet deceptively simple fact of life. Ultimately, fraudulent transfer law is but a debt-collection device. It was never intended to be anything but a debt-collection device. Collectively, creditors are entitled to a fair distribution of the estate when their debtor is insolvent.<sup>58</sup> Juxtaposed to this basic principle is the notion that a general creditor acquires no specific interest in his debtor's property until he gains, by process of law, the right to realize his debt through judgment and then execution.<sup>59</sup> Furthermore, a debtor does not hold its estate in trust for its general creditors.

With these basic principles in mind, one can see the essence of the harm caused by a fraudulent transfer: "[T]he fraudulent transfer infringes the creditors' collective right to a fair distribution of their debtor's estate, just as it infringes the single creditor's right to collect through judgment and attachment."<sup>60</sup> To distill this grand notion, one can conclude that the crux of fraudulent transfer law was, and should be, to protect creditors from "the unjust diminution of the debtor's estate."<sup>61</sup> Putting aside what

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*re* Ohio Corrugating Co.), 70 Bankr. 920, 927 (Bankr. N.D. Ohio 1987) (court's focus is on what debtor receives in exchange for asset surrendered, irrespective of third-party gain or loss); *see also* Cieri, Heiman, Henze, Jenks, Kirschner, Riley & Sullivan, *An Introduction to Legal and Practical Considerations in the Restructuring of Troubled Leveraged Buyouts*, 45 BUS. LAW. 333, 355-56 (1989) [hereinafter Cieri, Heiman]. *See generally* 1A BANKR. SERV. L. ED. § 5D:2, at 9 (1990).

<sup>57</sup> *See* General Elec. Credit Corp. v. Murphy (*In re* Rodriguez), 895 F.2d 725, 727 (11th Cir. 1990); Rubin v. Manufacturers Hanover Trust Co., 661 F.2d 979, 991 (2d Cir. 1981); *see also* Cieri, Heiman, *supra* note 46, at 355 & nn.98-100; Sherwin, *supra* note 5, at 474 n.96 (cases cited therein).

<sup>58</sup> 1 G. GLENN, *supra* note 1, § 44, at 72.

<sup>59</sup> *Id.* § 13, at 17.

<sup>60</sup> *Id.* § 45, at 73. Professor Glenn stated that this proposition is so self evident that it needs no exposition. *Id.*

<sup>61</sup> *Id.* § 195, at 348; *see* Mancuso v. Champion (*In re* Dondi Fin. Corp.), 119 Bankr. 106 (Bankr. N.D. Tex. 1990); *accord* Voest-Alpine Trading USA Corp. v. Vantage Steel Corp., 919 F.2d

this concept means for the time being, one should first determine what it does not mean. As previously mentioned, this concept does not mean that a debtor holds his estate in trust for his creditors. Moreover, the concept applies to the estate at large and not to a particular asset as a component of the estate.

The creditor's right to realize upon the debtor's property, conferred by judgment, put into effect by execution, supplemented by judgment creditor's bill and various substitutes for that remedy—is not a roving right. All he can ask is that he find assets, no matter of what sort, sufficient to raise the amount of the judgment debt with interest and cost. But he may not demand that any particular asset be kept on hand. In the absence of lien, mortgage, or trust express or constructive, the creditor cannot insist upon seeing tomorrow what he sees today as part of his debtor's estate. His right is that the estate, at the time when attachment is to issue or levy be made, shall not have been so depleted that he cannot be paid.<sup>62</sup>

Consequently, no injury can result from the sale of an asset at its fair value. "The reason is . . . the estate [does not] abate as a result of what was done. In the case of a fair sale, the creditor simply finds new value replacing old."<sup>63</sup>

Fraudulent transfer law recognizes that the creditor cannot complain of any transaction that leaves the debtor solvent. Additionally, fraudulent transfer law does not allow a creditor to complain of any transaction where the debtor receives reasonably equivalent value in exchange for the property transferred. Both of these are components of the heuristic offered here—a fraudulent transfer can be successfully attacked only if the debtor's estate was unfairly diminished. Moreover, fraudulent transfer law requires that these assessments be made at the time of the transfer. A subsequent failure of reasonably equivalent value, unforeseen by the parties at the time of the transfer, should have no invalidating effect.<sup>64</sup> In other words, what went out of the estate must be roughly equivalent to what replaced it. From a creditors' harm perspective, the transfer for equivalent value is nothing more than, to use Professor Glenn's words, a

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206 (3d Cir. 1990); *Running v. Widdes*, 52 Wis.2d 254, 190 N.W.2d 169 (1971); *Kummet v. Thielen*, 210 Minn. 302, 298 N.W. 245 (1941); *Davis v. Nielson*, 9 Wash. App. 864, 515 P.2d 995 (1973).

<sup>62</sup> 1 G. GLENN, *supra* note 1, § 196, at 349.

<sup>63</sup> *Id.* § 199, at 351.

<sup>64</sup> *Id.* § 275, at 471.

*"damnum absque injuria."*<sup>65</sup>

With this backdrop in mind, one can easily understand why, at least superficially, courts have been zealous (some would say fanatic) in condemning the three-party or indirect benefit transaction. When a debtor extends money in exchange for benefits conferred upon a third person, it should be asked whether the debtor's relations with the third person are such, by way of contract or property interest, that the transaction will increase the estate of the debtor rather than diminish it, or at least leave the debtor's estate substantially as it was. "Paying out money to enlarge a worthless husband from durance vile, is quite different from a transaction which benefits directly a third party corporation indeed—but a corporation whose shares are owned by the debtor."<sup>66</sup> One can also understand the zealousness of courts in addressing leveraged transactions. In its simplest terms, a leveraged buyout reduces the assets available to unsecured creditors by replacing old equity with new secured debt. Thus, old equity is able to elevate its position in the state priority pecking order at the expense of the general creditors.<sup>67</sup> Consequently, when one speaks of the debtor's estate, one means the estate available to his creditors.<sup>68</sup>

The article now turns to examples that are intended to support the heuristic. One age-old problem was whether the assignment for benefit of creditors was itself a fraudulent transfer.<sup>69</sup> At common law, the assignment was an express trust that the debtor created by conveyance of his assets to the assignee for the purpose of liquidating the estate assets and distributing their value among the debtor's creditors.<sup>70</sup> Fraudulent transfer law did not view the general assignment for the benefit of creditors as a fraudulent transfer.<sup>71</sup> Why? There was no unjust diminution of the estate; for, in reality, there was no diminution of the estate in the first instance. The assets remained for the purpose of satisfying the creditors' claims.

A second example also helps to show the efficacy of the creditor's harm heuristic. Assume that the debtor transferred a beautiful painting by Rembrandt. Also, assume that a general creditor had a distinct fondness for Rembrandts. This creditor did not have a lien on the painting; never-

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<sup>65</sup> *Id.* § 275, at 472.

<sup>66</sup> *Id.* § 276, at 474.

<sup>67</sup> See Sherwin, *supra* note 5, at 451-52.

<sup>68</sup> 1 G. GLENN, *supra* note 1, § 276, at 473.

<sup>69</sup> See *id.* § 102, at 201.

<sup>70</sup> See *id.*

<sup>71</sup> See *id.*

theless, he dreamed one day of owning the Rembrandt. Imagine the shock of the creditor when he finds out that his debtor has transferred the Rembrandt for a mere \$50.00. Can that creditor avoid the transfer and bring the painting back into the debtor's estate? It depends.

[Because] . . . courts will never act unless they have to, a creditor cannot raise the issue of fraudulent conveyance unless he needs the missing asset in order to satisfy his claim. If at present a debtor has assets that are sufficient to meet his debts, it is academic that previously he had made a fraudulent conveyance. Hence the well-settled rule that if a debtor had regained solvency, to his creditor's knowledge, prior to a suit to set aside the earlier transfer, the creditor will be dismissed.<sup>72</sup>

Another example involves a situation where a debtor donates his services to a charitable organization. A debtor's services are not an asset that his creditors can use to satisfy their claims; therefore, the donation of those services to a charitable organization, even when the debtor is insolvent, does not generate fraudulent transfer liability, even where the value of the beneficiary's estate is substantially enhanced.<sup>73</sup> But, of course, this is not the result where the debtor provides services to a beneficiary who, in turn, pays a designated third party for the services rendered. Although the debtor's labor itself is not an asset upon which the debtor's creditor can realize, the fruits of that labor—the remuneration—is.<sup>74</sup>

Professor Glenn provides a further example of an unjust diminution of the debtor's estate.

In the field of mining law, it is possible for a prospector to lose all right by sheer delay, against a man who has 'jumped' his claim. The creditors of this faineant, however, may have the adverse party's title set aside, as having been acquired by way of fraudulent conveyance, if they can show that their debtor allowed these rights to be gained, by conical, in order to keep them out of the estate that would otherwise be available for creditors.<sup>75</sup>

Again, what the examples should show is that a transfer must be scrutinized to determine whether it unjustly diminishes the debtor's estate. I have used the shorthand label of a "reasoned creditors' harm" to demon-

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<sup>72</sup> *Id.* § 111, at 220-21.

<sup>73</sup> *Id.* § 212, at 365.

<sup>74</sup> *See id.* § 213, at 365.

<sup>75</sup> *Id.* § 214, at 366.



strate the legitimacy and applicability of the heuristic. Nonetheless, the heuristic focuses not only on whether harm has come to the creditors, but also on whether the harm is unjust. It is this latter inquiry that truly defines the limits of fraudulent transfer law. Of course, one must keep at hand the fact that in assessing the unjust diminution of the estate, lack of diminution in the first instance is its own limitation. Consequently, a transfer by an insolvent debtor for less than reasonably equivalent value is a first-order limitation embodied in the concept of the unjust diminution of the debtor's estate.<sup>76</sup> Professor Smyser has convincingly reminded us of that basic precept.<sup>77</sup> The remainder of this article will turn to an examination of the remaining orders of limitation embodied in the concepts of transfer, affirmative defenses, and remedies under fraudulent transfer laws. It is this mesh of these limitations that properly define, like the lighthouses of old, the coastline of modern fraudulent transfer law.

## II. CONSTRUCTIVE FRAUD

To make out a successful Section 548(a)(2) claim, the trustee must prove (1) a transfer to the defendant of (2) an interest in property of the debtor<sup>78</sup> (3) during the year preceding the filing of the petition in bankruptcy<sup>79</sup> (4) without reasonably equivalent value<sup>80</sup> in exchange for such

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<sup>76</sup> Along with these requirements, the remaining elements of a § 548 or § 544 action are first-order limitations. For example, if the challenged transfer is one not conveying property of the debtor, then the transfer will not deprive the estate of something that could be used to satisfy creditors. See *Danning v. Bozek (In re Bullion Reserve of N.A.)*, 836 F.2d 1214 (9th Cir.), *cert. denied*, 486 U.S. 1056 (1988). Thus, it should come to no one's surprise that a transfer of exempt property is not generally actionable under the UFTA because there is no diminution in the debtor's estate. See, e.g., *Sisco v. Paulson*, 232 Minn. 250, 45 N.W.2d 385 (1950). The same, unfortunately, does not hold true for actions under § 548. Because exempt property is property of the estate under § 541, a transfer of exempt property may be challenged even where there may be no unjust diminution of the estate from a state law perspective. Nevertheless, the action and subsequent recovery of the fraudulently transferred assets or the value of the assets must be for the benefit of the creditors. See *NCNB Nat'l Bank v. Fogarty (In re Fogarty)*, 114 Bankr. 788 (Bankr. S.D. Fla. 1990) (debtors are precluded from avoiding a transfer where, under their reorganization plan, the debtors and not the creditors would benefit from the debtors' recovery of the avoided property).

<sup>77</sup> See Smyser, *supra* note 7, at 791.

<sup>78</sup> The Bankruptcy Code does not define the phrase "interest of the debtor in property." Although the question of what constitutes an interest of the debtor in property is a question of federal law, the courts will consult state law in determining whether this element is met. 1A BANKR. SERV. L. ED. § 5D:12, at 19 & n.1 (1990) (cases cited therein). The property requirement enjoys a broad scope and is generally construed in light of the purposes of fraudulent transfer law. Generally, the transfer must have depleted the debtor's estate. *Id.* § 5D:12, at 19-20 & n.2 (cases cited therein).

<sup>79</sup> It is the filing of the petition in bankruptcy and not any subsequent petition that is used as the timing reference under § 548. See *Bluford v. First Fidelity Mortgage Co. (In re Bluford)*, 40 Bankr. 640, 644 (Bankr. W.D. Mo. 1984). The appropriate reach-back period is often one of the most hotly

transfer (5) while the debtor was insolvent.<sup>81</sup>

### A. The "Transfer"

Transfer is broadly defined in Section 101(50) of the Bankruptcy Code to include "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest and foreclosure of the debtor's equity of redemption."<sup>82</sup> A transfer is protean and embrasive,<sup>83</sup> including a gift,<sup>84</sup> a nonjudicial foreclosure sale,<sup>85</sup> a

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contested issues in a fraudulent transfer action. Section 548(a) constitutes a grant of power to the trustee to avoid certain transfers deemed to have been made within one year of the filing of the bankruptcy petition. The reach-back period is not a statute of limitations. The reach-back requirement cannot be waived; it is not an affirmative defense. It serves as a means by which the trustee's power is limited in time so that § 548 does not serve as a form of unlimited insurance for creditors against the debtor's striking a bad deal. Consequently, transfers "deemed" to have taken place outside the one-year period are not subject to attack under § 548. However, one must be careful not to be misled by the realities of the transactions. Section 548(d)(1) states a policy and is not a recantation of the actual events. Thus, the law on when a transaction is deemed to have occurred (as opposed to when, in reality, it happened) must be consulted. Finally, all transfers within the applicable time period must be examined by the court.

<sup>80</sup> The phrase was "fair consideration" under the Bankruptcy Act of 1898 and incorporated a requirement of good faith that no longer exists under § 548(a)(2) or §§ 4 and 5 of the UFTA. See *Carr v. Demusis* (*In re Carr*), 34 Bankr. 653, 656 (D. Conn. 1983); see also UFTA § 3, 7A U.L.A. 427, 448-49 (1918) (employing a "fair consideration" standard).

<sup>81</sup> *Murphy v. General Elec. Credit Corp.* (*In re Rodriguez*), 77 Bankr. 939, 940 (Bankr. S.D. Fla. 1987), *aff'd*, 895 F.2d 725 (11th Cir. 1990); *In re Ristich*, 57 Bankr. 568, 574 (Bankr. N.D. Ill. 1986). The corresponding UFTA sections are §§ 4, 5, 7A U.L.A. 639, 652-53, 657 (1984). Although obvious, it is occasionally overlooked that postpetition (as opposed to prepetition) transfers are not voidable under § 548. *Nemeti v. Seaway Nat'l Bank* (*In re Nemeti*), 65 Bankr. 391, 394 (Bankr. N.D.N.Y. 1986).

<sup>82</sup> 11 U.S.C. § 101(50) (1988).

<sup>83</sup> See *Venice Western Motel, Ltd. v. Venice Motor Inn, Ltd.* (*In re Venice Western Motel, Ltd.*), 67 Bankr. 777, 780 (Bankr. M.D. Fla. 1986).

<sup>84</sup> *Schafer v. Hammond*, 456 F.2d 15, 17 (10th Cir. 1972).

<sup>85</sup> *Durrett v. Washington Nat'l Ins. Co.*, 621 F.2d 201, 204 (5th Cir. 1980) (seminal case holding that a foreclosure sale is a transfer); *accord* *First Fed. Sav. & Loan Ass'n v. Hulm* (*In re Hulm*), 738 F.2d 323, 325 (8th Cir.), *cert. denied*, 469 U.S. 990 (1984). *But cf.* *Madrid v. Lawyers Title Ins. Corp.* (*In re Madrid*), 725 F.2d 1197, 1198 (9th Cir.), *cert. denied*, 469 U.S. 833 (1984); *In re Winshall Settlor's Trust*, 758 F.2d 1136, 1138-39 (6th Cir. 1985).

Does the *Durrett* analysis apply to the personal property context? For example, if a debtor grants a security interest in all of its assets, there is little trouble finding a transfer once the interest is perfected. But if the debtor defaults, is the creditor's repossession and subsequent sale of the assets a new transfer? One bankruptcy court held that a pledge of securities as collateral and the subsequent involuntary sale of those securities upon the debtor's default each constituted separate transfers. *Calairo v. Pittsburgh Nat'l Bank* (*In re Ewing*), 33 Bankr. 288, 291-92 (Bankr. W.D. Pa. 1983), *rev'd*, 36 Bankr. 476 (W.D. Pa.), *aff'd*, 746 F.2d 1465 (3d Cir. 1984), *cert. denied*, 469 U.S. 1214 (1985). The court reasoned that the UCC sale must be a transfer, at least where the debtor's interest

filing of a *lis pendens* for alimony,<sup>86</sup> an execution on a judgment lien,<sup>87</sup> a renewal of a loan and payments thereunder,<sup>88</sup> a pledge of securities and subsequent involuntary sale,<sup>89</sup> a termination of a lease,<sup>90</sup> a settlement

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in the collateral exceeded the bank's secured debt. *Id.*

*Calairo* was subsequently reversed by the district court. 36 Bankr. 476 (W.D. Pa. 1984). The district court held that the only transfer was the original pledge of the collateral and not the subsequent sale, failing to discuss the new 1984 amendments to the Bankruptcy Code. *Id.* at 478. The district court was later affirmed by the Third Circuit in a summary disposition. 746 F.2d 1465, 1465 (3d Cir. 1984); see UFTA § 8(e)(2), 7A U.L.A. 639, 662 (1984) (a transfer is not voidable if the transfer results from enforcement of a security interest in compliance with Article 9 of the Uniform Commercial Code).

It seems that the *Durrett* analysis and the *Calairo* analysis cannot live side-by-side. A little background may be helpful. In *Durrett*, the Fifth Circuit addressed a foreclosure sale, pursuant to a power of sale in a deed of trust, under Texas law. In Texas, the debtor's right of redemption of the real property ceases when the property is struck at the courthouse steps. Furthermore, only the debtor and any guarantors or co-owners have a right to notice of the foreclosure sale. In other words, junior lienholders, even those who have perfected their liens in the county's real property records, are not entitled to notice of the foreclosure sale that will, under Texas law, extinguish their perfected lien. Thus, only where notifying a junior lienholder of the proposed foreclosure sale would be beneficial to the senior lienholder—where, for example, the senior believes the junior will purchase its debt and take it out of its credit relationship with the debtor—will the junior receive notice. Nonetheless, the usual practice is not to provide notice to junior lienholders. This result almost always amazes those practitioners from other jurisdictions who forcefully argue that such a foreclosure scheme violates the Due Process Clause of the Fourteenth Amendment. To them I used to quote at length the Texas cases finding no state action, to which we would often get into long esoteric discussions about the state action doctrine. Always, they found my defense of the Texas system unconvincing for obvious reasons. Lately, I tell my fellow practitioners that "[i]n Texas, however, people do things their own way." Nickles, *The Objectification of Debtor-Creditor Relations*, 74 MINN. L. REV. 371, 378 (1990). Although not sound legal analysis, the answer does have the attribute of foreclosing debate on the state action doctrine.

It was in this context that the Fifth Circuit addressed the issues in *Durrett*. I cannot help but believe that the system itself poisoned the court's analysis of the transfer and the reasonably equivalent value requirements. Furthermore, I cannot help but believe that the *Durrett* analysis, if good law, should apply to the Article 9 foreclosure sale as well. After all, the Article 9 foreclosure sale extinguishes the debtor's right of redemption in the same manner as the real property foreclosure under Texas law, an act that appears to be a transfer by the debtor under § 101(50). Certainly, there are more provisions in Article 9 to ensure a commercially reasonable disposition, see U.C.C. § 9-504, but these provisions go to the question of value and not whether the triggering transfer exists.

<sup>86</sup> *In re Ottaviano*, 63 Bankr. 338, 341 (Bankr. D. Conn. 1986).

<sup>87</sup> *Frank v. Berlin (In re Frank)*, 39 Bankr. 166, 167-69 (Bankr. E.D.N.Y. 1984).

<sup>88</sup> *B.Z. Corp. v. Continental Bank, N.A. (In re B.Z. Corp.)*, 34 Bankr. 546, 548 (Bankr. E.D. Pa. 1983).

<sup>89</sup> *Kelley v. Horner (In re Kelley)*, 7 Bankr. 384, 388-89 (Bankr. D.S.D. 1980).

<sup>90</sup> *Eder v. Queen City Grain, Inc. (In re Queen City Grain, Inc.)*, 51 Bankr. 722, 725-26 (Bankr. S.D. Ohio 1985); see also *Darby v. Atkinson (In re Ferris)*, 415 F. Supp. 33, 39 (W.D. Okla. 1976) (lease cancellation because of default is transfer subject to fraudulent transfer analysis). But see UFTA § 8(e)(1), 7A U.L.A. 639, 662 (1984) (leases terminated pursuant to their terms excluded from fraudulent transfer liability).

agreement,<sup>91</sup> a consignment of goods,<sup>92</sup> a bonus,<sup>93</sup> a planting of crops,<sup>94</sup> a bank's forbearance in collection of indebtedness in exchange for a security interest in livestock,<sup>95</sup> a garnishment of the debtor's bank account,<sup>96</sup> an attachment of a judgment lien,<sup>97</sup> a leveraged buyout,<sup>98</sup> an upstream, downstream, or cross-stream guaranty,<sup>99</sup> a ratification of security interests,<sup>100</sup> a draw on a credit line,<sup>101</sup> a collusive judgment,<sup>102</sup> an encumbrance,<sup>103</sup> a release by a beneficiary of an interest in a trust estate,<sup>104</sup> a change in a beneficiary of a life insurance policy,<sup>105</sup> a divorce or separation agreement,<sup>106</sup> a rescission of a profitable contract,<sup>107</sup> a payment of a dividend,<sup>108</sup> and a payment of usurious interest.<sup>109</sup> This list does not attempt to exhaust all of the possibilities of the term "transfer."<sup>110</sup>

<sup>91</sup> *In re Edward Harvey Co.*, 68 Bankr. 851, 858 (Bankr. D. Mass. 1987).

<sup>92</sup> *Campbell v. Macartie (In re Factory Tire Distribs., Inc.)*, 64 Bankr. 335, 338 (Bankr. W.D. Pa. 1986).

<sup>93</sup> *Id.* at 339.

<sup>94</sup> *Lemley-Cabiness Farms v. FDIC (In re Lemley Estate Business Trust)*, 65 Bankr. 185, 189 (Bankr. N.D. Tex. 1986).

<sup>95</sup> *In re Bob Schwärmer & Assocs., Inc.*, 27 Bankr. 304, 310 (Bankr. N.D. Ill. 1983).

<sup>96</sup> *Ellenberg v. DeKalb County, Ga. (In re Maytag Sales and Serv., Inc.)*, 23 Bankr. 384, 388 (Bankr. N.D. Ga. 1982) (case under § 547(b)).

<sup>97</sup> *Suppa v. Capalbo (In re Suppa)*, 8 Bankr. 720, 722 (Bankr. D.R.I. 1981) (case under § 547(b)).

<sup>98</sup> *Kupetz v. Continental Ill. Nat'l Bank & Trust Co.*, 77 Bankr. 754, 759-60 (C.D. Cal. 1987), *aff'd sub nom. Kupetz v. Wolf*, 845 F.2d 842 (9th Cir. 1988); *see United States v. Tabor Court Realty Corp.*, 803 F.2d 1288 (3d Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987). *See generally* Carlson, *supra* note 5, at 73.

<sup>99</sup> *Lawrence Paperboard Corp. v. Arlington Trust Co. (In re Lawrence Paperboard Corp.)*, 76 Bankr. 866, 874-76 (Bankr. D. Mass. 1987). *See generally* Coquillette, *Guaranty of and Security for the Debt of a Parent Corporation by a Subsidiary Corporation*, 30 CASE W. RES. 433 (1980); Rosenberg, *Intercorporate Guaranties and the Law of Fraudulent Conveyances: Lender Beware*, 125 U. PA. L. REV. 235 (1976).

<sup>100</sup> *Mitchell v. Travis (In re Jackson Sound Studios, Inc.)*, 473 F.2d 503, 506 (5th Cir. 1973).

<sup>101</sup> *Rubin v. Manufacturers Hanover Trust Co.*, 661 F.2d 979, 989-91 (2d Cir. 1981).

<sup>102</sup> *Petrides v. Park Hill Restaurant, Inc.*, 265 A.D. 509, 511, 39 N.Y.S.2d 645, 647 (1943).

<sup>103</sup> *Service Mortgage Corp. v. Welson*, 293 Mass. 410, 412, 200 N.E. 278, 279 (1936).

<sup>104</sup> *Schaefer v. Fisher*, 137 Misc. 420, 426, 242 N.Y.S. 308, 314 (1930).

<sup>105</sup> *Id.*

<sup>106</sup> *FDIC v. Malin*, 802 F.2d 12, 18 (2d Cir. 1986).

<sup>107</sup> *Wilson v. Holub*, 202 Iowa 549, 552, 210 N.W. 593, 595 (1926).

<sup>108</sup> *Mancuso v. Champion (In re Dondi Fin. Corp.)*, 119 Bankr. 106, 109 (Bankr. N.D. Tex. 1990).

<sup>109</sup> *Larrimer v. Feeney*, 411 Pa. 604, 607, 192 A.2d 351, 353 (1963).

<sup>110</sup> Because what constitutes a transfer is a question of federal law, state law on the issue is not controlling. *See McKenzie v. Irving Trust Co.*, 323 U.S. 365, 369-70 (1945); *First Fed. Sav. & Loan Ass'n v. Hulm (In re Hulm)*, 738 F.2d 323, 326 (8th Cir.), *cert. denied*, 469 U.S. 990 (1984); *Lovett v. Shuster*, 633 F.2d 98, 104 (8th Cir. 1980). For purposes of § 548, "transfer" should be construed to include an obligation incurred. *See* 11 U.S.C. §§ 101(50), 548(a) (1988); *see also* 1A BANKR. SERV.

The time when a transfer is deemed made for purposes of fraudulent transfer actions depends on Section 548(d)(1) and applicable state law. Section 548(d)(1) states:

For the purposes of this section, a transfer is made when such transfer is so perfected that a bona fide purchaser from the debtor against whom applicable law permits such transfer to be perfected cannot acquire an interest in the property transferred that is superior to the interest in such property of the transferee, but if such transfer is not so perfected before the commencement of the case, such transfer is made immediately before the date of the filing of the petition.<sup>111</sup>

Thus, a fraudulent transfer is deemed to have occurred under Section 548(d)(1) when the transfer becomes valid against a subsequent bona fide purchaser pursuant to applicable state law.<sup>112</sup> If the transfer is not perfected against a bona fide purchaser before the filing of the petition, the transfer is deemed to have occurred immediately before the date of the filing.<sup>113</sup> The purpose of Section 548(d)(1) is two-fold: first, the time of perfection serves as an objective point in computing the reach-back period of the trustee; and, second, it discourages secret, that is, unperfected liens.<sup>114</sup>

One finds the second-order limitation of fraudulent transfer law inherent in the chameleon-like quality of a "transfer." In a two-party transaction, the transfer is obvious. A transfers its property worth \$100 to B, who in exchange pays A \$25. The transfer is A's parting with property in exchange for substantially lower value.

However, the concept of "transfer" when more than two parties are

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L. ED. § 5D:6, at 13-14 (1990) ("a 'transfer' should be construed as including the incurring of an obligation").

<sup>111</sup> 11 U.S.C. § 548(d)(1) (1988).

<sup>112</sup> See *Sandoz v. Bennett (In re Emerald Oil Co.)*, 807 F.2d 1234, 1237 (5th Cir. 1987); *Madrid v. Lawyers Title Ins. Corp. (In re Madrid)*, 725 F.2d 1197, 1200 (9th Cir.), cert. denied, 469 U.S. 833 (1984); *Lovett*, 633 F.2d at 104; *Furedy v. Appleman (In re Vodco Volume Dev. Co.)*, 567 F.2d 967, 970 (10th Cir. 1977), cert. denied, 439 U.S. 806 (1978); *Main v. Brim (In re Main)*, 75 Bankr. 322, 326 (Bankr. D. Ariz. 1987); *Frank v. Berlin (In re Frank)*, 39 Bankr. 166, 171 (Bankr. E.D.N.Y. 1984); *Schatzman v. Campo (In re Oesterle)*, 2 Bankr. 122, 124 (Bankr. S.D. Fla. 1979).

<sup>113</sup> See *Oesterle*, 2 Bankr. at 124 (actual "transfer" made well before one year of the filing of the petition but recorded two days after the filing; held, transfer deemed to have occurred immediately before filing); see also *Cook*, supra note 20, at 269-70 (rule facilitates trustee's burden of proof on insolvency because it is highly likely that the debtor was insolvent immediately before bankruptcy).

<sup>114</sup> *In re Madrid*, 725 F.2d at 1200; *Nemeti v. Seaway Nat'l Bank (In re Nemeti)*, 65 Bankr. 391, 395 (Bankr. N.D.N.Y. 1986); see 4 COLLIER ON BANKRUPTCY ¶ 548.08, at 548-87 to -88 (15th ed. 1990).

involved can be problematic. Take for example the typical leveraged buyout structure. The acquirer typically forms a minimally capitalized shell corporation. The lender loans money directly to the shell corporation, which uses the proceeds of the loan to cash out the shareholders of the target corporation. Subsequently, the acquirer merges the target and the shell corporation, the target assuming the responsibility of the shell's debt. At the same time, the unencumbered assets of the target are pledged as collateral to secure the original acquiring loan. In this simple leveraged buyout, a number of parties are involved.<sup>115</sup> To the untrained eye, there also appears to be more than one transfer. How does a court, when scrutinizing this transaction, determine which transfer or transfers to measure against the fraudulent transfer benchmark? One approach is to collapse all the transfers into one "transfer" for purposes of fraudulent transfer analysis. Another approach is to dissect the transaction into a number of transfers, scrutinizing each specific transfer under fraudulent transfer law. The answer to this perplexing question provides the second order limitation to the application of fraudulent transfer law.

Although the case law in this area is still evolving, one can glean certain principles that courts consider important in determining what is the appropriate transfer for fraudulent transfer analysis. The answer appears to rest on a court's evaluation of the intent of the parties, the knowledge of the parties, and the notice provided to the parties at the time of the transfer. For example, in the leveraged buyout discussed above, if the lender were aware or should have been aware that the funds were to be used by the acquirer to pay off the shareholders of the target corporation, then a court will readily collapse the various transfers into one for purposes of assessing fraudulent transfer liability.<sup>116</sup> Nevertheless, if a court were to conclude that the lender did not know and that a reasonably prudent lender would not have known of the diversion of funds from creditors of the target corporation to the shareholders of the corporation, then the transfer should be viewed from the eyes of the reasonably prudent lender for purposes of assessing fraudulent transfer liability. This approach, however, may lead to an anomalous result. In any given transaction, a transfer may be defined differently, depending on whose eyes the court employs. Nonetheless, the evolving body of case law in this area does sup-

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<sup>115</sup> For a more complete discussion of various forms of leveraged buyouts, see Carlson, *supra* note 5, at 80-83.

<sup>116</sup> See, e.g., *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288, 1302-03 & n.8 (3d Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987).

port this outcome.

In *Wieboldt Stores, Inc. v. Schottenstein*,<sup>117</sup> the court denied a motion to dismiss pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure, ruling that the various transactions that made up the leveraged buyout in that case should be viewed as a single transaction.<sup>118</sup> The court based this conclusion on the facts that the parties were aware of the nature of the leveraged buyout and had been counseled regarding the possible consequences of any leveraged buyout under fraudulent transfer laws.<sup>119</sup> Nonetheless, the court dismissed the complaint with respect to those shareholders who were not controlling or insider shareholders.<sup>120</sup> According to the court, the debtor did not allege that these shareholders were aware that the acquisition encumbered all of the debtor's assets or that the property they received for the tender of their shares was the debtor's property rather than the property of the buyer.<sup>121</sup> The shareholders were aware only that a public tender offer had been made for the shares of the debtor's stock.<sup>122</sup> In reaching its conclusion, the court relied on *United States v. Tabor Court Realty Corp.*<sup>123</sup> and *Kupetz v. Wolf*<sup>124</sup> for the basic proposition that a court should focus not on the formal structure of the transaction but rather on the knowledge or intent of the parties in assessing fraudulent transfer liability.<sup>125</sup>

The following summarizes the facts in *Wieboldt Stores, Inc. v. Schottenstein*.<sup>126</sup> Wieboldt Stores, Inc. ("WSI") was a well-known retailer in the Chicago area, owning and operating twelve stores. No longer able to meet its obligations as they came due, Wieboldt's board approved a tender offer by WSI Acquisition. Subsequently, WSI acquired 99% of the debtor's stock for over \$38.4 million. To finance the purchase, it was necessary to sell the debtor's flagship State Street store in order to pay off an existing loan secured by the debtor's real estate assets. The property was then mortgaged to a lender. Each of the lenders, those providing the principal financing of the tender offer, the mortgagee, and the accounts lender, were aware of the others' commitments and of WSI's tender offer. During

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<sup>117</sup> 94 Bankr. 488 (N.D. Ill. 1988).

<sup>118</sup> *Id.* at 500-02.

<sup>119</sup> *Id.* at 502.

<sup>120</sup> *Id.* at 503.

<sup>121</sup> *Id.*

<sup>122</sup> *Id.* at 503-04.

<sup>123</sup> 803 F.2d 1288 (3d Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987).

<sup>124</sup> 845 F.2d 842 (9th Cir. 1988).

<sup>125</sup> *Wieboldt Stores, Inc.*, 94 Bankr. at 500-02.

<sup>126</sup> *See id.* at 493-97.

the negotiations, the principal lender indicated that it would require a statement of the debtor's solvency from a nationally recognized accounting firm. The lender was informed, however, that the debtor would only continue to cooperate with the leveraged buyout if the lender dropped its demand. Consequently, no solvency certificate was ever produced.

After the tender offer, the principal lender's loan was secured by assets freed from prior obligations by loans from the other lenders. The debtor became liable to the lender for \$32.5 million. Although the debtor's board initially believed that the tender offer would produce \$10 million in working capital, they later realized this would not occur. In fact, the debtor did not receive any working capital as a result of the transaction.

Less than a year later, the debtor was in bankruptcy, and a fraudulent transfer action, subsequently, was filed. The action named 119 defendants, grouped into three categories: controlling shareholders, officers and directors; other shareholders who tendered more than 1,000 shares of stock; and lenders.

After quickly resolving that fraudulent transfer laws did apply to leveraged buyouts, the court confronted the issue of how to view the transaction.<sup>127</sup> A number of defendants argued that the tender offer and the leveraged buyout were composed of a series of interrelated but independent transactions. In the case of the principal lender, for example, these defendants maintained that the pledge of the debtor's assets was a transaction separate from the funding of the loan. Hence, the defendants argued that they received WSI property in exchange for those shares, not the debtor's property. The debtor, however, urged the court to collapse the interrelated transactions into one aggregate transaction. This approach, the court observed, required a determination that the defendants receiving the transfers were direct transferees who received an interest of the debtor and that WSI and any others were mere conduits of the debtor's property.<sup>128</sup>

Carefully reviewing the rulings in *Kupetz* and *Tabor Court Realty*, the court observed that both the Ninth and Third Circuits focused on the parties' knowledge of the transactions and their intent in determining the proper anatomy of the transfer.<sup>129</sup> In *Kupetz*, the Ninth Circuit affirmed the district court's decision that there was no fraudulent transfer because the shareholders did not sell their shares to defraud creditors, and they did

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<sup>127</sup> *Id.* at 500.

<sup>128</sup> *Id.* at 503.

<sup>129</sup> *Id.* at 500-02.



not know that the buyer was engaged in a leveraged buyout.<sup>130</sup> In *Tabor Court Realty*, however, the Third Circuit held a lender liable because it knew of the buyer's intended use of the loan proceeds.<sup>131</sup> The lender realized that the loan would deplete the debtor's assets to the point that the debtor would be functionally insolvent. Moreover, it upheld the district court's decision to integrate the series of transactions between the lender, the buyer, and the sellers.<sup>132</sup>

Similarly, in *Wieboldt*, the court determined that the board and the insider shareholders knew that WSI intended to finance its acquisition through a leveraged buyout, rather than with its own funds.<sup>133</sup> They knew that the debtor was insolvent before the leveraged buyout and that the leveraged buyout would further encumber the debtor's assets.<sup>134</sup> The court also found that attorneys advised the former Wieboldt board of fraudulent transfer laws and suggested that the leveraged buyout be structured to avoid liability.<sup>135</sup> Given the knowledge of the parties and the structuring of the leveraged buyout, the court concluded that the transactions should be collapsed into one transaction with respect to the directors, the insider shareholders, the controlling shareholders, and the lenders.<sup>136</sup>

The court, however, was not willing to collapse the transactions with respect to the non-insider or non-controlling shareholders.<sup>137</sup> The debtor did not allege that these shareholders were aware that the acquisition encumbered virtually all of the debtor's assets or that they received the debtor's property in exchange for their shares.<sup>138</sup> In fact, the court found that the shareholders knew only that WSI had made a tender offer for shares of the debtor's stock.<sup>139</sup>

The court's determination of the appropriate transfer had the effect of shielding the non-insider and non-controlling shareholders from fraudulent transfer liability. Under Section 550(b), a trustee cannot recover fraudulently conveyed property from a subsequent transferee who takes the property in good faith for value and without knowledge that the origi-

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<sup>130</sup> *Kupetz v. Wolf*, 845 F.2d 842, 847-48 (9th Cir. 1988).

<sup>131</sup> *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288, 1296 (3d Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987).

<sup>132</sup> 803 F.2d at 1302-03 & n.8.

<sup>133</sup> *Wieboldt Stores, Inc.*, 94 Bankr. at 502.

<sup>134</sup> *Id.* at 502.

<sup>135</sup> *Id.*

<sup>136</sup> *Id.*

<sup>137</sup> *Id.* at 503.

<sup>138</sup> *Id.*

<sup>139</sup> *Id.*

nal transfer was voidable.<sup>140</sup> Based on the court's limitation of the term "transfer," from the perspective of the non-insider, non-controlling shareholders, "WSI was the direct transferee of [the debtor's] property, and the shareholders were merely indirect transferees because WSI was viewed as an independent entity in the transaction."<sup>141</sup>

Thus, one can discern from *Wieboldt*, *Kupetz*, and *Tabor Court Realty*, a clear second-order limitation. Although the term "transfer" under Section 101(50) is broadly defined and all encompassing, it does appear to have inherent limitations in application. In determining the transfer, courts will scrutinize the intent and knowledge of the parties. Consequently, the anatomy of the transfer as seen through the eyes of a particular target defendant provides a second-order limitation to the applicability of fraudulent transfer law to modern transactions.<sup>142</sup>

### B. Failure of Reasonably Equivalent Value

Receiving less than reasonably equivalent value for a transfer made or obligation incurred is one of the necessary elements of a constructive fraudulent transfer.<sup>143</sup> Consequently, as previously discussed,<sup>144</sup> this requirement is also a component of the first-order limitations to fraudulent transfer law. The assessment of reasonably equivalent value is objective and is generally a question of fact.<sup>145</sup> Courts have generally employed a

<sup>140</sup> 11 U.S.C. § 550(b) (1988).

<sup>141</sup> *Id.* at 503-04.

<sup>142</sup> Moreover, certain types of transfers are categorically excluded from the application of fraudulent transfer laws. These exclusions are also second-order limitations. Under the Code, margin and settlement payments, *see* 11 U.S.C. §§ 741(5), (8), 761(15) (1988), made by or to a commodity broker, *see* § 101(5), forward contract merchant, *see* § 101(25), stockbroker, *see* § 101(48), financial institution, *see* § 101(21), or securities clearing agency, *see* § 101(42), before the filing of the bankruptcy petition cannot be avoided except on the basis of actual fraud. *See* 11 U.S.C. §§ 546(e), 548(a)(1) (1988); *see also* *Kaiser Steel Corp. v. Charles Schwab & Co.*, 913 F.2d 846, 850 (10th Cir. 1990) (consumption of a leveraged buyout held to be a settlement payment exempted from avoidance). Additionally, margin or settlement payments made by or to a repo participant, *see* § 101(40), in connection with a repurchase agreement, *see* § 101(41), cannot be avoided except on the basis of actual fraud. *See* 11 U.S.C. §§ 546(f), 548(a)(1) (1988).

Under the UFTA, a number of specific transfers are excluded from fraudulent transfer liability. Examples of these transfers include regularly conducted, noncollusive real estate foreclosure sales, *see* UFTA § 3(b), 7A U.L.A. 639, 650 (1984), regularly conducted Article 9 personal property foreclosure sales, *see* UFTA § 8(e)(2), 7A U.L.A. at 662, and leases terminated pursuant to their terms, *see* UFTA § 8(e)(1), 7A U.L.A. at 662.

<sup>143</sup> *See* 11 U.S.C. § 548(a)(2)(A) (1988).

<sup>144</sup> *See supra* note 66 and accompanying text.

<sup>145</sup> *See* *Klein v. Tabatchnick*, 610 F.2d 1043, 1047 (2d Cir. 1979); *Jacoway v. Anderson Cajun's Wharf (In re Ozark Restaurant Equip. Co.)*, 74 Bankr. 139, 143 (Bankr. W.D. Ark.), *remanded*, 77

case-by-case approach in assessing reasonably equivalent value while observing the unfairness of applying mechanical tests.<sup>146</sup>

Reasonably equivalent value is not susceptible to simple formulation. Ideally, it should signify the reasonable estimate of what can be realized from the debtor's assets by converting them into cash under possibly guarded (but not forced-sale) conditions. The focus is on the consideration received by the debtor, not on the value given by the transferee.<sup>147</sup> The purpose of fraudulent transfer law is the preservation of the debtor's estate for the benefit of its unsecured creditors.<sup>148</sup> Consequently, what constitutes reasonably equivalent value must be determined from the standpoint of the debtor's creditors—a view consistent with my working hypothesis.<sup>149</sup> In addition, courts have shown little regard for consideration which is conjectural or indeterminate.<sup>150</sup> Intangible benefits, such as new or more motivated management, rarely constitute reasonably equivalent value.<sup>151</sup>

"Value" is defined as "property, or satisfaction or securing of a present or antecedent debt of the debtor, but does not include an unperformed promise to furnish support to the debtor or to a relative of the debtor."<sup>152</sup> Under the Code, the proper valuation of an asset for purposes of assessing reasonably equivalent value appears to be that "amount which can be realized from the assets within a reasonable time" and not upon immediate liquidation.<sup>153</sup> In addition, where the assets have a greater value as an ongoing business, that value is usually determinative.<sup>154</sup>

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Bankr. 686 (W.D. Ark.), *on remand*, 83 Bankr. 591 (Bankr. W.D. Ark. 1987), *aff'd in part and rev'd in part*, 850 Bankr. 342 (8th Cir. 1988). *But see* Durrett v. Washington Nat'l Ins. Co., 621 F.2d 201, 203 (5th Cir. 1980) (question of law in mortgage foreclosure context).

<sup>146</sup> See, e.g., Adwar v. Capgro Leasing Corp. (*In re Adwar*), 55 Bankr. 111, 115 (Bankr. E.D.N.Y. 1985); see also Rubin v. Manufacturers Hanover Trust Co., 661 F.2d 979, 994 (2d Cir. 1981) (rejecting any requirement of "mathematical precision" in determining reasonably equivalent value). *But see* Durrett, 621 F.2d at 203 (observing that a foreclosure bid price of less than 70% of fair market value would not constitute reasonably equivalent value).

<sup>147</sup> See Ohio Corrugating Corp. v. Security Pac. Business Credit, Inc. (*In re Ohio Corrugating Corp.*), 70 Bankr. 920, 926-27 (Bankr. N.D. Ohio 1987).

<sup>148</sup> See, e.g., First Nat'l Bank v. Minnesota Utility Contracting, Inc. (*In re Minnesota Utility Contracting, Inc.*), 110 Bankr. 414, 420 (D. Minn. 1990).

<sup>149</sup> See Mancuso v. Champion (*In re Dondi Fin. Corp.*), 119 Bankr. 106, 109 (Bankr. N.D. Tex. 1990); Bowery v. Vines, 178 Tenn. 98, 102, 156 S.W.2d 395, 397 (1941).

<sup>150</sup> See, e.g., Credit Managers Ass'n v. Federal Co., 629 F. Supp. 175, 182 (C.D. Cal. 1985).

<sup>151</sup> See *id.* at 182.

<sup>152</sup> 11 U.S.C. § 548(d)(2)(A) (1988).

<sup>153</sup> See, e.g., Utility Stationery Stores, Inc. v. American Portfolio (*In re Utility Stationery Stores, Inc.*), 12 Bankr. 170, 176 (Bankr. N.D. Ill. 1981) (§ 547(b) action).

<sup>154</sup> Danning v. Progressive Pharmaceutical Sys., Inc. (*In re Western Adams Hosp. Corp.*), 609

Although it is clear that payment on an antecedent debt constitutes value, the payment is not dispositive of the issue of *reasonably equivalent value*.<sup>155</sup> Rather, the debt must be legitimate and bona fide; moreover, the debt must be compared to the value transferred by the debtor to see if reasonably equivalent value is lacking.<sup>156</sup> Unlike the UFTA or the Code, the Texas UFTA<sup>157</sup> does provide a noninclusive definition of reasonably equivalent value. Under Texas UFTA Section 24.004(d), reasonably equivalent value includes, without limitation, a "transfer or obligation that is within the range of values for which the transferor would have willfully sold the assets in an [arm's] length transaction."<sup>158</sup> This is consistent with the decision in *Anderson Industries, Inc. v. Anderson (In re Anderson Industries, Inc.)*,<sup>159</sup> which analyzed reasonably equivalent value in light of the fact that the bargained for exchange was reached through arm's length negotiations where, presumably, the purchaser was the most informed party as to the value of the asset.<sup>160</sup>

The crux of reasonably equivalent value is whether the value transferred is disproportionately small compared to the value actually received by the debtor.<sup>161</sup> The bargaining position of the parties, their relationship, the adequacy of the price, the prevailing market conditions, and the marketability of the property transferred are all relevant considerations.<sup>162</sup>

F.2d 929, 930 (9th Cir. 1979) (per curiam).

<sup>155</sup> *Demusis v. Carr (In re Carr)*, 40 Bankr. 1007, 1008 (D. Conn. 1984). For a discussion of different categories of value, see 1A BANKR. SERV. L. ED. §§ 5D:34 to :44, at 36-41 (1990).

<sup>156</sup> See *Plymouth United Sav. Bank v. Lee*, 278 Mich. 545, 548, 270 N.W. 781, 782 (1936). How about the situation where a debtor who has borrowed \$1 million grants a security interest to its creditor in all of its assets worth \$5 million—is the perfection of the security interest a fraudulent transfer? I believe common sense would lead one to conclude no. Regardless of the breadth of the security interest, the creditor is only entitled to satisfaction of the debt. In other words, although \$5 million in assets are encumbered, it is only to the extent of the \$1 million indebtedness. The UFTA follows this common sense approach. See UFTA, Prefatory Note, 7A U.L.A. 639, 641 (1984). This, however, may not be the case under the UFCA. Bad faith coupled with property securing a present advance or antecedent debt in an amount disproportionately small as compared with the value of the property may lead a court to find a lack of fair consideration. UFCA § 3(b), 7A U.L.A. 427, 449 (1918).

<sup>157</sup> TEX. BUS. & COM. CODE ANN. § 24.004(d) (Vernon 1987).

<sup>158</sup> *Id.*; see *Kjeldahl v. United States (In re Kjeldahl)*, 52 Bankr. 926, 934 (Bankr. D. Minn. 1985) (reasonably equivalent value is the amount which reasonable minds would agree is a close or fair exchange given all the circumstances surrounding the transfer).

<sup>159</sup> 55 Bankr. 922 (Bankr. W.D. Mich. 1985).

<sup>160</sup> *Id.* at 927-28.

<sup>161</sup> See 1A BANKR. SERV. L. ED. § 5D:45, at 42 (1990).

<sup>162</sup> See *Cook*, *supra* note 20, at 278; see also *Jacoway v. Anderson (In re Ozark Restaurant Equip. Co.)*, 850 F.2d 342 (8th Cir. 1988) (analysis of reasonably equivalent value in fraudulent transfer context requires consideration of "the entire situation" including market conditions).

Unfortunately, the case law on reasonably equivalent value is hopelessly confused. Aside from several general rules regarding reasonably equivalent value discussed above, each court seems to address the issue in a subjective and almost personal manner. For example, one court, resigned to the fact that no true market comparison could be made to determine reasonably equivalent value because no such market existed, nevertheless created a hypothetical market to gauge the price paid by the transferee.<sup>163</sup> All in all, the cases on reasonably equivalent value have been deficient in providing a sensible and predictable manner to judge whether a debtor has transferred an asset for less than reasonably equivalent value.

A more functional approach to the endeavor should be embraced. A functional approach should be easier to apply and more predictable in its outcome. It will not change the existing fraudulent transfer policies; rather, a functional approach should help ensure that they are better understood and more consistently applied.<sup>164</sup> This approach subtly shifts the focus from the value received to the context or disposition of that value, not unlike Section 9-504 of the Uniform Commercial Code, which focuses on the circumstances surrounding the disposition of the collateral in gauging commercial reasonableness.<sup>165</sup> Section 9-507 states that inadequacy of price alone should not lead a court to conclude that the Article 9 disposition was not commercially reasonable.<sup>166</sup> Why? I believe that this admoni-

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<sup>163</sup> See *Cooper v. Ashley Communications, Inc. (In re Morris Communications NC, Inc.)*, 75 Bankr. 619, 622-25 (Bankr. W.D.N.C. 1987), *rev'd*, 914 F.2d 458 (4th Cir. 1990).

<sup>164</sup> See generally Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227 (1990) (lauding the functional approach to bankruptcy issues).

<sup>165</sup> See U.C.C. § 9-504(3). Section 9-504(3) provides:

(3) Disposition of the collateral may be by public or private proceedings and may be made by way of one or more contracts. Sale or other disposition may be as a unit or in parcels and at any time and place and on any terms but every aspect of the disposition including the method, manner, time, place and terms must be commercially reasonable. Unless collateral is perishable or threatens to decline speedily in value or is of a type customarily sold on a recognized market, reasonable notification of the time and place of any public sale or reasonable notification of the time after which any private sale or other intended disposition is to be made shall be sent by the secured party to the debtor, if he has not signed after default a statement renouncing or modifying his right to notification of sale. In the case of consumer goods no other notification need be sent. In other cases notification shall be sent to any other secured party from whom the secured party has received (before sending his notification to the debtor or before the debtor's renunciation of his rights) written notice of a claim of an interest in the collateral. The secured party may buy at any public sale and if the collateral is of a type customarily sold in a recognized market or is of a type which is the subject of widely distributed standard price quotations he may buy at private sale.

*Id.*

<sup>166</sup> U.C.C. § 9-507(2). Section 9-507(2) provides:

tion is necessary because courts, like people, fall victim to the lure of hindsight. This was clearly the trap sprung by the bankruptcy judge in *Morris Communications*.<sup>167</sup> In that case, the debtor sold stock in a company for \$5,000.<sup>168</sup> Within a matter of months, the value of the stock rose to \$286,000 because of unpredictable developments in the market area for cellular phone service. It appears that the acquired company went from a one in twenty-two chance of procuring a cellular license from the FCC under a lottery system, to an assured partnership in a license with the other twenty-one applicants pursuant to a full settlement.

From a review of the facts, one can see how the bankruptcy judge was truly concerned that a valuable asset had been transferred from the estate. To the court, blinded by hindsight, the debtor sold a \$286,000 asset for \$5,000, notwithstanding that according to the court the parties acted in good faith in an arm's length transaction. Nonetheless, to avoid the transfer for the benefit of the entire estate, the court had to find that a fraudulent transfer occurred. The reasonably equivalent value rubric was a convenient mechanism by which to doom the transfer. By resorting to a hypothetical market, for none in fact existed, the court concluded that \$50,000 (not the \$5,000 paid) represented the fair market value of the stock at the time of the transfer.<sup>169</sup> Consequently, because the debtor was also insolvent at the time of the transfer, the transfer was avoided and the property ordered returned to the estate.<sup>170</sup>

The Fourth Circuit reversed.<sup>171</sup> First, the court concluded that the

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(2) the fact that a better price could have been obtained by a sale at a different time or in a different method from that selected by the secured party is not of itself sufficient to establish that the sale was not made in a commercially reasonable manner. If the secured party either sells the collateral in the usual manner in any recognized market therefore or if he sells at the price current in such market at the time of his sale or if he has otherwise sold in conformity with reasonable commercial practices among dealers in the type of property sold he has sold in a commercially reasonable manner. The principles stated in the two preceding sentences with respect to sales also apply as may be appropriate to other types of disposition. A disposition which has been approved in any judicial proceeding or by any bona fide creditors' committee or representative of creditors shall conclusively be deemed to be commercially reasonable, but this sentence does not indicate that any such approval must be obtained in any case nor does it indicate that any disposition not so approved is not commercially reasonable.

*Id.*

<sup>167</sup> See *Cooper v. Ashley Communications, Inc. (In re Morris Communications NC, Inc.)* 75 Bankr. 619 (Bankr. W.D.N.C. 1987), *rev'd*, 914 F.2d 458 (4th Cir. 1990).

<sup>168</sup> *Id.* at 621.

<sup>169</sup> *Id.* at 629.

<sup>170</sup> *Id.* at 628-29.

<sup>171</sup> *Cooper v. Ashley Communications, Inc. (In re Morris Communications NC, Inc.)*, 914 F.2d

determination of reasonably equivalent value must be made at the time of the transfer.<sup>172</sup> Second, the court held that the value determination must be made on a case-by-case basis, with special heed given to the market price.<sup>173</sup> Nonetheless, the court did not hold that the fair market value of the asset was necessarily dispositive of the reasonably equivalent value issue. The court avoided the issue because there was no market value for the asset. There was no evidence of comparable sales or bids on similar property. Rather, the court focused on the conditions surrounding the disposition of the asset. There was no evidence of bad faith. The debtor and the buyer were both willing parties dealing at arm's length. Thus, the court held that the bankruptcy court was clearly erroneous in its finding that reasonably equivalent value was lacking.<sup>174</sup>

*Morris Communications* is merely the latest in a line of cases embracing a functional approach to the reasonably equivalent value issue. Distilling these cases, one can deduce a more disciplined approach to this complex and troubling area. The court should consider a trilogy of indicators in assessing reasonably equivalent value. First, did the parties to the transfer act in good faith? Good faith should include "(1) an honest belief in the propriety of the activities in question; (2) no intent to take unconscionable advantage of others; and (3) no intent, or knowledge of the fact that the activities in question will hinder, delay, or defraud others."<sup>175</sup> Second, was the transfer between a willing purchaser and a willing seller at a price to which they agreed at arm's length? In addressing this issue, the court should consider the "bargaining position of the parties," their relationship, the prevailing market conditions, and the "marketability of the property transferred."<sup>176</sup> Third, if a market for the asset exists, what is the fair market value at the time of the transfer? The astute reader, knowledgeable about basic economic theory, readily recognizes that the answer to indicators one and two should have a direct impact on the answer to indicator three. After all, the definition of the fair market value of something is the price arrived at by arm's length negotiation between a willing buyer and a willing seller, neither acting under compulsion.

Much to the chagrin of the drafters of the Bankruptcy Code and the

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458, 459 (4th Cir. 1990).

<sup>172</sup> *Id.* at 466.

<sup>173</sup> *Id.* at 467.

<sup>174</sup> *Id.* at 474.

<sup>175</sup> *Southern Indus., Inc. v. Jeremias*, 66 A.D.2d 178, 183, 411 N.Y.S.2d 945, 949 (App. Div. 1978).

<sup>176</sup> *Cook, supra* note 20, at 278.

UFTA, the functional approach thrusts good faith back into the reasonably equivalent value maelstrom, a fact consistent with post-Code and UFTA case law.<sup>177</sup> Thus, good faith in one variety or another is still very much alive in the reasonably equivalent value determination, not as proof of the prima facie case, but as a badge of fair value.<sup>178</sup>

Reasonably equivalent value presupposes a range of values with the parameters of good faith and an arm's length transaction providing substance.<sup>179</sup> It will be the rare case, indeed, where indicators one and two are met and not indicator three because each factor builds on itself.<sup>180</sup> Good faith is necessary for a finding of a willful arm's length transaction which, in turn, is necessary for a finding that the price paid is in the appropriate range of values.

Reasonably equivalent value recognizes that, from a creditor's view, the value requirement could logically be tied to the liquidation value of the asset and not necessarily its going concern value. After all, the fraudulent transfer affects the unsecured creditor's ability to realize upon its debtor's assets by execution, a procedure that usually results in a price more like liquidation value than going concern value. Thus, the courts have never required a dollar-for-dollar exchange.<sup>181</sup> Something less than the actual market value of the asset may be acceptable so long as the values exchanged do not shock the conscience.<sup>182</sup> "Inadequacy of price does not mean an honest difference of opinion as to price, but a consideration so far short of the real value of the property as to startle a correct mind, or shock the moral sense."<sup>183</sup> Again, it is hard to imagine the case where the parties acted in good faith, reaching a price through a willful sale at arm's length, and still conclude that the values exchanged shock the conscience. Thus, in practice, indicators one and two will serve as proxies

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<sup>177</sup> See, e.g., *Cooper v. Ashley Communications, Inc. (In re Morris Communications NC, Inc.)*, 914 F.2d 458, 474 (4th Cir. 1990). Under the Bankruptcy Code and the UFTA, the drafters dropped good faith from the definition of reasonably equivalent value.

<sup>178</sup> See, e.g., *Cooper v. Ashley Communications, Inc. (In re Morris Communications NC, Inc.)*, 914 F.2d 458 (4th Cir. 1990); *Mancuso v. Champion (In re Dondi Fin. Corp.)*, 119 Bankr. 106 (Bankr. N.D. Tex. 1990).

<sup>179</sup> See *Freitag v. Strand of Atlantic City*, 205 F.2d 778 (3d Cir. 1953) (bona fides of exchange must be determined in light of value of property conveyed).

<sup>180</sup> See *Anderson Indus., Inc. v. Anderson (In re Anderson Indus., Inc.)*, 55 Bankr. 922, 927-28 (Bankr. W.D. Mich. 1985).

<sup>181</sup> See, e.g., *Mancuso v. Champion (In re Dondi Fin. Corp.)*, 119 Bankr. 106, 109 (Bankr. N.D. Tex. 1990).

<sup>182</sup> *Id.*

<sup>183</sup> 37 AM. JUR. 2D *Fraudulent Conveyances* § 18, at 708 (1968).



for indicator three in most if not all cases.<sup>184</sup> Therefore, as long as the divergence from the actual fair market value arises in an arm's length transaction and is attributable to good faith negotiations, then the transfer price is within the range of acceptable consideration, that is, reasonably equivalent value.<sup>185</sup> This concept recognizes that the buyer can get a good deal, even a great deal, but not an obscene deal at the expense of the debtor's creditors, that is, when the debtor is insolvent.

The functional approach to reasonably equivalent value recognizes that the purpose of fraudulent transfer law is not to allow the debtor to re-trade a transaction struck in good faith and arrived at by arm's length negotiations. Such a transfer should not be a viable target of fraudulent transfer law.

### 1. *Date on Which Reasonably Equivalent Value Is Determined*

The relevant time for determining the existence of reasonably equivalent value is at the time the transfer is deemed to have occurred.<sup>186</sup> Subsequent appreciation or depreciation of the value of the property should be irrelevant.<sup>187</sup>

In *Kupetz v. Wolf*,<sup>188</sup> the court further honed the law regarding the time at which reasonably equivalent value must be assessed. In *Kupetz*, the sellers sold a business to a well-financed buyer in exchange for reasonably equivalent value. The buyer then entered into a leveraged buyout with a third party. The trustee argued that the court should collapse and review all the transactions to determine whether reasonably equivalent value existed.<sup>189</sup> The court disagreed, holding that the transactions were

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<sup>184</sup> Indicators one and two are similar to the "method, manner, time, place, and terms" tests embodied in UCC § 9-504. See UCC § 9-504. "The 'method, manner, time, place, and terms' tests are really proxies for 'insufficient price,' and their importance lies almost exclusively in the extent they protect against an unfairly low price." J. WHITE & R. SUMMERS, UNIFORM COMMERCIAL CODE § 26-9, at 1109 (2d ed. 1980).

<sup>185</sup> Cf. *Telefest, Inc. v. VU-TV, Inc.*, 591 F. Supp. 1368 (D.N.J. 1984) (where there are indicia of a bona fide financing arrangement, not designed as a shield against other creditors, lack of perceptible direct benefit should not be viewed as tantamount to lack of fair consideration). The UFTA implicitly recognizes this principle by excluding transfers pursuant to Article 9 and real property foreclosure sale from fraudulent transfer liability. See UFTA § 3(b), 8(e)(2), 7A U.L.A. 639, 650, 662 (1984).

<sup>186</sup> See *Prevue Prods., Inc. v. Morton Shoe Co. (In re Morton Shoe Co.)*, 24 Bankr. 1003, 1011 (Bankr. D. Mass. 1982); see also 11 U.S.C. § 548(d) (1988).

<sup>187</sup> See *Cooper v. Ashley Communications, Inc. (In re Morris Communications NC, Inc.)*, 914 F.2d 458, 466 (4th Cir. 1990).

<sup>188</sup> 845 F.2d 842 (9th Cir. 1988).

<sup>189</sup> *Id.* at 845.

separate and that only the first transaction was relevant in determining whether the debtor's transfer to the sellers was fraudulent.<sup>190</sup> *Kupetz* teaches that separate transfers—intended to be separate—are not lumped together for the purpose of assessing reasonably equivalent value.

## 2. Indirect Benefits and Third-Party Transactions

Often the threshold question here is whether the payment or guaranty by a subsidiary of a parent's debt is reasonably equivalent value.<sup>191</sup> There are two lines of cases addressing reasonably equivalent value in

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<sup>190</sup> *Id.*

<sup>191</sup> The payment or guaranty by the parent of a wholly-owned subsidiary's debt is less problematic because the courts have held that the parent presumably benefits from a reduction in debt of its "asset," i.e., the subsidiary's stock it holds. This may not necessarily be the case. For example, you represent Bravo Corp. which wants to enter into a data-processing contract with Lima Corp., the wholly-owned subsidiary of November Corp. Bravo demands November Corp. to guarantee Lima Corp.'s obligations under the data processing contract. Do the transactions contemplated generate any fraudulent transfer risks for Bravo?

The guaranty fact pattern depicts the classic downstream guaranty situation. Most courts would conclude that because November owned the stock in Lima, if the transaction benefited Lima, that benefit would "ride-up" to November through the stock ownership. *See, e.g.,* *Lawrence Paperboard Corp. v. Arlington Trust Co. (In re Lawrence Paperboard Corp.)*, 76 Bankr. 866, 871 (Bankr. D. Mass. 1987). But what if Lima is hopelessly insolvent at the time of the guaranty? If so, the guaranty by November may well have been a fraudulent transfer. Why? Because the unsecured creditors of November are harmed by the transaction. Assuming no increase in November's net worth, a safe assumption when the subsidiary is in a precarious financial situation, November's unsecured creditors will go to judgment and execute on the worthless stock in Lima, a hopelessly insolvent company. At the same time, the creditors would have to contend with the claims of Bravo to November's assets. *See* *General Elec. Credit Corp. v. Murphy (In re Rodriguez)*, 895 F.2d 725 (11th Cir. 1990); *see* *Flaschen, Recent Bankruptcy Decisions Threaten Lenders with Increased Liability*, 11 BUSINESS LAWYER UPDATE, Jan./Feb. 1991, at 1, 2, 9.

Now, you again represent Bravo Corp. who wants to enter into a data processing contract with Foxtrot, Inc. Foxtrot wholly-owns Hotel Corp. and Echo Co., both of which will indirectly benefit from the proposed data processing agreement. Bravo has never contracted with Foxtrot before and contemplates obtaining guaranties from Hotel and Echo. Do the transactions contemplated generate any fraudulent transfer risks for Bravo?

The guaranty fact pattern depicts the classic upstream guaranty situation. Unlike the downstream guaranty, courts are reluctant to find the existence of reasonably equivalent value in the upstream guaranty context. *See, e.g.,* *Mellon Bank v. Metro Communications, Inc. (In re Metro Communications, Inc.)*, 95 Bankr. 921, 933 (Bankr. W.D. Pa. 1989). Here, Hotel and Echo (subsidiaries of Foxtrot) are guarantying a data processing contract between Foxtrot and Bravo. The fact pattern suggests that indirect benefits for Hotel and Echo do exist. It is imperative that these indirect benefits be memorialized. Although the upstream guaranty battle is always difficult, it can be won based on the indirect benefit or identity of interest approach. *See* *Rubin v. Manufacturers Hanover Trust Co.*, 661 F.2d 979, 988 (2d Cir. 1981). If Hotel and Echo are using or benefiting in some way from the data processing, then the indirect benefit approach might be satisfied. If the data processing arrangement between Bravo and Foxtrot is necessary for Hotel and Echo to function effectively, then both the indirect benefit and identity of interest tests may be satisfied.

third-party transactions.

One line of cases supports the proposition that while the payment by a subsidiary of its parent's debt constitutes value, the value is generally not reasonably equivalent.<sup>192</sup> A case in point is *In re Computer Universe, Inc.*,<sup>193</sup> in which the court stated the general rule that "an insolvent debtor receives less than a reasonably equivalent value where it transfers its property in exchange for consideration that passes to a third party."<sup>194</sup> In *Computer Universe*, the debtor transferred computer equipment in satisfaction of a debt owed by the debtor's parent to the creditor. The court held that value given by the creditor must enhance the debtor's financial position to constitute reasonably equivalent value.<sup>195</sup> Consequently, a reasonably equivalent value was lacking. The maxim that payment solely for the benefit of another is not reasonably equivalent value bears heavily in this type of case. The courts holding this view read literally the language in Section 548(a)(2)(A) and do not permit the indirect benefit to the debtor to be calculated unless the debtor actually received the value.<sup>196</sup> This analysis is brittle, having been chipped away in recent cases.<sup>197</sup> Under this interpretation, possibly only a downstream guaranty would constitute reasonably equivalent value.

The weight of authority, however, acknowledges that indirect benefits received by a debtor for guaranteeing the payment of a third-party's debt may constitute reasonably equivalent value.<sup>198</sup> A germinal case regarding indirect benefits is *Rubin v. Manufacturers Hanover Trust Co.*<sup>199</sup> *Rubin* involved the measurement of value received by guarantors of debts for the obligations guaranteed. In *Rubin*, a complex network of cor-

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<sup>192</sup> E.g., *Older v. Winslow (In re Winslow Plumbing, Heating and Contracting Co.)*, 424 F. Supp. 910, 914, 915 (D. Conn. 1976).

<sup>193</sup> *Hall v. Arthur Young and Co. (In re Computer Universe, Inc.)*, 58 Bankr. 28 (Bankr. M.D. Fla. 1986).

<sup>194</sup> *Id.* at 30-31; see *Klein v. Tabatchnick*, 610 F.2d 1043, 1047 (2d Cir. 1979); cf. *Rubin v. Manufacturers Hanover Trust Co.*, 661 F.2d 979, 991 (2d Cir. 1981).

<sup>195</sup> *Computer Universe*, 58 Bankr. at 31.

<sup>196</sup> *Id.*

<sup>197</sup> See, e.g., *First Software Corp. v. Computer Assocs. Int'l (In re First Software Corp.)*, 107 Bankr. 417 (D. Mass. 1989).

<sup>198</sup> See, e.g., *Klein*, 610 F.2d at 1047; *First Nat'l Bank v. Minnesota Utility Contracting, Inc. (In re Minnesota Utility Contracting, Inc.)*, 110 Bankr. 414, 420 (D. Minn. 1990); *Murphy v. Capital Bank (In re Rodriguez)*, 77 Bankr. 944, 946 (Bankr. S.D. Fla. 1987); *Garrett v. Falkner (In re Royal Crown Bottlers, Inc.)*, 23 Bankr. 28, 30 (Bankr. N.D. Ala. 1982). Although the trustee always shoulders the risk of nonpersuasion, the burden of producing evidence may shift to the transferee in an indirect benefits case. See *Minnesota Utility Contracting, Inc.*, 110 Bankr. at 418-19.

<sup>199</sup> 661 F.2d 979 (2d Cir. 1981).

porations cashed checks, sold money orders, and issued food stamps. Manufacturers Hanover Trust lent money to the companies to help the check cashing operation distribute cash. Manufacturers Hanover Trust's loans were often guaranteed by other companies within the network. After the network filed for bankruptcy, the trustee tried to set aside Manufacturers Hanover Trust's liens on the guarantor entities' cash, arguing that the loans were fraudulent transfers because the guarantors had not received fair consideration for their guaranty obligations. The district court found that the guaranties were supported by fair consideration because all of the companies in the network had been operated as one large conglomerate and therefore possessed an identity of economic interest.<sup>200</sup>

Refusing to rely on the identity of interests rationale<sup>201</sup> alone, the Second Circuit required a complete factual analysis of the extent to which each guarantor received economic value in exchange for the obligations it guaranteed. While acknowledging the many cases that have held that transfers made to benefit third parties are not made for fair consideration, the Second Circuit stated its view of indirect benefits:

If the consideration given to the third person has ultimately landed in the debtor's hands, or if the giving of the consideration to the third person otherwise confers an economic benefit upon the debtor, then the debtor's net worth has been preserved . . . provided, of course, that the value of the benefit received by the debtor approximates the value of the property or obligation he has given up. . . . In . . . these situations, the net effect of the transactions on the debtor's estate is demonstrably insignificant, for he has received, albeit indirectly, either an asset or the discharge of a debt worth approximately as much as the property he has given up or the obligation he has incurred.<sup>202</sup>

*Rubin* stands for the proposition that the fact that a third party initially received consideration given for the debtor's obligation does not necessarily mean that reasonably equivalent value is lacking for the debtor.<sup>203</sup> Rather, *Rubin* requires the court to compare what the debtor actually received for its obligation with what the debtor actually gave up.<sup>204</sup> When there exists a significant disparity from the value received and the obliga-

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<sup>200</sup> *Id.* at 988.

<sup>201</sup> See *infra* notes 129-63 and accompanying text.

<sup>202</sup> *Rubin*, 661 F.2d at 991-92.

<sup>203</sup> *Id.* at 992-93.

<sup>204</sup> *Id.* at 993.

tion assumed, then reasonably equivalent value is lacking.<sup>205</sup>

The reason for this requirement is obvious: 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 § 67(d) [Bankruptcy Act of 1898], the transaction was not supported by "fair" consideration.<sup>206</sup>

In *In re Lawrence Paperboard Corp.*,<sup>207</sup> the court addressed the complex issue of intercorporate guaranties. The question in *Lawrence Paperboard Corp.* was whether the debtor's intercorporate upstream and cross-stream guaranties were executed in exchange for fair consideration. The official unsecured creditors' committee urged the court to find that the guaranty of a third party's debt is prima facie not made for fair consideration.<sup>208</sup> The court, however, embraced the *Rubin* analysis, noting further that the mere failure of the guaranties to recite that they were made for consideration was not controlling.<sup>209</sup> Consequently, the court observed that downstream guaranties are generally supported by reasonably equivalent value because the parent will receive the benefit of any loan.<sup>210</sup> Moreover, the court suggested that upstream (subsidiary guarantees parent's debt) and cross-stream (sister corporations guarantee each others' debt) guaranties may be supported by reasonably equivalent value where indirect benefits attributable to the business relationship exist, funds are disbursed from obligor to guarantor, and reciprocal guaranties exist.<sup>211</sup>

A bankruptcy court employed a similar analysis in *Murphy v. General Electric Credit Corp. (In re Rodriguez)*.<sup>212</sup> In reviewing a three-party transaction, the court concluded that the transfer by the debtor was not made in exchange for reasonably equivalent value.<sup>213</sup> The court held

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<sup>205</sup> *Id.* at 994.

<sup>206</sup> *Id.* at 991.

<sup>207</sup> *Lawrence Paperboard Corp. v. Arlington Trust Co. (In re Lawrence Paperboard Corp.)*, 76 Bankr. 866 (Bankr. D. Mass. 1987).

<sup>208</sup> *Id.* at 874.

<sup>209</sup> *Id.*

<sup>210</sup> *Id.*

<sup>211</sup> *Id.*

<sup>212</sup> 77 Bankr. 939 (Bankr. S.D. Fla. 1987), *aff'd*, *General Elec. Credit Corp. v. Murphy (In re Rodriguez)*, 895 F.2d 725 (11th Cir. 1990).

<sup>213</sup> *Id.* at 942.

that the parent-debtor's payments did not increase the value of its subsidiary; rather, the payments "merely reduced the subsidiary's potential deficiency judgment while delaying foreclosure."<sup>214</sup> While noting that a payment by the debtor of a third party's debt may in certain circumstances constitute reasonably equivalent value, the court nevertheless held that there was no reasonably equivalent value present where the debtor's net worth was not increased.<sup>215</sup>

Furthermore, other forms of indirect economic benefits may constitute, by themselves or in the aggregate, reasonably equivalent value. For example, goodwill, in a business context, may constitute reasonably equivalent value.<sup>216</sup> Mere self-serving statements, however, do not suffice to establish goodwill; evidence such as a long record of "highly profitable operations," a "valuable customer list," or a "trade name developed by the company," is needed.<sup>217</sup> Furthermore, the maintenance of a parent's financial strength may constitute reasonably equivalent value.<sup>218</sup> Yet another example is where a smaller company uses its larger affiliate's distribution system to distribute its own products.<sup>219</sup> Judge Posner, applying the "indirect benefits" approach, cogently stated:

Whether Xonics Photochemical derived a benefit from its guarantees was a factual question, and we cannot say that the bankruptcy judge's resolution of it was clearly erroneous. Although the primary benefit of the loan accrued to the borrower, Xonics Medical Systems, that company's fortunes were entwined with those of Xonics Photochemical because the smaller company used its larger affiliate's distribution system to distribute its own products. The benefit may not have been great but neither was the cost. Xonics Photochemical was not paying any interest on the loan; it just was a guarantor, and all concerned assumed that the loan would be duly repaid and no guarantor would be out of pocket. The co-signed note was to secure a line of credit on which Xonics Photochemical as well as Xonics Medical Systems could draw so again there was benefit.<sup>220</sup>

All of these benefits should be quantified.<sup>221</sup>

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<sup>214</sup> *Id.* at 941.

<sup>215</sup> *Id.* at 942.

<sup>216</sup> *E.g.*, Colfax, Inc. v. D'Agostino (*In re* J.K. Chemicals, Inc.), 7 Bankr. 897, 898 (Bankr. D.R.I. 1981).

<sup>217</sup> *Consove v. Cohen (In re Roco Corp.)*, 701 F.2d 978, 983-84 (1st Cir. 1983).

<sup>218</sup> *See, e.g.*, *Williams v. Twin City Co.*, 251 F.2d 678, 681 (9th Cir. 1958).

<sup>219</sup> *See In re Xonics Photochemical, Inc.*, 841 F.2d 198, 202 (7th Cir. 1988).

<sup>220</sup> *Id.*

<sup>221</sup> *See Lawrence Paperboard Corp. v. Arlington Trust Co. (In re Lawrence Paperboard Corp.)*,

Courts have also viewed the three-party transaction through a different lens. Where there was sufficient commingling of affairs to establish an identity of interests, a court may ignore the separate existence of each entity for the purposes of finding reasonably equivalent value.<sup>222</sup> The argument (focusing on common economic identity) is relevant to show that the continued financial health was vitally important and was thus a benefit.<sup>223</sup>

Recently, in *Tryit Enterprises v. General Electric Capital Corp. (In re Tryit Enterprises)*,<sup>224</sup> the court embraced a sensible approach to assessing the existence of fair consideration under the identity of interests theory. The court held that because the debtors held themselves out as a single business enterprise and availed themselves of the financial benefits derived from their consolidated financial condition, the defendant did in fact give fair consideration to the debtors' business enterprise.<sup>225</sup> Consequently, no fraudulent transfer existed.

In *Tryit Enterprises*, the debtors incurred obligations for each other through cross-guarantee and cross-collateralization provisions in the loan agreements, ostensibly obligating them to repay more funds than they had received.

Since the assets of affiliated corporations are not generally treated as a common pool available to the creditors of each affiliate, unusual circumstances must be present to so treat them. The circumstances present should be such as to make it inequitable to allow the other affiliates to set up the principle of limited liability due to the fact that the creditors of all the affiliates had thought they were dealing with a unitary enterprise.<sup>226</sup>

The court viewed the debtors—separate legal entities under state law—as a single business enterprise under fraudulent transfer law. Acknowledging that “[t]he court is to look through the forms to the realities of the relationship between two or more entities to determine whether

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76 Bankr. 866, 874-75 (Bankr. D. Mass. 1987).

<sup>222</sup> See, e.g., *Mayo v. Pioneer Bank & Trust Co.*, 270 F.2d 823, 830 (5th Cir. 1959), *cert. denied*, 362 U.S. 962 (1960); *McNellis v. Raymond*, 287 F. Supp. 232, 239 (N.D.N.Y. 1968), *aff'd in part and rev'd in part*, 420 F.2d 51 (2d Cir. 1970); *In re Nelsen*, 24 Bankr. 701, 702 (Bankr. D. Or. 1982).

<sup>223</sup> See Walls, *Promises to Keep: Intercorporate Guarantees and Fraudulent Transfers in Bankruptcy*, 19 U.C.C. L.J. 219, 231-32 (1987).

<sup>224</sup> 121 Bankr. 217 (Bankr. S.D. Tex. 1990).

<sup>225</sup> *Id.* at 224.

<sup>226</sup> *Id.* at 223 (citation omitted).

each is separate or a single business enterprise,"<sup>227</sup> the court based its conclusion on a host of factors. The defendant conceded that it knew that the debtors were separate legal entities; nevertheless, the defendant (a creditor) proved that it treated the debtors as a single business enterprise, relying on the combined assets in assessing fraudulent transfer liability.<sup>228</sup> The court also found that the debtors were working towards consolidation, held themselves out in business as a single enterprise, used "Tryit Enterprises" to refer to all the debtors (including use of the name in a telephone listing), used the same "Tryit Enterprises" letterhead for business, and listed themselves as a single enterprise in trade directories.<sup>229</sup> Moreover, the court was impressed that a vendor sued one of the debtors, "incorrectly" naming it "Tryit Enterprises."<sup>230</sup>

The court further concluded that other factors were present that persuaded it to view the separate entities as a single enterprise, including "a 'corporate' office that pays the bills for its affiliates, [where] each affiliate is charged with its proportional share of the main office expense,"<sup>231</sup> and "situations in which the same principals have overlapping ownership among the business entities, operate from the same office, use the same telephone number and post office box, have centralized accounting, and refer to all of the companies by a single name."<sup>232</sup>

Although the courts have become more receptive to arguments disregarding the formal structure of a transaction, such as in *Kupetz* and *Wieboldt*, they have been more reluctant in disregarding corporate formalities in the indirect benefit situation. Take, for example, the holding company that wholly owns one operating subsidiary. Most creditors, probably all consensual creditors, know what type of structure with which they are dealing. The only asset in the holding company is the ownership of the subsidiary's stock. The true value in the corporate structure is in its operating subsidiary. Transfers of all types flow back and forth between the parent and subsidiary. While some of these transfers may be related to the actual transaction at hand, some may not. The Internal Revenue Service may recognize this corporate structure as one enterprise, allowing the structure to file a consolidated tax return.<sup>233</sup> Moreover, state law may

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<sup>227</sup> *Id.* at 222 (citation omitted).

<sup>228</sup> *Id.* at 221.

<sup>229</sup> *Id.* at 221-22.

<sup>230</sup> *Id.* at 222.

<sup>231</sup> *Id.* at 223 (citation omitted).

<sup>232</sup> *Id.* (citation omitted).

<sup>233</sup> I.R.C. §§ 1501-04 (1988).



recognize this corporate structure as one enterprise, as a joint venture, partnership by estoppel, or as a single business enterprise.<sup>234</sup> Furthermore, the Bankruptcy Code may recognize, through substantive consolidation, the possible treatment of the structure as one enterprise.<sup>235</sup> Corporate formalities aside, one is hard-pressed to understand why the courts are not more receptive to arguments that the entire corporate structure should be treated as one enterprise for fraudulent transfer purposes. One commentator has stated:

It should be recognized, however, that certain members of a family of corporations may convey certain benefits on each other by virtue of intercompany transactions unrelated, as well as related, to the alleged fraudulent transaction. These benefits can be best included in the calculus of reasonably equivalent value by considering those quantifiable benefits reasonably expected at the time of the transaction to accrue in the future to the debtor, directly or indirectly.<sup>236</sup>

Courts and commentators agree that the determination of reasonably equivalent value is more complicated in the context of the three-way transaction. The courts, therefore, have developed the doctrines of indirect benefits and identity of interests to help to determine the existence of reasonably equivalent value in complex transactions. "The doctrines, however, tend to be skewed in one direction or another, or depend too much on how the transactions are characterized. The latest approach demands quantification of these burdens and benefits but is skewed, because its results are dependent on the timing of the bankruptcy petition."<sup>237</sup> The courts' reluctance in collapsing the formal structure of the corporate group diverges from the realities of modern transactions, places a premium on inefficient machinations concerning the structure of a transaction, and hampers the structuring of modern transactions, all in an inefficient effort to elevate form over substance. In determining the extent of a transfer subject to a fraudulent transfer analysis, the courts are quick to observe that they are not confined by the formal structure of the transaction.<sup>238</sup>

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<sup>234</sup> *Tryit Enters.*, 121 Bankr. at 222.

<sup>235</sup> 11 U.S.C. § 510 (1988).

<sup>236</sup> Littman, *Multiple Intent, Veil Piercing, and Burdens and Benefits: Fraudulent Conveyance Law and Multiparty Transactions*, 39 UNIV. MIAMI L. REV. 307, 339-40 (1985).

<sup>237</sup> *Id.* at 339.

<sup>238</sup> See, e.g., *Kupetz v. Wolf*, 845 F.2d 842 (9th Cir. 1988); *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288 (3d Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987); *Wieboldt Stores, Inc. v. Schottenstein*, 94 Bankr. 488 (N.D. Ill. 1988).

Why, then, should the result be dictated by the formal corporate structure at hand when the realities of the situation prove otherwise?

### C. *Insolvency*

If a debtor is or becomes insolvent and does not receive reasonably equivalent value from the transferee, the transfer is voidable regardless of intent.<sup>239</sup> According to one commentator, the insolvency requirement, when coupled with the value requirement, ensures that only a transaction which actually harms the creditors is avoidable.<sup>240</sup> Consequently, the insolvency requirement is a key component of the first-order limitations to fraudulent transfer liability.

Insolvency is a term of art under the Code. It includes a "balance-sheet" test, a test focusing on whether the business debtor is left with unreasonably small capital,<sup>241</sup> and an "insolvency" test, which focuses on whether the debtor intends to incur debts beyond its ability to pay.<sup>242</sup>

Under the Code, a debtor is insolvent when the sum of its debts is

<sup>239</sup> 11 U.S.C. § 548(a)(2) (1988).

<sup>240</sup> See Rasmussen, *Guarantees and Section 548(a)(2) of the Bankruptcy Code*, 52 UNIV. CHI. L. REV. 194 (1985).

<sup>241</sup> This article focuses on the balance-sheet test of insolvency. While most of the discussion applies equally to the remaining tests under the Code and the UFTA, there are a number of issues concerning these tests not discussed in the article. For a detailed and persuasive analysis of the "unreasonably small capital" test, see Markell, *supra* note 3, at 494-508. Mr. Markell is correct when he states "it is inevitable that arguments will arise pressing for new or expansive interpretations of [the 'unreasonably small capital'] action." *Id.* at 494 (footnote omitted). Mr. Markell is equally correct when he observes that "lawyers seeking to set aside questionable transfers will inevitably come to rely more heavily upon the unreasonably small capital section." *Id.* (footnote omitted). This is largely due to the ability of lawyers and accountants to manipulate the balance sheet to manufacture solvency. The crux of the "unreasonably small capital" test is that a debtor is not entitled to increase its risk of failure by, for example, increasing the risk of outstanding loans beyond a certain level. See Note, *Fraudulent Conveyance Law and Leveraged Buyouts*, 87 COLUM. L. REV. 1491, 1509 (1987). What is unreasonably small capital generally "depends on the nature of the enterprise in which one is engaged." See *Jenney v. Vining*, 120 N.H. 377, 379, 415 A.2d 681, 683 (1980).

<sup>242</sup> 11 U.S.C. § 548(a)(2)(B) (1988); see also REVISED MODEL BUSINESS CORP. ACT § 6.40, Off. Comment 2 (3d ed. 1985) (explanation of how equitable insolvency test is to be applied). For a thorough analysis of insolvency under fraudulent transfer law, see Cook & Mendales, *The Uniform Fraudulent Transfer Act: An Introductory Critique*, 62 AM. BANKR. L.J. 87 (1988). The UFTA counterparts are §§ 2 and 4(a)(2), 7A U.L.A. 639, 648, 653 (1984). Due diligence for a capital adequacy analysis would include: a review of historical performance, projections, industry trends, product/market strategies, operating cost structures, capital spending programs, contingent liabilities, and financial flexibility; interviews with corporate and division management; visits at major plant locations; interviews with advisors, experts, and other professionals; thorough review of documents; and comparisons with similar companies and competitors. See P. Much, *Leveraged Transactions and Capital Adequacy: Addressing the Economic Risks of Fraudulent Conveyances* 12-13 (1989). Mr. Much's monograph is invaluable.

greater than all of its assets at a "fair valuation"—the "balance sheet" approach.<sup>243</sup> In employing the Code's balance sheet test of insolvency, the fair valuation and not the book value of the assets is used.<sup>244</sup> Exempt assets are explicitly excluded from the calculations as well as any property which could be the subject of a Section 548(a) action.<sup>245</sup> Rights of subrogation and of contribution are assets that must be quantified; however, one should value doubtful or contingent claims at less than face value.<sup>246</sup> Moreover, a liability on a guaranty may be viewed as creating a claim under Sections 101(4) and 101(9) and is also an asset.<sup>247</sup> Furthermore, when particular assets of the debtor are not easily liquidated, the face value is generally discounted.<sup>248</sup>

Fair value does not mean the amount the property would bring in the worst circumstances or in the best. . . . For example, a forced sale price is not fair value though it may be used as evidence on the question of fair value. . . . The general idea of fair value is the amount of money the debtor could raise from its property in a short period of time, but not so short as to approximate a forced sale, if the debtor operated as a reasonably prudent and diligent businessman with his interest in mind, especially a proper concern for the payment of his debts.<sup>249</sup>

Some courts have embraced going concern values for inventory and

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<sup>243</sup> 11 U.S.C. § 101(31) (1988). See *Varon v. Trimble, Marshall & Goldman, P.C. (In re Euro-Swiss Int'l Corp.)*, 33 Bankr. 872, 885 (Bankr. S.D.N.Y. 1983). But see *Ohio Corrugating Co. v. DPAC, Inc. (In re Ohio Corrugating Co.)*, 91 Bankr. 430, 440 (Bankr. N.D. Ohio 1988) (court employed equity or cash flow analysis, focusing on the debtor's ability to pay its debts as they became due).

<sup>244</sup> *Euro-Swiss Int'l Corp.*, 33 Bankr. at 885-86.

<sup>245</sup> See 11 U.S.C. § 101(31)(i), (ii) (1988); Rosenberg, *supra* note 99, at 253-54.

<sup>246</sup> *Join-In Int'l (U.S.A.) Ltd. v. New York Wholesale Distribs. Corp. (In re Join-In Int'l (U.S.A.) Ltd.)*, 56 Bankr. 555, 560 (Bankr. S.D.N.Y. 1986); see 1A BANKR. SERV. L. ED. § 5D:76, at 60 (1990).

<sup>247</sup> See 11 U.S.C. § 101(4), (19) (1988).

<sup>248</sup> *Northern Va. Bank v. Vecco Constr. Indus., Inc. (In re Vecco Constr. Indus., Inc.)*, 9 Bankr. 866, 871 (Bankr. E.D. Va. 1981); see *Constructora Maza, Inc. v. Banco de Ponce*, 616 F.2d 573, 577 (1st Cir. 1980).

<sup>249</sup> *Ohio Corrugating Co. v. DPAC, Inc. (In re Ohio Corrugating Co.)*, 91 Bankr. 430, 436-37 (Bankr. N.D. Ohio 1988) (quoting *In re Joe Flynn Rare Coins*, 81 Bankr. 1009, 1017 (Bankr. D. Kan. 1988)). See generally 1A BANKR. SERV. L. ED. § 5D:75, at 60 (1990). A co-op of commentators has concluded that the UFCA's "present fair salable value" and the UFTA and Bankruptcy Code's "fair valuation" probably should be viewed as interchangeable standards. See Cieri, Heiman, *supra* note 56, at 361. For an interesting analysis of problems of asset valuation, see Note, *supra* note 241, at 1504-07.

not for equipment,<sup>250</sup> while others have disregarded illiquid assets in the solvency calculus,<sup>251</sup> and still others have employed a temporal standard in assessing which valuation to use, that is, a presumption that going concern value is applicable unless at the relevant point in time the business is so ill that the liquidation value of the assets is more appropriate.<sup>252</sup> One commentator has concluded that the proper valuation is the going concern value of the assets as a whole.<sup>253</sup>

The UFTA definition of asset is designed to focus the courts' attention on the property available to the debtor's unsecured creditors. The definition of asset under the UFTA includes all of the property of the debtor, expressly excluding any property that has been disposed of in such a way as to "hinder, delay, or defraud creditors" of the debtor.<sup>254</sup> Assets are also defined to exclude exempt property, property subject to a valid lien, and an interest in property held by the entirety to the extent that the property is not subject to claims against only one of the joint parties in interest.<sup>255</sup> The comment to Section 1 of the UFTA notes that the UFTA continues in substance the UFCA definition of assets;<sup>256</sup> the only substantial difference is that in order to be an asset under the UFCA, the property would have to be leviable.<sup>257</sup> Thus, the comment explains, a surety's subrogation or contribution claim could be an asset under the UFTA, even though it would not be leviable,<sup>258</sup> and, therefore, would not be an asset under the UFCA.

Because of the similarity between Section 548(a)(2) and the UFTA formulations of insolvency, a discussion of cases decided under the Bankruptcy Code regarding assets should afford an accurate sense of the standard under the UFTA as well. In *Consove v. Cohen (In re Roco Corp.)*,<sup>259</sup> the First Circuit considered a transfer by an allegedly insolvent debtor. The defendant argued that the debtor was not insolvent *at the time of the* transfer as long as the court included, among the debtor's assets, the

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<sup>250</sup> See, e.g., *Ohio Corrugating Co.*, 91 Bankr. at 437-38.

<sup>251</sup> See, e.g., *Wieboldt Stores, Inc. v. Schottenstein*, 94 Bankr. 488, 505 (N.D. Ill. 1988).

<sup>252</sup> See, e.g., *Vadnais Lumber Supply, Inc. v. Byrne (In re Vadnais Lumber Supply, Inc.)*, 100 Bankr. 127, 131 (Bankr. D. Mass. 1989).

<sup>253</sup> 2 COLLIER ON BANKRUPTCY ¶ 101.31[5], at 101-93 to -94 (15th ed. 1988). See generally Cieri, Heiman, *supra* note 56, at 361-62.

<sup>254</sup> UFTA § 2(d), 7A U.L.A. 639, 648 (1984).

<sup>255</sup> UFTA § 1(2), 7A U.L.A. at 644.

<sup>256</sup> UFTA § 1, Comment 1, 7A U.L.A. at 643.

<sup>257</sup> *Id.*

<sup>258</sup> Of course, a creditor's bill in equity or a turnover action may nevertheless reach the asset.

<sup>259</sup> 701 F.2d 978 (1st Cir. 1983).

value of the corporate goodwill. The court held that the goodwill asserted by the defendant was not the type of hard asset that the court could take into account because the defendant had "provided nothing more than self-serving statements to back his goodwill claims."<sup>260</sup> The court did observe, however, that goodwill could be considered in some cases if there were strong evidence of its existence and value, such as a record of a business' high profitability over an extended period, a customer list, or a trade name developed in the course of the debtor's business.<sup>261</sup> Because evidence was lacking, the court was unable to include any goodwill as an asset to establish the debtor's solvency.<sup>262</sup>

In *Harmon v. Sorluccho (In re Sorluccho)*,<sup>263</sup> the court determined that a lumber operation's value included the expectations of increased profitability.<sup>264</sup> At the time of the transfer, the debtor fully expected, and had every reason to expect, that the Small Business Administration ("SBA") would roll over the lumber operation's financing in a way that would enhance the value of the enterprise.<sup>265</sup> The fact that the SBA later changed its policy and did not renew the financing did not affect the value determination at the time of the *transfer*.<sup>266</sup>

Insolvency requires a comparison of assets and debts. There are several methods by which a court may value the assets of a debtor to determine whether the alleged fraudulent transfer left the defendant insolvent. Even when the value of the remaining unencumbered assets are sufficient under a fair market value analysis to prevent a finding of insolvency, the risk that the transfer may be found fraudulent may still exist. Rather than placing a fair market value upon the debtor's assets, the court may use the forced-sale value, that is, the amount that could be received from the property from an immediate sale, where the seller had to sell but the buyer was under no compulsion to buy. The difference in the results of the two methods of valuation is accentuated when the debtor's assets are illiquid and a forced-sale would result in a severe discount. In determining fair valuation (the test under the UFTA and presumably under the Bankruptcy Code), a court must consider the property's intrinsic value,

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<sup>260</sup> *Id.* at 984.

<sup>261</sup> *Id.*

<sup>262</sup> *Id.*

<sup>263</sup> 68 Bankr. 748 (Bankr. D.N.H. 1986).

<sup>264</sup> *Id.* at 751.

<sup>265</sup> *Id.* at 750.

<sup>266</sup> *Id.* at 751.

selling value, and earning power.<sup>267</sup>

The UFTA section defining insolvency incorporates a definition of debt that expressly excludes secured debt.<sup>268</sup> Because the unsecured creditors of the debtor are not able to reach property subject to a valid lien and because the creditors holding such liens are able to satisfy their claims against the encumbered property, the drafters determined that the policies of fraudulent transfer law would not be served by including either property subject to a lien as an asset or the obligations secured by such property as a debt for purposes of the solvency calculus.

In *Mellon Bank, N.A. v. Metro Communications, Inc. (In re Metro Communications, Inc.)*,<sup>269</sup> the court articulated a sensible approach in assessing the insolvency of the debtor. Mellon commenced an adversary proceeding to determine its secured status. The committee of unsecured creditors, as intervenors, charged that the transactions involving the debtor and Mellon rendered the debtor insolvent and/or left the debtor with an unreasonably small capital, constituting a fraudulent transfer. After trial, the court concluded that Mellon was not a secured creditor, having failed to meet its burden of proof as to its perfected status.<sup>270</sup> Moreover, among other things, the court concluded that the debtor's guarantee of the Mellon loan to its parent was a fraudulent transfer.<sup>271</sup> Therefore, the court ordered Mellon to prepare a complete and accurate accounting of all payments from the debtor and to disgorge those payments, along with legal interest from the date of receipt.<sup>272</sup>

In assessing whether Mellon gave reasonably equivalent value to the debtor, the court relied on the following facts: "Debtor guaranteed a \$1.85 million loan granted to its parent, TCI. TCI used the funds to purchase Debtor's shares from Debtor's former shareholders. TCI collateralized the loan by pledging Debtor's stock, Debtor's guaranty and Debtor's security interest in all of its unencumbered assets."<sup>273</sup> The debtor, therefore, had granted a security interest in all of its assets for \$1.85 million of allegedly contingent debt. The court concluded, however, that the contingency of the debt was illusory. TCI was simply a shell holding company. The only

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<sup>267</sup> 2 COLLIER ON BANKRUPTCY ¶ 101.31, at 101-84.1 to -87 (15th ed. 1989).

<sup>268</sup> UFTA § 2(e), 7A U.L.A. 639, 648 (1984).

<sup>269</sup> 95 Bankr. 921 (Bankr. W.D. Pa. 1989).

<sup>270</sup> *Id.* at 929.

<sup>271</sup> *Id.* at 934. Moreover, the *Mellon Bank* court held that the burden of proof on all elements rested with the party asserting the transfer as fraudulent and that the standard of proof for a constructive fraudulent transfer action was a preponderance of the evidence. *Id.* at 932-33.

<sup>272</sup> *Id.*

<sup>273</sup> *Id.* at 933.

means of debt repayment that ever existed was through the debtor. Therefore, the court concluded that the debtor "incurred an obligation for which it received *substantially less* than a reasonably equivalent value in exchange."<sup>274</sup>

In assessing insolvency, the court employed the following analysis (in dictum):

Debtor had \$1.85 million in debt for which it had pledged all of its assets and for which Debtor received no part of the actual \$1.85 million. Debtor's former shareholders were paid \$1.85 million in exchange for their shares of stock. If, as it is often stated, fair market value is the sum a willing buyer will pay a willing seller in an [arm's length] transaction, then Debtor's stock had a fair valuation of \$1.85 million.<sup>275</sup>

In other words, the price agreed upon by the parties—\$1.85 million—is the best estimate of the equity of the corporation, that is, the fair value of its assets less liabilities. Furthermore, the debtor pledged its stock and remaining unencumbered assets as collateral for the \$1.85 million loan, thus eliminating existing equity. The debtor was, therefore, insolvent because its liabilities exceeded its assets.

Some courts have been willing to treat projected cash flow as an asset where a company is balance sheet insolvent.<sup>276</sup> Under this analysis, "a company having a negative net worth would not be insolvent if its business operations were expected to produce sufficient cash to pay off its debts as they matured."<sup>277</sup> Unlike a company's other assets, cash flow projections are directly related to the company's business prospects and are, therefore, contingent.<sup>278</sup>

As a result, cash flow is less likely to be reachable by creditors as a residual asset should the debtor default on its obligations. Nevertheless, some recognition must be given to projected cash flow for purposes of solvency analysis. Even secured creditors expect to be repaid from the flow of cash rather than from recovery of the collateral on default.<sup>279</sup>

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<sup>274</sup> *Id.* at 934.

<sup>275</sup> *Id.*

<sup>276</sup> See, e.g., *Telefest, Inc. v. VU-TV, Inc.*, 591 F. Supp. 1368, 1376 (D.N.J. 1984); *United States v. Gleneagles Investment Co.*, 565 F. Supp. 556, 579 (N.D. Pa. 1983), *aff'd sub nom. United States v. Tabor Realty Corp.*, 803 F.2d 1288 (3d Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987); see Note, *supra* note 241, at 1507.

<sup>277</sup> *Gleneagles*, 565 F. Supp. at 579.

<sup>278</sup> Note, *supra* note 241, at 1507-08.

<sup>279</sup> *Id.* at 1508.

No cases, however, have strongly embraced the asset view of cash flow. There are also some problems with the treatment of cash flow as an additional component of hard asset value. Besides the concern of the proper discount rate, aggregating discounted cash flow, hard assets, and goodwill as assets may result in double counting.

Generally, the valuation of doubtful or contingent claims must be at less than stated value.<sup>280</sup> Unfortunately, there is a dearth of case law analyzing the treatment of contingent claims other than in the guaranty context; therefore, it is to this area of the law that we must turn for guidance.<sup>281</sup>

There appears to be little uniformity in the manner in which guaranties are treated for purposes of determining insolvency. One view is to treat the guaranty as a contingent liability, discounting the amount of the guaranty by the probability of the guarantor's liability on the guaranty.<sup>282</sup> This approach is viewed as the "liability theory treatment" of guaranties.<sup>283</sup> Another view has included the full amount of the guaranty as a liability but added as an offsetting asset any rights of subrogation or contribution that may exist.<sup>284</sup> This approach is viewed as the "asset theory treatment" of guaranties.<sup>285</sup> Yet another view simply includes the entire amount of the guaranty as a matured liability without any offset or reduction.<sup>286</sup> While one can quantify a debtor's right of subrogation and contribution from its parent, such reliance may be placed on the thin edge of a wedge.<sup>287</sup> Mr. Rosenberg cleverly points out that the value of a guaranty as a contingent asset in all likelihood would be discounted severely because it would no longer be collectible.<sup>288</sup>

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<sup>280</sup> *Join-In Int'l (U.S.A.) Ltd. v. New York Wholesale Distribs. Corp. (In re Join-In Int'l (U.S.A.) Ltd.)*, 56 Bankr. 555, 560 (Bankr. S.D.N.Y. 1986). In the interests of finality and dischargeability, bankruptcy courts are not constrained like other courts in the claims estimation process and possess uniquely broad powers. See 11 U.S.C. § 502(c) (1988).

<sup>281</sup> For a thorough analysis of the treatment of guaranties, see Alces, *Generic Fraud in the Uniform Fraudulent Transfer Act*, 9 CARDOZO L. REV. 743, 746-54 (1987), and Alces & Dorr, *supra* note 12, at 558-60.

<sup>282</sup> See, e.g., *In re Xonics Photochemical, Inc.*, 841 F.2d 198, 199-200 (7th Cir. 1988); *Cate v. Nicely (In re Knox Kreations, Inc.)*, 474 F. Supp. 567, 571-72 (E.D. Tenn. 1979), *aff'd in part and rev'd in part on other grounds*, 656 F.2d 230 (6th Cir. 1981).

<sup>283</sup> See Coquillette, *supra* note 99, at 455-60.

<sup>284</sup> See, e.g., *Hemphill v. T & F Land Co. (In re Hemphill)*, 18 Bankr. 38, 47-48 (Bankr. S.D. Iowa 1982).

<sup>285</sup> See Coquillette, *supra* note 99, at 455-59.

<sup>286</sup> See, e.g., *Chase Manhattan Bank (N.A.) v. Oppenheim*, 109 Misc. 2d 649, 440 N.Y.S.2d 829, 831 (Sup. Ct. 1981).

<sup>287</sup> See Rosenberg, *supra* note 99, at 256.

<sup>288</sup> *Id.*



In *Xonics Photochemical*,<sup>289</sup> Judge Posner made several observations relating to the contingent nature of intercorporate guaranties. The Seventh Circuit found fascinating the parties' apparent inability to recognize the contingent nature of the intercorporate guaranties.<sup>290</sup> The court further found absurd the parties' notion that any entity with contingent liabilities greater than its net assets would be insolvent.<sup>291</sup> The court observed that contingent liabilities are usually listed as a footnote on a firm's balance sheet or are too remote or small to list at all, noting that the debtor did not list the obligations on its balance sheet.<sup>292</sup>

The *Xonics Photochemical* court further observed that many compelling reasons existed not to value contingent liabilities at their face value on a balance sheet, including the remote nature of the liability and the fact that the liability must be discounted by the probability of occurrence.<sup>293</sup> The court frankly disagreed with the parties' treatment of the guaranty for purposes of determining that the debtor was insolvent, dispelling the "unsettling impression that contingent liabilities must for purposes of determining solvency be treated as definite liabilities even though the contingency has not occurred."<sup>294</sup>

The constructive fraud provisions of the UFTA require that the debtor be insolvent at the time of the transfer or be rendered insolvent by the transfer.<sup>295</sup> The UFTA contains the so called legal test of insolvency: an entity is insolvent if its debts exceed its assets.<sup>296</sup> The UFTA, in addition, incorporates the equitable test of insolvency, providing that an entity is presumed to be insolvent if it is generally not paying its debts as they become due. This presumption is rebuttable.<sup>297</sup> In *Cellar Lumber Co. v. Holley*,<sup>298</sup> the court explained the difference between legal and equitable insolvency: "Legal insolvency refers to the situation where the entire assets of an individual are insufficient to pay his debts. A broader concept, originating with merchants or traders, is equitable insolvency, or the inability to pay debts as they become due in the ordinary course of

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<sup>289</sup> *In re Xonics Photochemical, Inc.*, 841 F.2d 198 (7th Cir. 1988).

<sup>290</sup> *Id.* at 199.

<sup>291</sup> *Id.* at 200.

<sup>292</sup> *Id.*

<sup>293</sup> *Id.*

<sup>294</sup> *Id.* at 201.

<sup>295</sup> UFTA §§ 4, 5, 7A U.L.A. 639, 652-53, 657 (1984).

<sup>296</sup> UFTA § 2(a), 7A U.L.A. at 648.

<sup>297</sup> UFTA § 2(b), 7A U.L.A. at 648. The reason for the presumption is the practical problems that attend proof of legal insolvency.

<sup>298</sup> 9 Ohio App. 2d 288, 224 N.E.2d 360 (1967).

business.”<sup>299</sup>

### 1. *Date on Which Insolvency is Determined*

The clear weight of authority suggests that the appropriate time at which to gauge the insolvency of the debtor is the date on which the transfer is deemed to have occurred under Section 548(d)(1).<sup>300</sup> The time at which to test for insolvency under Section 548 may substantially differ from the time under state law.<sup>301</sup>

A minority of cases have held that the date the transfer is deemed made should not be determinative of all issues.<sup>302</sup> One court observed that a transaction might render a party insolvent, but, through an unexpected windfall, gain, or gift, that party might be solvent at the time when the last technical step in perfection occurred.<sup>303</sup>

### 2. *Proof of Insolvency*

Insolvency is a question of fact to be proved by the trustee by a preponderance of the evidence.<sup>304</sup> There is no presumption of insolvency in a Section 548 action. As previously discussed, this is not the case with an action under the UFTA.

The UFTA attaches primary importance to cash flow analysis by establishing a presumption of insolvency where a debtor is “generally not paying his . . . debts as they become due.”<sup>305</sup> There is a valid question regarding the effect of the presumption of insolvency under the UFTA. Comment 2 of the UFTA Section 2 explicitly states that this presumption is rebuttable but leaves unanswered the effect of the presumption.<sup>306</sup> Comment 2 provides: “The presumption imposes on the party against whom the presumption is directed the burden of proving that the nonexistence of insolvency as defined in Section 2(a) is more probable than its exis-

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<sup>299</sup> *Id.* at 290, 224 N.E.2d at 363.

<sup>300</sup> *See, e.g.,* McCullough v. Ventura Constr. Co. (*In re Brio Ref., Inc.*), Tex. Bankr. Ct. Rptr., March 1987, at 120 (Bankr. N.D. Tex. 1986); Clay v. Traders Bank (*In re Briarbrook Dev. Corp.*), 11 Bankr. 515, 517-18 (Bankr. W.D. Mo. 1981); *see also* Rosenberg, *supra* note 99, at 252 (“the relevant date of the determination of insolvency is undoubtedly the date of transfer”).

<sup>301</sup> Rosenberg, *supra* note 99, at 253.

<sup>302</sup> *See, e.g.,* Jackson v. Star Sprinkler Corp., 575 F.2d 1223, 1230-31 (8th Cir. 1978).

<sup>303</sup> *Id.*

<sup>304</sup> Join-In Int'l (U.S.A.) Ltd. v. New York Wholesale Distribs. Corp. (*In re Join-In Int'l (U.S.A.) Ltd.*), 56 Bankr. 555, 560 (Bankr. S.D.N.Y. 1986).

<sup>305</sup> UFTA § 2(b), 7A U.L.A. 639, 648 (1984); *see* Cieri, Heiman, *supra* note 56, at 363.

<sup>306</sup> UFTA § 2, Comment 2, 7A U.L.A. at 649.

tence.”<sup>307</sup> Thus, the drafters intended to shift to the debtor not only the burden of production, but also the risk of nonpersuasion.<sup>308</sup> As explained by the section’s comments, the UFTA rule is different from Federal Rule of Evidence 301, “which explicitly leaves the ‘burden of proof in the sense of the risk of nonpersuasion . . . upon the party on whom it was originally cast.’ ”<sup>309</sup>

Proof by direct evidence of the insolvency of the debtor is usually difficult; thus, insolvency is frequently determined by inference.<sup>310</sup> Courts will generally permit a party to use the debtor’s schedules, unaudited balance sheets, prepetition financial statements, and appraisal testimony as evidence on the issue of insolvency.<sup>311</sup> If the trustee relies on balance sheets to prove insolvency, the trustee should present “evidence to show whether the balance sheets reflect a fair valuation of the assets.”<sup>312</sup> Review of financial statements at various times to ensure the continuous insolvency of the debtor is not necessary.<sup>313</sup>

Courts have also used the process of retrojection to aid in assessing insolvency. Retrojection is the process by which a court works backwards from the date of the filing of the petition to identify factors from which insolvency may be presumed.<sup>314</sup> “[I]nsolvency at the prior time may be inferred from the actual insolvency at a later date.”<sup>315</sup> Retrojection is based on the notion that it is the rare debtor who becomes insolvent overnight; rather, insolvency is a cumulative process. When employing retrojection, however, the trustee must prove the absence of any substantial changes in the debtor’s assets and liabilities between the retrojection

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<sup>307</sup> See Shupack, *supra* note 12, at 829.

<sup>308</sup> *Id.*

<sup>309</sup> *Id.* at 829-30.

<sup>310</sup> See *Constructora Maza, Inc. v. Banco de Ponce*, 616 F.2d 573, 577-78 (1st Cir. 1980).

<sup>311</sup> See, e.g., *McCullough v. Ventura Constr. Co. (In re Brio Ref., Inc.)*, Tex. Bankr. Ct. Rptr., March 1987, at 121 (Bankr. N.D. Tex. 1986); *Lemley-Cabbiness Farms v. FDIC (In re Lemley Estate Business Trust)*, 65 Bankr. 185 (Bankr. N.D. Tex. 1986); *Berge v. Sweet (In re Berge)*, 33 Bankr. 642, 649 (Bankr. W.D. Wis. 1983).

<sup>312</sup> *Whitlock v. Max Goodman & Sons Realty (In re Goodman Indus., Inc.)*, 21 Bankr. 512, 520 (Bankr. D. Mass. 1982).

<sup>313</sup> *Henderson v. Buchanan (In re Western World Funding, Inc.)*, 52 Bankr. 743, 785 (Bankr. D. Nev. 1985).

<sup>314</sup> See *Misty Management Corp. v. Lockwood*, 539 F.2d 1205, 1213 (9th Cir. 1976); *New York Credit Men’s Adjustment Bureau, Inc. v. Adler*, 2 Bankr. 752, 756 & n.5 (S.D.N.Y. 1980); *Inland Sec. Co. v. Estate of Kirshner*, 382 F. Supp. 338, 345 (W.D. Mo. 1974).

<sup>315</sup> *Fitzgerald v. Cheverie (In re Edward Harvey Co.)*, 68 Bankr. 851, 857 (Bankr. D. Mass. 1987); *Foley v. Briden (In re Arrowhead Gardens, Inc.)*, 32 Bankr. 296, 301 (Bankr. D. Mass. 1983), *aff’d*, 776 F.2d 379 (1st Cir. 1985).

dates.<sup>316</sup>

### III. ACTUAL FRAUD

To make out a successful Section 548(a)(1) claim, the trustee must prove (1) a transfer to the defendant of (2) an interest in property of the debtor (3) during the year preceding the filing of the petition in bankruptcy (4) accomplished with the actual intent of the debtor to hinder, delay, or defraud a creditor.<sup>317</sup> Furthermore, the first category of transfers and obligations declared by the UFTA to be fraudulent is one made or incurred with actual "intent to hinder, delay, or defraud" any creditor of the debtor.<sup>318</sup> The language in the two acts appeared in the Statute of Elizabeth<sup>319</sup> and has been the core of fraudulent transfer law.

Fraudulent intent is rarely susceptible to direct proof.<sup>320</sup> Nevertheless, "intent may be established by circumstantial evidence, or by inferences drawn from a course of conduct."<sup>321</sup> Furthermore, the court may infer fraudulent intent from the circumstances of the case.<sup>322</sup>

Consistent with the fact that a debtor rarely will testify establishing his actual intent to defraud, the courts have historically developed "badges of fraud"<sup>323</sup> as a means circumstantially to prove the actual fraudulent intent.<sup>324</sup> Time and experience have countless proved the reliability of these ageless indicia of fraud.

While fraudulent acts are as varied as the fish in the sea, there has emerged from this body of case law a number of factors to which courts

<sup>316</sup> See *Kanasky v. Randolph (In re R. Purbeck & Assocs., Ltd.)*, 27 Bankr. 953, 955 (Bankr. D. Conn. 1983).

<sup>317</sup> 11 U.S.C. § 548(a)(1) (1988). However, a debtor's intent to prefer a creditor at the expense of its *other* creditors is not tantamount to fraudulent intent. See *Roelmeyer v. Intercontinental Bank (In re Lucar Enters., Inc.)*, 49 Bankr. 717, 718-19 (Bankr. S.D. Fla. 1985).

<sup>318</sup> UFTA § (4)(a)(1), 7A U.L.A. 639, 652 (1984).

<sup>319</sup> See *supra* note 3.

<sup>320</sup> See *Roland v. United States*, 838 F.2d 1400, 1402-03 (5th Cir. 1988) (applying Texas law); *Salomon v. Kaiser (In re Kaiser)*, 722 F.2d 1574, 1582 (2d Cir. 1983); *Consove v. Cohen (In re Roco Corp.)*, 701 F.2d 978, 984 (1st Cir. 1983); *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288, 1304 (3d Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987).

<sup>321</sup> See, e.g., *First Beverly Bank v. Adeeb (In re Adeeb)*, 787 F.2d 1339, 1343 (9th Cir. 1986); *Devers v. Bank of Sheridan, Mont. (In re Devers)*, 759 F.2d 751, 753-54 (9th Cir. 1985); *Farmers Co-Operative Ass'n v. Strunk*, 671 F.2d 391, 395 (10th Cir. 1982).

<sup>322</sup> *Devers*, 759 F.2d at 754.

<sup>323</sup> See *Boston Trading Group, Inc. v. Burnazos*, 835 F.2d 1504, 1509 (1st Cir. 1987) ("where a court finds things such as insolvency and inadequate consideration present, there is an allowance to presume fraud and void the transaction").

<sup>324</sup> See, e.g., *Roland*, 838 F.2d at 1402-03; *Boston Trading Group, Inc.*, 835 F.2d at 1509; *Kaiser*, 722 F.2d at 1582. See generally 1A BANKR. SERV. L. ED. § 5D:30, at 31 (1990).

have attached weight in assessing fraudulent transfer liability.<sup>325</sup> These factors include the relationship between the parties to the transaction,<sup>326</sup> the disparity in value of the assets transferred and value given,<sup>327</sup> the secrecy of the transaction,<sup>328</sup> the timing of the transaction,<sup>329</sup> the existence of a legitimate business purpose for the transaction,<sup>330</sup> a general transfer without a reservation of necessities,<sup>331</sup> the debtor's retained use of the property transferred,<sup>332</sup> a transfer outside the ordinary course of business,<sup>333</sup> unusual clauses in the business instrument,<sup>334</sup> and the insolvency status of the debtor at the time of the transaction.<sup>335</sup> Of course, the more

<sup>325</sup> At Section 4(b) of the UFTA, a new feature specifies factors (badges of fraud) that may be given consideration in inferring actual intent to defraud. See UFTA § 4, 7A U.L.A. 639, 653 (1984). As Comment 5 accompanying § 4 of the UFTA explains, however, "[p]roof of the existence of any one or more of the factors enumerated in subsection (b) may be relevant evidence as to the debtor's actual intent but does not create a presumption that the debtor has made a fraudulent transfer or incurred a fraudulent obligation." UFTA § 4, Comment 5, 7A U.L.A. at 654.

<sup>326</sup> *Marc Rich & Co. A. G. v. United States (In re Grand Jury Subpoena Duces Tecum)*, 731 F.2d 1032, 1041 (2d Cir. 1984); *Andrews v. Reynolds*, 409 N.W.2d 128, 130 (S.D. 1987); *Montana Nat'l Bank v. Michels*, 631 P.2d 1260, 1263 (Mont. 1981); *Cardiovascular & Thoracic Surgery, Inc. v. DiMazzio*, 37 Ohio App. 3d 162, 165, 524 N.E.2d 915, 918 (1987); cf. *Columbia Int'l Corp. v. Perry*, 54 Wash. 2d 876, 877, 344 P.2d 509, 512 (1959) (close personal relationship of transferor to transferee not conclusive of fraudulent intent).

<sup>327</sup> *Grand Jury Subpoena*, 731 F.2d at 1041; *United States v. Leggett*, 292 F.2d 423, 426 (6th Cir.), cert. denied, 368 U.S. 914 (1961); *Tipp v. United Bank*, 23 Ark. App. 176, 178, 745 S.W.2d 141, 143 (1988); *DiMazzio*, 524 N.E.2d at 918; *Dahnken, Inc. v. Wilmarth*, 726 P.2d 420, 422 (Utah 1986); *Butcher v. Butcher (In re Estate of Reed)*, 566 P.2d 587, 590 (Wyo. 1977); *Lewis v. Estate of Lewis*, 45 Wash. App. 387, 391, 725 P.2d 644, 647 (Wash. Ct. App. 1986); *Michels*, 631 P.2d at 1263.

<sup>328</sup> *Tipp*, 745 S.W.2d at 143; *Michels*, 631 P.2d at 1263; *Grand Jury Subpoena*, 731 F.2d at 1041.

<sup>329</sup> *Tipp*, 745 S.W.2d at 143; *DiMazzio*, 524 N.E.2d at 918; *Wilmarth*, 726 P.2d at 422; *Michels*, 631 P.2d at 1263; *Estate of Reed*, 566 P.2d at 590; *Texas Sand Co. v. Shield*, 381 S.W.2d 48, 52-53 (Tex. 1964).

<sup>330</sup> *Tipp*, 745 S.W.2d at 143; *Michels*, 631 P.2d at 1263; see *Grand Jury Subpoena*, 731 F.2d at 1041.

<sup>331</sup> *DiMazzio*, 524 N.E.2d at 918; *Michels*, 631 P.2d at 1263; *Shield*, 381 S.W.2d at 53.

<sup>332</sup> *Tipp*, 745 S.W.2d at 143; *DiMazzio*, 524 N.E.2d at 918; *Wilmarth*, 726 P.2d at 422; *Michels*, 631 P.2d at 1263; *United States v. Leggett*, 292 F.2d 423, 426 (6th Cir.), cert. denied, 368 U.S. 914 (1961).

<sup>333</sup> *Tipp*, 745 S.W.2d at 143; *Grand Jury Subpoena*, 731 F.2d at 1041; *Michels*, 631 P.2d at 1263.

<sup>334</sup> *United States v. Morton*, 682 F. Supp. 999, 1002 (E.D. Mo. 1988); *United States v. Jones*, 631 F. Supp. 57, 60 (W.D. Mo. 1986); *Farmers and Merchants Bank v. Titus (In re Titus)*, 75 Bankr. 256, 259 (Bankr. W.D. Mo. 1985).

<sup>335</sup> *Roland v. United States*, 838 F.2d 1400, 1403 (5th Cir. 1988); *Adams v. Wilhite*, 636 S.W.2d 851, 854-57 (Tex. Ct. App.), rev'd on other grounds, 640 S.W.2d 875 (Tex. 1982). See generally 1A BANKR. SERV. L. ED. § 5D:30, at 32-34 (1990); 1 G. GLENN, *supra* note 1, §§ 305-307(a), 309, 346, at 532-36, 537-38, 605-06.

badges of fraud present, the greater the likelihood of a court finding actual fraud. However, a single badge of fraud may stamp a transaction as fraudulent.<sup>336</sup>

Because the required intent (to "hinder, delay, or defraud") is stated in the disjunctive,<sup>337</sup> it is not a defense that the debtor intended merely to delay or to hinder seizure of his property.<sup>338</sup> "Hinder" and "delay" have separate significance for fraudulent transfer purposes. That the debtor believed that his actions were necessary to allow fortunes to improve is no defense to an action under the actual fraud theory.<sup>339</sup> Moreover, it is the debtor's intent that is relevant under Section 548(a)(1),<sup>340</sup> unless the transferee controls the debtor.<sup>341</sup> Finally, the intent to defraud must have existed at the time of the transfer.<sup>342</sup>

One source of difficulty with the actual intent to defraud requirement has been generated by *Gleneagles*.<sup>343</sup> In *Gleneagles*, the court subtly converted actual intent into an objective standard by holding that the leveraged buyout at issue was an intentional fraud on creditors because the parties could reasonably foresee that a diversion of corporate assets, combined with adverse financial conditions, would hinder creditors.<sup>344</sup> The Third Circuit affirmed.<sup>345</sup> By its nature, intentional fraud is an unpredictable standard. Some have argued that the *Gleneagles* modification of what has since the Statute of Elizabeth been a subjective inquiry may be problematic.<sup>346</sup> As the argument goes, it tends to blur the distinction between actual and constructive fraud. This subtle shift diverted the law's focus

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<sup>336</sup> *Butcher v. Butcher (In re Estate of Reed)*, 566 P.2d 587, 590 (Wyo. 1977).

<sup>337</sup> See 11 U.S.C. § 548(a)(1) (1988).

<sup>338</sup> See *Stratton v. Sioux Falls Paint & Glass (In re Stratton)*, 23 Bankr. 284, 288 (D.S.D. 1982); see also *Vener*, *supra* note 12, at 238 ("it is enough that the intention be merely to delay or to hinder seizure of a debtor's property").

<sup>339</sup> See *Shapiro v. Wilgus*, 287 U.S. 348, 354 (1932); *Klein v. Rossi*, 251 F. Supp. 1, 2 (E.D.N.Y. 1966); *Flushing Sav. Bank v. Parr*, 81 A.D.2d 655, 667, 438 N.Y.S.2d 374, *appeal dismissed*, 443 N.Y.S.2d 61, 54 N.Y.2d 770, 426 N.E.2d 752 (1981).

<sup>340</sup> See *Wilson v. Upreach Ministries (In re Missionary Baptist Foundation of Am., Inc.)*, 24 Bankr. 973, 977-78 (Bankr. N.D. Tex. 1982). Of course, under § 548(c), the transferee's intent is relevant to the inquiry of the good faith and value defense.

<sup>341</sup> See *Pirrone v. Taboroff (In re Vaniman Int'l, Inc.)*, 22 Bankr. 166, 182 (Bankr. E.D.N.Y. 1982).

<sup>342</sup> See *Roland v. United States*, 838 F.2d 1400, 1402 (5th Cir. 1988); *Neubauer v. Cloutier*, 265 Minn. 539, 546, 122 N.W.2d 623, 629 (1963) (UFCA case).

<sup>343</sup> *United States v. Gleneagles Inv. Co.*, 565 F. Supp. 556, 580-82, *aff'd sub nom. United States v. Tabor Court Realty Corp.*, 803 F.2d 1288 (3d Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987).

<sup>344</sup> *Id.* at 580-83.

<sup>345</sup> *Tabor Court Realty Corp.*, 803 F.2d at 1305.

<sup>346</sup> See *Cieri, Heiman, supra* note 56, at 353.

from the debtor's motive to its knowledge.<sup>347</sup> As such, the "new" modification is nothing more than the objectification of the intent inquiry, a method embraced by American courts for some time.<sup>348</sup>

#### IV. AFFIRMATIVE DEFENSE

Each of the three principal fraudulent transfer statutes protects good faith initial transferees to the extent they give *value to the debtor*. Likewise, subsequent good faith transferees are protected if they give value.

Under the UFTA, notwithstanding voidability of a transfer or an obligation incurred, a good faith transferee or obligee is entitled, to the extent of the *value given the debtor for the transfer or obligation*, to: (i) a lien on or a right to retain any interest in the asset transferred; (ii) enforcement of any obligation incurred; or (iii) a reduction in the amount of the liability on the judgment.<sup>349</sup> This section is an adaptation of Section 548(c) of the Bankruptcy Code, which provides in relevant part:

[A] transferee or obligee . . . 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 or obligation.<sup>350</sup>

The protection is limited in that it protects initial transferees only to the extent they give value to the debtor in good faith.<sup>351</sup> However, a subsequent transferee from the initial transferee is protected from fraudulent transfer liability where the former takes for value, in good faith, and without knowledge of the voidability of the transfer,<sup>352</sup> or from someone up the chain of title who acted in good faith and gave value.<sup>353</sup> These limitations must be closely scrutinized in assessing whether a particular transferee may cloak itself in the savings clauses.<sup>354</sup>

Satisfying the good faith element of the various savings clauses can be problematic because of the subjective nature of the inquiry.<sup>355</sup> At a mini-

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<sup>347</sup> *Id.*

<sup>348</sup> See *Denny v. Dana*, 56 Mass. (2 Cush.) 160, 172 (1848) (while fraudulent intent is necessary, every person is presumed to intend the natural and probable consequences of his own acts).

<sup>349</sup> UFTA § 8, 7A U.L.A. 639, 662-63 (1984).

<sup>350</sup> 11 U.S.C. § 548(c) (1988).

<sup>351</sup> See *id.* But cf. *Carlson*, *supra* note 5, at 86-87.

<sup>352</sup> See 11 U.S.C. § 550(b)(1), (a)(2) (1988).

<sup>353</sup> See 11 U.S.C. § 550(b)(2) (1988).

<sup>354</sup> See 11 U.S.C. §§ 548(c), 550(b) (1988); UFTA § 8, 7A U.L.A. 639, 662-63 (1984).

<sup>355</sup> See *Merrill v. Abbott (In re Independent Clearing House Co.)*, 77 Bankr. 843, 861-62 (D.

mum, good faith requires (i) a lack of actual knowledge of the insolvency or inadequate capitalization of the debtor and (ii) a lack of knowledge of those facts as would put a reasonably prudent person on inquiry as to the adequate financial condition of the debtor.<sup>356</sup> The objective component must be included to make meaningful the requirement of good faith. Professor Sherwin further refines the good faith inquiry (although in specific response to the "fair consideration" requirement as part of a creditor's prima facie case under the UFCA), modifying its components based on the type of defendant attempting to employ it.<sup>357</sup> Bad faith on the part of an independent lender occurs "only if the lender had actual knowledge of facts that establish a fraud and failed to make a reasonable judgment that the transaction met the financial standards set out in fraudulent conveyance statutes."<sup>358</sup> However, bad faith on the part of buying and selling shareholders would also occur "if they had notice of the facts from which the court concludes the transaction was a fraud."<sup>359</sup>

Because a buyer is presumed "to know what he is getting," non-equivalency in values exchanged is evidence of the transferee's lack of good faith.<sup>360</sup> Moreover, a less than arm's length transaction may negate good faith.<sup>361</sup> The value given need not be reasonably equivalent value<sup>362</sup> but, as to the initial transferee, must be given to the debtor.<sup>363</sup> The absence of an actual intent to defraud creditors is thus not equivalent to good faith.<sup>364</sup>

Professor Carlson has suggested that the requirement found in Section 548(c) that value be given to the debtor should be disregarded.<sup>365</sup> Professor Carlson bases this approach on the fact that the requirement that value be given to the debtor did not appear in Section 67(d) of the Bankruptcy Act of 1898, the UFCA, or in any legislative history of Section 548(c).<sup>366</sup> Thus, according to Professor Carlson, the language is a

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Utah 1987).

<sup>356</sup> See Cieri, Heiman, *supra* note 56, at 368; Bernstein, *Leveraged Buyouts: Legal Problems and Practical Suggestions*, in *LEVERAGED BUYOUTS* 119, 135-36 (S. Diamond ed. 1985); 4 *COLLIER ON BANKRUPTCY* ¶ 548.07, at 548-70 to -79 (15th ed. 1990).

<sup>357</sup> Sherwin, *supra* note 5, at 521.

<sup>358</sup> *Id.*

<sup>359</sup> *Id.*

<sup>360</sup> See 1 G. GLENN, *supra* note 1, § 294, at 511.

<sup>361</sup> Bullard v. Aluminum Co. of Am., 468 F.2d 11, 13 (7th Cir. 1972).

<sup>362</sup> Carr v. Demusis (*In re Carr*), 34 Bankr. 653, 657 (Bankr. D. Conn. 1983), *aff'd*, 40 Bankr. 1007 (D. Conn. 1984).

<sup>363</sup> See Bonded Fin. Servs., Inc. v. European Am. Bank, 838 F.2d 890, 893 (7th Cir. 1988).

<sup>364</sup> See Carr, 34 Bankr. at 657.

<sup>365</sup> Carlson, *supra* note 5, at 86.

<sup>366</sup> *Id.* at 86-87.



drafting error.<sup>367</sup> Furthermore, he suggests, as support for his view, the ability of parties to craft a transaction in such a way as to appear that value has been given to the debtor in the sense that it received value, where the value is not, in fact, retained.<sup>368</sup>

As a matter of policy, Professor Carlson's view has its merits and demerits. As a matter of statutory construction, however, he is in error. The requirement that value be given to the debtor in this situation is not so absurd as to lead one to the inescapable conclusion that a drafting error had been made. To the contrary, the directional value requirement has some support in the history and purpose of fraudulent transfer law. Recall that by the time the court reaches the affirmative defense in Section 548(c), it has already concluded that a fraudulent transfer exists.<sup>369</sup> Thus, the debtor received less than reasonably equivalent value for the property transferred while insolvent, an unreasonable exchange at the expense of its unsecured creditors. Recalling that the essential purpose of fraudulent transfer law is to prevent the unjust diminution of the estate, one can easily support the utility of the directional value requirement embodied in Section 548(c).

Furthermore, Professor Carlson's support for his argument that the directional value requirement can be circumscribed by clever structuring is unconvincing. As previously discussed, courts are not constrained by the formal structure of the transaction where the parties know or should have known otherwise. If the lender, for example, knows that its funds are eventually going to the target's former shareholders, then the court will charge it with that view of the transfer.<sup>370</sup>

One glitch in the affirmative defenses under the Code is highlighted by the following example. Suppose Aleph Corp. sold a horse worth \$1,000,000 to Wilbur Post for \$750,000. Subsequently, Aleph Corp. sought relief under Chapter 11 of the Bankruptcy Code. Aleph Corp. then brought a fraudulent transfer action against Wilbur, arguing that the \$750,000 consideration for a horse worth \$1,000,000 was a transfer for which Aleph Corp. received less than reasonably equivalent value while

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<sup>367</sup> *Id.* at 86.

<sup>368</sup> *Id.* at 87.

<sup>369</sup> Professor Carlson's approach, which would focus solely on the good faith of the initial transferee, does carry with it the utility that the court need not reach the complex and slippery valuation issue required in § 548(a)(2) unless the court first determines that the defendant acted in bad faith. *See id.* at 76. This is, of course, the case with subsequent transferees under the present statutes. *E.g.*, 11 U.S.C. § 550(a) (1988).

<sup>370</sup> *See, e.g.*, *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288 (3d Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987); *Wieboldt Stores, Inc. v. Schottenstein*, 94 Bankr. 488 (N.D. Ill. 1988).

insolvent. Aleph Corp. also challenges the transfer as one made with the actual intent to hinder, delay, or defraud its creditors. At trial, the court concludes that the horse was worth \$1,000,000; that Aleph Corp. was insolvent at the time of the transfer; that the \$750,000 payment was an exchange for a reasonably equivalent value; and that the debtor, in fact, possessed the actual intent to hinder, delay, or defraud its creditors when it made the transfer. The proceedings then turn to the application of any affirmative defenses.

The applicability and scope of affirmative defenses will turn on whether the action is based on Section 548 or state law incorporated by Section 544(b). Section 8(a) of the UFTA, an adaptation of Section 9 of the UFCA,<sup>371</sup> provides that a transferee of an actual intent fraudulent transfer has an absolute defense if it took the transfer in good faith and for a reasonably equivalent value.<sup>372</sup> However, there is no equivalent defense in the Code. Under Section 548(c), a good faith transferee is entitled to a lien or offset to the extent of the value actually given by the transferee to the debtor in exchange for the transfer.<sup>373</sup> To the extent that reasonably equivalent value does not equal the value of the asset actually transferred by the transferee, a good faith transferee of an actual intent fraudulent transfer is afforded additional protection under Section 8(a) of the UFTA beyond that provided under Section 548(c) of the Code. Consequently, in our example, under the UFTA or UFCA, Wilbur would have a complete defense; unfortunately, under the Code, Wilbur would probably have to return the horse subject to a lien securing \$750,000.

Finally, under Section 550(d)(1), a good faith transferee possesses a meager lien on the property recovered by the trustee under Section 548(a) to secure the lesser of the cost of any improvement made and any increase in value of the property as a result of the improvement.<sup>374</sup> This provision is intended to protect the good faith transferee's reliance on the transfer as lawful.<sup>375</sup>

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<sup>371</sup> See UFCA § 9, 7A U.L.A. 427, 577-78 (1918).

<sup>372</sup> See UFTA § 8(a), Comment 1, 7A U.L.A. 639, 662-63 (1984).

<sup>373</sup> See 11 U.S.C. § 548(c) (1988).

<sup>374</sup> Section 550(d)(1) is a more limited defense than § 548(c). See 11 U.S.C. § 550(d)(1) (1988).

<sup>375</sup> The question of whether the transferee of a fraudulent transfer attacked by the trustee under state law through § 544(b) can be saddled with the limited defense under § 550 or can avail itself of the liberal defenses under the UFTA takes on singular importance. A transferee who is attacked under § 544(b) as the recipient of a fraudulent transfer under state law cannot resort to the liberal protection under § 548(c). See 11 U.S.C. § 548(c) (1988). However, the cases are divided over whether the transferee must find its only solace under § 550 or can turn for relief to the affirmative defenses provided in the UFTA. Compare *Osage Crude Oil Purchasing, Inc. v. Osage Oil & Transp.*,

It is under the notion of affirmative defenses that one discerns the third-order limitations that properly confine fraudulent transfer law. As previously discussed, a good faith initial transferee who gives value is protected to the extent of the value actually given to the debtor. Moreover, any subsequent good faith transferees who give value are completely protected. Furthermore, improvements by a good faith transferee receive a limited form of protection.

Additionally, there is a distinct group of situations on which fraudulent transfer law was never intended to tread. Section 10 of the UFTA provides:

Unless displaced by the provisions of this [Act], the principles of law and equity, including the law merchant and the law relating to principal and agent, estoppel, laches, fraud, misrepresentation, duress, coercion, mistake, insolvency, or other validating or invalidating cause, supplement its provisions.<sup>376</sup>

The UFCA, in Section 11, also contains a supplementary provision.<sup>377</sup> Moreover, Section 105(a) of the Bankruptcy Code has been interpreted to endow the bankruptcy courts with the powers of a court of equity.<sup>378</sup> Consequently, an historical perusal of the cases involving defenses like those identified in Section 10 of the UFTA should help delineate the third-order limitations of fraudulent transfer law, limitations that protect certain transferees even though they may not neatly fit within a specific savings statute.

Like today, the situation of a subsequent creditor (a creditor whose relationship arises after the transfer) who complains of a fraudulent transfer was problematic at common law. Professor Glenn noted in his treatise that at common law, as a matter of certainty in pleading, "the subsequent creditor who complains of a fraudulent conveyance should state the circumstances under which he extended credit, so as to show that, if he did so after the transfer was made, he was not aware of the fact at the time. . . ."<sup>379</sup> Implicitly embodied in Professor Glenn's cautionary note are the equitable doctrines of waiver and estoppel. Because the creditor's right

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Inc. (*In re* Osage Crude Oil Purchasing, Inc.), 103 Bankr. 256 (Bankr. N.D. Okla. 1989) with Webster v. Barbara (*In re* Otis & Edwards, P.C.), 115 Bankr. 900 (Bankr. E.D. Mich. 1990).

<sup>376</sup> UFTA § 10, 7A U.L.A. 639, 666 (1984).

<sup>377</sup> UFCA § 11, 7A U.L.A. 427, 634 (1918).

<sup>378</sup> See 11 U.S.C. § 105(a) (1988); see, e.g., *In re Morristown & Erie R.R. Co.*, 885 F.2d 98 (3d Cir. 1989).

<sup>379</sup> 1 G. GLENN, *supra* note 1, § 76, at 129.

under fraudulent transfer law was a right to act to have the court adjudicate the transfer as void, a creditor could ratify the transaction both expressly or by conduct.<sup>380</sup> Once the creditor affirmed or ratified the transaction with full knowledge of the facts, any subsequent action based on disaffirmance was barred.<sup>381</sup>

The doctrines of waiver and estoppel rest upon the fundamental principle that, as between the debtor and its transferee, the transfer is valid and enforceable.<sup>382</sup> This result is embodied in the concept of voidability as opposed to voidness. Professor Glenn noted the situation of a creditor who notifies a third party that his principal's transaction is fraudulent.<sup>383</sup> In those circumstances, it would be reasonable to expect the creditor to act immediately, by attachment or injunction. "[A] creditor who delays should not complain if the third party honours his obligation after waiting a reasonable time upon the demanding creditor."<sup>384</sup>

Since its inception, fraudulent transfer law has recognized that it was possible for the debtor's transfer to injure subsequent creditors.<sup>385</sup> Nevertheless, not all subsequent creditors fell within the law's protective ambit. As Professor Glenn pithily noted, a creditor extends credit based on what the debtor presently has, not on what the debtor once had.<sup>386</sup>

Hence the court has a duty, in the case of a subsequent creditor, that is quite different from the task which arises when the complaining creditor holds a claim which preceded the conveyance. The court must now find some connection between the act of the debtor and the liability which subsequently accrued, something to justify the statement that the debtor's conveyance was intended to injure the subsequent creditor. This justifying circumstance should lead to an inference of fact, and the question basically is one

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<sup>380</sup> *Id.* § 113, at 223.

<sup>381</sup> *Id.* (citing *Robins v. Wooten*, 128 Ala. 373, 30 So. 681 (1900)).

<sup>382</sup> *Id.* § 114, at 225. The fraudulent transfer conveys both legal and equitable title to the transferee. See *Lawson v. Liberty Nat'l Bank & Trust Co.*, 18 Bankr. 384 (W.D.N.Y. 1982). Although the transferor of a fraudulent transfer cannot revoke the transfer, an executory contract for purposes of defrauding creditors is void. See *Severance v. Knight-Counihan Co.*, 29 Cal. 2d 561, 177 P.2d 4 (1947).

Can a debtor purge the taint associated with a fraudulent transfer? In *Carman v. Athearn*, 77 Cal. App. 2d 585, 175 P.2d 926 (1947), the court concluded that where a debtor, after transferring property to defraud his creditors, purges the fraudulent conduct by paying his creditors in full, the debtor is entitled to a reconveyance and the clean hands doctrine has no application. *Carman*, 175 P.2d at 933-34.

<sup>383</sup> 1 G. GLENN, *supra* note 1, § 125, at 240.

<sup>384</sup> *Id.*

<sup>385</sup> *Id.* § 317, at 555.

<sup>386</sup> *Id.* § 319, at 556.

of fact.<sup>387</sup>

Professor Glenn then embellishes this observation with the following example:

Thus, a debtor sells a piece of property and pays all his debts with part of the proceeds. At that moment, then, it is nobody's concern what he does with the balance. He may keep it, or he may give it away, and no one can gainsay him unless there is a specific equity arising from trust, contract or fraud. Later the party contracts new debts, but the proceeds of his activities are so squandered that the time arrives when this person, once a man of substance, is insolvent. But for a new creditor to ask the court to extend its process to gifts that were made when there were no creditors, is to invoke the rule of *post hoc, ergo propter hoc*. There is no such general rule under the statutes of fraudulent conveyances, any more than there is such a generalization in logic. Unless, then, there is more than the events, in order of time, of gift first, debts later, the subsequent creditor has no grievance. In all cases there must be more than mere time.<sup>388</sup>

Therefore, one can deduce from a perusal of cases,<sup>389</sup> Section 11 of the UFCA, Section 10 of the UFTA,<sup>390</sup> and Section 105 of the Code that the inability of certain subsequent creditors to attack a transfer as fraudulent is still part of the fabric of modern fraudulent transfer law.

In *Kupetz v. Wolf*,<sup>391</sup> the Ninth Circuit upheld the sale of a business that had been financed through a leveraged buyout against attack as a fraudulent transfer.<sup>392</sup> In concluding that no fraudulent transfer existed, the court relied on, among other considerations, the fact that the trustee in bankruptcy represented no creditors whose claims arose prior to the date of the leveraged buyout and who did not have an opportunity to evaluate the effect of the leveraged buyout before entering into a credit relationship.<sup>393</sup>

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<sup>387</sup> *Id.* § 319, at 556-57.

<sup>388</sup> *Id.* § 319, at 557.

<sup>389</sup> See, e.g., *Brill v. W.B. Foshay Co.*, 65 F.2d 420 (8th Cir.), *cert. denied*, 290 U.S. 643 (1933); *In re Central Metallic Casket Co.*, 170 F. Supp. 320 (D. Wis. 1959), *aff'd*, 273 F.2d 506 (7th Cir. 1960); *Cooch v. Grier*, 30 Del. Ch. 255, 59 A.2d 282 (1948); *Davison v. Charpentier*, 72 N.Y.S.2d 746 (Sup. Ct. 1946), *aff'd*, 72 N.Y.S.2d 296, 272 A.D. 825 (App. Div. 1947).

<sup>390</sup> See UFTA, Prefatory Note, 7A U.L.A. 639, 642 (1984) ("The Act recognizes that laches and *estoppel* may operate to preclude a particular creditor from pursuing a remedy against a fraudulent transfer or obligation even though the statutory period of limitations has not run." (emphasis added)).

<sup>391</sup> 845 F.2d 842 (9th Cir. 1988).

<sup>392</sup> *Id.* at 843.

<sup>393</sup> *Id.* at 848-50.

In *Credit Managers Association v. Federal Co.*,<sup>394</sup> the district court held that a leveraged buyout by existing management of a corporation was not a fraudulent transfer under California's version of the UFCA.<sup>395</sup> Specifically, after having found that there was no fair consideration for the obligation incurred by the former parent owner of the corporation, the court did find that the corporation was not left with unreasonably small capital at the time of the transfer.<sup>396</sup> More importantly for our purposes, even if the leveraged buyout was a fraud on creditors, the court was apparently ready to conclude that the creditors challenging the transaction must be creditors who held claims at or before the time of the transfer. The court observed that many of the corporation's creditors at the time the transaction was challenged had become creditors after the transfer and much of the corporation's outstanding debt was incurred after the leveraged buyout.

These creditors made a post-buyout decision to extend credit on new terms to a new entity . . . . As the creditors' plaintiff represents [sic] did not have any substantial stake in Crescent at the time of the buyout, there does not appear to be a strong reason to give these creditors the right to attack the buyout as harmful to them. It would seem that if leveraged buyouts are to be susceptible to attack on fraudulent conveyance grounds, only those who were creditors at the time of the transaction should have a right to attack the transaction.<sup>397</sup>

The court did not specifically decide the estoppel issue because neither party raised it.<sup>398</sup>

Nonetheless, several commentators have argued that the doctrines of estoppel and waiver cannot preclude a subsequent creditor from bringing a fraudulent transfer action because, under UFCA Section 5 and UFTA Section 4, a subsequent creditor is granted standing to bring such an action.<sup>399</sup> Unfortunately, these commentators are confusing two separate and

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<sup>394</sup> 629 F. Supp. 175 (C.D. Cal. 1985).

<sup>395</sup> *Id.* at 188.

<sup>396</sup> *Id.* at 183, 187.

<sup>397</sup> *Id.* at 180; *see also* *Ohio Corrugating Co. v. DPAC, Inc. (In re Ohio Corrugating Co.)*, 91 Bankr. 430 (Bankr. N.D. Ohio 1988) (constructive fraud provision may only be used to protect creditors existing at the time of the transfer).

<sup>398</sup> *Id.* at 181.

<sup>399</sup> *See, e.g.,* Carlson, *supra* note 5, at 119. Professor Carlson is incorrect when he states that "the *Credit Managers* court is off base in introducing assumption of the risk [estoppel and waiver?] into fraudulent conveyance law." *Id.* It did not; the estoppel and waiver doctrines were a part of the fabric of fraudulent transfer law well before the *Credit Managers* case. Moreover, Professor Carlson's

distinct concepts. The doctrine of standing determines the universe of parties that can properly *bring* an action in the first instance. Assuming that a particular party can bring the action, the doctrines of estoppel and waiver help shrink the universe to those who can properly *maintain* the action. The doctrine of standing and the doctrines of estoppel and waiver are not congruous.

To say, however, that all subsequent creditors are unable to maintain a fraudulent transfer action is a gross misstatement of the law. Even before the UFCA, it appears that the law distinguished between consensual and nonconsensual creditors.<sup>400</sup> The doctrines of waiver and estoppel require that the party against whom the doctrines are to apply step forward with full knowledge of the situation.<sup>401</sup> Equity does not cry foul when a party, with full knowledge of the transaction, enters into a new creditor relationship with the debtor. To permit otherwise would transform the debtor and transferees into underwriters of the creditor's investment.<sup>402</sup> This is, of course, not the case with the nonconsensual subsequent creditor. This person did not have the luxury of choosing his debtor. Here, one is usually talking about tort claimants and the taxing authorities. These creditors did not choose to deal with their debtor at all, let alone after a full disclosure of all relevant facts. Consequently, the doctrines of estoppel and waiver do not serve as substantive limitations in this situation.<sup>403</sup>

## V. REMEDIES

A proper analysis of the trustee's remedies under the Bankruptcy Code requires consideration of Sections 544(b), 548, 550, and 551. Sections 544(b) and 548 grant the trustee the power to avoid the transfer.<sup>404</sup>

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view does not do justice to § 11 of the UFCA and § 10 of the UFTA.

<sup>400</sup> 1 G. GLENN, *supra* note 1, §§ 329-40.

<sup>401</sup> See *Davison v. Charpentier*, 72 N.Y.S.2d 746 (Sup. Ct. 1946), *aff'd*, 72 N.Y.S.2d 296, 272 A.D. 825 (App. Div. 1947). See generally 31 C.J.S. *Estoppel* §§ 61, 72 (1964).

<sup>402</sup> But see Rubenstein, *A Practical Guide to Fraudulent Conveyances and Leveraged Buyouts*, FAULKNER & GRAY'S BANKR. L. REV., Summer 1990, at 20, 25. Mr. Rubenstein asserts that fraudulent transfer law is not an insurance policy against business downturn but a policy against fraud. *Id.* Although the point is well-taken, Mr. Rubenstein also confuses the concepts of standing and estoppel. It is one thing to say that Creditor A has standing to bring the action. It is yet another thing entirely to conclude that Creditor A can maintain the action. To allow Creditor A to do so in all situations where the constructive fraud elements are met would render § 11 of the UFCA and § 10 of the UFTA meaningless.

<sup>403</sup> See generally 1 G. GLENN, *supra* note 1, §§ 327-40.

<sup>404</sup> See 11 U.S.C. §§ 544(b), 548 (1988).

Section 551 provides that any transfer avoided under Sections 548 or 544(b) is automatically preserved for the benefit of the estate but only with respect to property of the estate.<sup>405</sup> Section 550 provides:

[T]he trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from—

- (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made;<sup>406</sup> or
- (2) any immediate or mediate transferee of such initial transferee.<sup>407</sup>

In the words of one court, "Section 550(a) is the operative arm for reaching property or the value of property that is the subject of an avoided fraudulent transfer."<sup>408</sup> Although there usually are a number of target transferees, the trustee is entitled to only a single satisfaction from the initial transferee or a subsequent transferee.<sup>409</sup> Moreover, the recovery provision is tempered by the protection against liability to transferees of avoided fraudulent transfers under Sections 548(c) and 550(a) and (d).

In *Cooper v. Ashley Communications, Inc. (In re Morris Communications NC, Inc.)*,<sup>410</sup> the court held that the general rule was that the fraudulently transferred property itself should be returned to the estate in order to avoid unnecessary contests over valuation.<sup>411</sup> Thus, the remedy is

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<sup>405</sup> See 11 U.S.C. § 551 (1988); see, e.g., *Retail Clerks Welfare Trust v. McGarty (In re Van De Kamp's Dutch Bakeries)*, 908 F.2d 517 (9th Cir. 1990).

<sup>406</sup> Thus, an entity for whose benefit a transfer is made is liable regardless of the fact that the entity may have never actually received the property.

<sup>407</sup> 11 U.S.C. § 550(a) (1988).

<sup>408</sup> *In re Gingery*, 48 Bankr. 1000, 1003 (Bankr. D. Colo. 1985).

<sup>409</sup> See 11 U.S.C. § 550(c) (1988); see also *Pereira v. Kaiser (In re Big Apple Scenic Studio, Inc.)*, 63 Bankr. 85 (Bankr. S.D.N.Y. 1986) (trustee could not recover transfers from debtor's principal, who was transferor not transferee). For a discussion concerning the recoverability of rents from fraudulently transferred property, see Annotation, *Accountability and Liability for Rents and Profits of Grantee of Fraudulently Conveyed Real Property*, 60 A.L.R.2d 593 (1958).

An interesting question arises as to whether a defendant in a § 548 or § 544(b) action has a right to contribution. In *Wieboldt Stores, Inc. v. Schottenstein*, 111 Bankr. 162 (N.D. Ill. 1990), the court answered no, finding no explicit statutory grant of a contribution right and no implied cause of action under the Supreme Court's pronouncement in *Cort v. Ash*, 422 U.S. 66 (1975). *Wieboldt Stores*, 111 Bankr. at 167-68. The result seems harsh. It allows a debtor in possession to favor selectively certain transferees at the expense of other, often times, more culpable transferees. The possible abuses, especially in the leveraged buyout situation, with the fraudulent transfer plaintiff often being the debtor in possession, are mind-boggling.

<sup>410</sup> 75 Bankr. 619 (Bankr. W.D.N.C. 1987), *rev'd on other grounds*, 914 F.2d 458 (4th Cir. 1990).

<sup>411</sup> *Id.* at 629.



generally a prescription for rescission, an equitable tool.<sup>412</sup> "One consequence of this rule is that the estate normally receives the value of any appreciation in the property's value from the date of transfer at least where the increase is caused by market factors."<sup>413</sup> However, where the property has depreciated in value, courts are likely to hold its return to be inappropriate.<sup>414</sup> "Any relief other than entry of a money judgment" for the property's value as of the date of transfer would fail to make the estate whole and "would encourage transferees to resist recovery as long as possible in order to maximize what would amount to free rent."<sup>415</sup> From a perusal of the cases, it appears that the measure of damages for a money judgment is the fair market value of the property at the time of the transfer.<sup>416</sup> Furthermore, while it appears that prejudgment interest and punitive damages may be awardable in appropriate circumstances, it does not appear that attorneys' fees are recoverable.<sup>417</sup>

Some courts construe Section 105 of the Bankruptcy Code to provide a grant of equitable jurisdiction to the bankruptcy courts confined by the constraints of their non-article III role.<sup>418</sup> With this in mind, one may ask whether the remedies under Sections 548, 550, and 551 are exhaustive or whether, under Section 105, the trustee may seek to employ an equitable remedy in aid of its action under Section 548. Although the law is unclear in this area, the better view is that to the extent the equitable remedy is not inconsistent with the Bankruptcy Code, a court exercising its powers under Section 105 should recognize the equitable remedy.

Under the UFTA, a party challenging the transfer has a host of remedies available, including: (i) "avoidance of the transfer or obligation to the extent necessary to satisfy the creditor's claim"; (ii) "an attachment or other provisional remedy against the asset transferred or other property of the transferee"; (iii) "an injunction against further disposition by the debtor or a transferee, or both, of the asset transferred or of other property"; (iv) "appointment of a receiver to take charge of the asset transferred or of other property of the transferee"; (v) "any other relief the circumstances may require," possibly including the imposition of a con-

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<sup>412</sup> Smyser, *supra* note 7, at 816.

<sup>413</sup> 1A BANKR. SERV. L. ED. § 5D:106, at 79 (1990).

<sup>414</sup> See, e.g., Hall v. Arthur Young and Co. (*In re* Computer Universe, Inc.), 58 Bankr. 28 (Bankr. M.D. Fla. 1986).

<sup>415</sup> *Id.* at 32.

<sup>416</sup> See, e.g., Joing v. O & P Partnership (*In re* Joing), 82 Bankr. 495 (D. Minn. 1987).

<sup>417</sup> See 1A BANKR. SERV. L. ED. §§ 5D:107 - :109, at 80-81 (1990).

<sup>418</sup> See, e.g., Johnson v. First Nat'l Bank, 719 F.2d 270 (8th Cir. 1983), *cert. denied*, 465 U.S. 1012 (1984).

structive trust, an injunction, or declaratory relief; (vi) "[i]f a creditor has obtained a judgment on a claim against the debtor, the creditor, if the court so orders, may levy execution on the asset transferred or its proceeds."<sup>419</sup> This judgment may be entered against (a) the first transferee of the asset or the person for whose benefit the transfer was made; or (b) any subsequent transferee other than a good faith transferee who took for value or from any subsequent transferee.<sup>420</sup>

The courts disagree regarding the appropriate remedies where a trustee is successful in bringing an action under Section 544(b). The section itself is federal law; therefore, a number of courts conclude that although the trustee's cause of action is based on state law (here the UFTA), the trustee's remedies are identified by reference to Sections 550 and 551. Because of the substantial similarity between the remedies under state (UFTA) and bankruptcy law, this may be more an academic issue than a practical one.<sup>421</sup>

A fair reading of the "mere conduit" cases supports the overt recognition of this fourth-order limitation making only a true transferee liable. In *Kaiser Steel Resources, Inc. v. Jacobs (In re Kaiser Steel, Inc.)*,<sup>422</sup> the court recognized a continuing trend suggesting that financial institutions will not be subject to liability if they have simply channeled payments from a debtor to a third party, that is, acted as mere conduits.<sup>423</sup> In *Kaiser Steel*, the district court held that a brokerage firm, which had received funds for its clients in a stock redemption transaction as a part of a leveraged buyout, was a "mere conduit" and not a transferee of a fraudulent transfer for purpose of Section 550.<sup>424</sup>

In *Kaiser Steel*, Charles Schwab & Co. held stock for its customers' accounts in a street name through the system established in connection with the securities clearing process.<sup>425</sup> Schwab was not in the business of buying and selling stock for its own account, but rather acted for its customers with regard to their stock transactions.<sup>426</sup> In conjunction with the leveraged buyout of Kaiser's common shareholders, Schwab received cash and shares of preferred stock on behalf of its customers, which were

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<sup>419</sup> UFTA § 7, 7A U.L.A. 639, 660 (1984).

<sup>420</sup> UFTA § 8, 7A U.L.A. at 662-63.

<sup>421</sup> This, unfortunately, may not be the case with remedies provided for by the UFCA.

<sup>422</sup> 110 Bankr. 514 (D. Colo.), *aff'd*, 913 F.2d 846 (10th Cir. 1990).

<sup>423</sup> *Id.* at 519 (citing *Lowry v. Security Pac. Bus. Credit, Inc. (In re Columbia Data Prods., Inc.)*, 892 F.2d 26 (4th Cir. 1989)).

<sup>424</sup> *Id.* at 521.

<sup>425</sup> *Id.* at 519.

<sup>426</sup> *Id.* at 517.

tendering their common shares to Kaiser.<sup>427</sup> After bankruptcy, Kaiser sought to recover from several parties, including Schwab, under Section 548.<sup>428</sup>

Schwab argued that it was not liable under the fraudulent transfer laws because it was not an initial transferee of the fraudulent transfer. Applying agency principles, however, the bankruptcy court found that Schwab was acting as an undisclosed agent on behalf of its customers and, thus, might be deemed an initial transferee under Section 550.<sup>429</sup>

On appeal, the district court reversed the bankruptcy court's holding, concluding that the bankruptcy court should have applied the control test adopted by the Seventh Circuit in *Bonded Financial Services, Inc. v. European American Bank*,<sup>430</sup> to determine whether Schwab was a transferee or a mere conduit of the leveraged buyout consideration.<sup>431</sup> Under the control test adopted by the Seventh Circuit, "the minimum requirement of status as a 'transferee' is dominion over the money or other asset, the right [not the mere naked power] to put the money to one's own purposes."<sup>432</sup> As a result, Schwab could not be deemed a transferee:

Schwab never held a beneficial interest in any Kaiser stock, received no consideration for facilitating the conversion of its customers' stock, and had no ability to control the disposition of funds paid to its customers in the merger. It was simply a financial intermediary, not a 'transferee.'<sup>433</sup>

*Kaiser* adds further support to the conduit liability theory adopted by courts to protect innocent intermediaries that have no beneficial interest in, or control over, transferred property from exposure to fraudulent transfer actions. Based on the *Kaiser* court's analysis, intermediaries should be protected from fraudulent transfer liability provided that they limit their control over or interest in funds.<sup>434</sup>

Although neither the statute nor the legislative history indicates under what circumstances the court should order a transferee to pay the value of the transferred property rather than to return the transferred

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<sup>427</sup> *Id.*

<sup>428</sup> *Id.* at 516.

<sup>429</sup> *Id.* at 518-19.

<sup>430</sup> 838 F.2d 890 (7th Cir. 1988).

<sup>431</sup> *Kaiser Steel*, 110 Bankr. at 520.

<sup>432</sup> *Bonded Fin. Servs.*, 838 F.2d at 893.

<sup>433</sup> *Kaiser Steel*, 110 Bankr. at 521.

<sup>434</sup> See Nordberg v. Societe Generale (*In re Chase & Sanborn Corp.*), 848 F.2d 1196, 1199-1200 (11th Cir. 1988); *Bonded Fin. Servs., Inc. v. European Am. Bank*, 838 F.2d 890 (7th Cir. 1988).

property itself, one court has concluded that Section 550(a) expresses a congressional intent that a transferee should return the property transferred unless to do so would be inequitable, in which event he must pay the property's value.<sup>435</sup> Although one court has stated that Section 550(a) means that "[i]t is simply within the court's discretion to determine whether a return of the value of property or return of the actual property is the appropriate remedy,"<sup>436</sup> the general rule favors the return of the fraudulently transferred property to the estate to avoid unnecessary contests over valuation.<sup>437</sup> Furthermore, one commentator explains that "[o]ne consequence of this rule is that the estate normally receives the value of any appreciation in the property's value from the date of transfer at least where the increase is caused by market factors."<sup>438</sup>

When the property, which is the subject of an avoided fraudulent transfer, has depreciated in value because of market factors or use by the transferee, a court should not return the property itself.<sup>439</sup> Only a money judgment for the property's value would make the estate whole and discourage transferees from resisting "recovery as long as possible in order to maximize [what would amount to] free rent."<sup>440</sup> Similarly, when the transferee no longer has the property transferred, a money judgment for the value of the property should be entered.<sup>441</sup> In *Ferrari v. Computer Associates International, Inc. (In re First Software Corp.)*,<sup>442</sup> inventory held by the transferee declined by almost \$1.5 million in value as a consequence of on-going product revisions and improvements. The court refused to order the return of the inventory and instead ordered recovery of its value at the time of the transfer.<sup>443</sup>

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<sup>435</sup> *General Indus., Inc. v. Shea (In re General Indus., Inc.)*, 79 Bankr. 124, 135 (Bankr. D. Mass. 1987) (citing *Cooper v. Ashley Communications, Inc. (In re Morris Communications NC, Inc.)*, 75 Bankr. 619, 629 (Bankr. W.D.N.C. 1987), *rev'd on other grounds*, 914 F.2d 458 (4th Cir. 1990)); see *Armstrong v. Vedaa (In re Vedaa)*, 49 Bankr. 409, 411 (Bankr. N.D. 1985).

<sup>436</sup> *First Software Corp. v. Computer Assocs. Int'l, Inc. (In re First Software Corp.)*, 107 Bankr. 417, 423 (D. Mass. 1989).

<sup>437</sup> *Cooper v. Ashley Communications, Inc. (In re Morris Communications NC, Inc.)*, 75 Bankr. 619, 629 (Bankr. W.D.N.C. 1987), *rev'd on other grounds*, 914 F.2d 458 (4th Cir. 1990).

<sup>438</sup> 1A BANKR. SERV. L. ED. § 5D:106, at 79 (1990).

<sup>439</sup> *Hall v. Arthur Young and Co. (In re Computer Universe, Inc.)*, 58 Bankr. 28 (Bankr. M.D. Fla. 1986).

<sup>440</sup> *Id.* at 32.

<sup>441</sup> *Williams v. Kidder Skis Int'l (In re Fitzpatrick)*, 73 Bankr. 655 (Bankr. W.D. Mo.), *aff'd in part and rev'd in part on other grounds*, 60 Bankr. 808 (W.D. Mo. 1985).

<sup>442</sup> 84 Bankr. 278 (Bankr. D. Mass. 1988), *aff'd*, 107 Bankr. 417 (D. Mass. 1989).

<sup>443</sup> *Id.* at 286; see also *Brown v. Borchers & Heimsoth Constr. Co. (In re Apollo Hollow Metal and Hardware Co.)*, 71 Bankr. 179, 183 (Bankr. W.D. Mo. 1987) (court would not allow defendant to return remaining inventory in full satisfaction of its liability to debtor where a defendant had used

Under present case law, a court will order money damages, and not the return of property, where the property cannot be returned.<sup>444</sup> For example, where the present holder of the property is protected as a good faith transferee for value, any prior transferee may be liable for money damages; nevertheless, the court could not award a return of property and disadvantage the good faith transferee.

Although one can advance the argument that courts should award damages in lieu of the property because so much has been done to the transferred property, such as additions and improvements, that the character of the property transferred is no longer even remotely similar to the property as it presently exists, the courts have uniformly refused to recognize the equities on the side of the transferee.<sup>445</sup> The courts have relegated the transferee to his protections under Section 548(c) to a lien in the returned property to the extent he gave value to the debtor plus an additional lien in the property up to the cost of any improvements in the property or the market value increase due to those improvements, whichever is less, under Section 550(d).<sup>446</sup>

After a perusal of the fraudulent transfer cases analyzing appropriate remedies, one is led to the inescapable conclusion that, to use the words of Professors Baird and Jackson, the remedy is "needlessly crude."<sup>447</sup> In their haste to do what is in the best interest of the estate, courts have forgotten that the remedy should be, as stated by Professor Smyser, "an equitable one designed to place the parties to the transfer in the position they would have occupied had the improper transfer not occurred."<sup>448</sup> No where is the remark of Professors Baird and Jackson more accentuated than in regard to the law on the time to fix the value of the transferred property if the court orders a monetary award rather than a return of the property.

Section 550(a) provides that a court may order recovery of the value of transferred property, but does not indicate at what time value is to be determined.<sup>449</sup> Although most cases either assume or hold that value is

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and consumed portions of the debtor's former inventory); *Computer Universe*, 58 Bankr. at 32 (court ruled that plaintiff could not be made whole by return of depreciated computer equipment and, therefore, ordered defendant to pay money damages).

<sup>444</sup> See 1A BANKR. SERV. L. ED. § 5D:106, at 80 (1990).

<sup>445</sup> See, e.g., *Coleman v. Graff*, 94 N.J. Eq. 223, 119 A. 280 (1922).

<sup>446</sup> See 1A BANKR. SERV. L. ED. § 58:69, at 66 (1990); 11 U.S.C. §§ 548(c), 550(d) (1988).

<sup>447</sup> Baird & Jackson, *supra* note 5, at 843.

<sup>448</sup> Smyser, *supra* note 7, at 821.

<sup>449</sup> 11 U.S.C. § 550(a) (1988); see *Cooper v. Ashley Communications, Inc. (In re Morris Communications NC, Inc.)*, 75 Bankr. 619, 629 (Bankr. W.D.N.C. 1987), *rev'd on other grounds*, 914

determined at the time the transfer was made,<sup>450</sup> in *In re Computer Universe, Inc.*,<sup>451</sup> the court held that the date of the filing of the bankruptcy petition was the measuring date in determining the value to be awarded under Section 550(a).<sup>452</sup> Moreover, in *Morris Communications*,<sup>453</sup> the bankruptcy court ordered the return of stock which, although worth \$50,000 at the time of its transfer according to the bankruptcy court, was worth \$280,000 at the time of its recovery at trial.<sup>454</sup> As one commentator has noted, "no case has yet gone so far in pursuing the benefit of the estate that it has used a date subsequent to the latter of the petition or the transfer date in determining the value of property subject to recovery, but there is no logical bar to the use of a date of recovery."<sup>455</sup> Consequently, if the property in *Morris Communications* had not been recoverable, it would appear at least plausible that the court would have awarded a judgment for the plaintiff in the amount of \$280,000, the value of the assets at trial.<sup>456</sup>

Unfortunately, in their quest for acting in the best interest of the estate, courts are forgetting the basic tenet of fraudulent transfer law and the fact that there exists ample authority to temper a fraudulent transfer remedy by equitable principles. Fraudulent transfer law is a debt-collection device whose sole purpose is to prevent the unjust diminution of the debtor's estate. It is at this stage, the assessment of an appropriate and equitable remedy, that one uncovers another fourth-order limitation.

Traditionally, courts, including bankruptcy courts, possessed the power to ensure that the fraudulent transfer remedy produced an equitable result.<sup>457</sup>

Fraudulent conveyance statutes have traditionally invalidated fraudulent transfers only to the extent necessary to remedy the injury. Fraudulent

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F.2d 458 (4th Cir. 1990); see also Martin, NORTON BANKRUPTCY LAW ADVISOR, Aug. 1990, at 7-8 ("The courts do not uniformly agree upon the timing of the 'value' assessment.").

<sup>450</sup> See *In re First Software Corp.*, 107 Bankr. 417, 423 (D. Mass. 1989); *Official Creditors Comm. v. Agri Dairy Prods., Inc. (In re James B. Downing & Co.)*, 74 Bankr. 906, 911 (Bankr. N.D. Ill. 1987); *Derryberry v. Albers (In re Albers)*, 67 Bankr. 530, 534 (Bankr. N.D. Ohio 1986); *Craig v. Pueblo Corp. (In re Crabtree)*, 49 Bankr. 806, 811 (Bankr. E.D. Tenn. 1985).

<sup>451</sup> 58 Bankr. 28 (Bankr. N.D. Fla. 1986).

<sup>452</sup> *Id.* at 32.

<sup>453</sup> 75 Bankr. 619 (Bankr. W.D.N.C. 1987), *rev'd on other grounds*, 914 F.2d 458 (4th Cir. 1990).

<sup>454</sup> *Id.* at 629.

<sup>455</sup> Martin, *supra* note 449, at 8.

<sup>456</sup> *Id.*

<sup>457</sup> See Smyser, *supra* note 7, at 822.

transfers are voidable at the insistence and for the benefit of the grantor's creditors. They are not void as between grantor and grantee. Thus, invalidation of a fraudulent conveyance for the benefit of creditors does not rescind the transfer insofar as the parties to the conveyance are concerned. As between the grantor and grantee, the grantee retains his interest in the transferred property. Where the fraudulently transferred property is sold to satisfy the claims of the defrauded creditors, it is the grantee who retains the equitable right of redemption and in the event there is any surplus remaining from the proceeds of the sale after satisfying the creditors' claims it belongs to the grantee.<sup>458</sup>

In assessing the damage award under Section 550(a), courts have embraced the language in Section 551, which states that the transfer avoided is automatically preserved for the benefit of the estate.<sup>459</sup> Seizing on the "benefit of the estate" language, the courts generally award a return of the property, where there has been depreciation, or, as in *Computer Universe*, a money judgment equal to the value of the property at the time of the filing of the bankruptcy petition.<sup>460</sup> Keeping in mind that the determination of value for all other purposes is made at the time of the transfer, one is hard-pressed to justify using a different measuring date for the damages awarded. Based on equitable principles and the purposes behind fraudulent transfer law, one can deduce a fourth-order limitation to the application of fraudulent transfer law to modern transactions—a truly equitable remedy. If the property transferred depreciates in value, the debtor may recover money damages equal to the value of the property at the time of the transfer. Why? Because it is an equitable result. But equity is a two-way street. If the property appreciates in value, the truly equitable remedy may also be a money judgment equal to the value of the property at the time of the transfer and not the return of the property. The following examples are provided to demonstrate this point.

First, take a simple example. The debtor transfers to Andy Taylor a guitar worth \$100 for \$50. Andy pays the \$50 in good faith. Subsequently, the debtor files a bankruptcy petition and seeks to avoid the sale as a constructive fraudulent transfer. At trial, the court concludes that not only was the debtor insolvent at the time of the transfer, but that the \$50 payment by Andy was an amount less than reasonably equivalent in value. Now, the court must decide what remedy to fashion. Under Section

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<sup>458</sup> *Id.* at 822 & nn.127-130 (footnotes omitted).

<sup>459</sup> See Martin, *supra* note 449, at 8.

<sup>460</sup> See *id.*

550(a), it may order Andy to return the guitar to the debtor, granting Andy a lien on the guitar for \$50, or it may order Andy to pay the debtor an additional amount up to \$50, representing the difference in the value given and the value of the guitar at the time of the sale. Suppose Andy has become attached to the guitar and wants to keep it. Also suppose that the court is persuaded by the equities of the situation and allows Andy to keep the guitar if Andy pays \$50. Andy agrees to do so. At this point in time, the creditors of the debtor have no complaint. At the time of the original sale, an asset worth \$100 was transferred for \$50 to Andy, unjustly enriching Andy at the expense of the creditors. Requiring Andy to pay \$50 (the difference between what Andy actually paid in good faith and what the guitar was worth at the time of the transfer) addresses the specific harm caused by the transfer. Thus, what Andy has risked, even though he has acted in good faith, is the possibility of being subsequently assessed a fraudulent transfer tax by a court. The amount of the tax is determined by deducting the amount of the value given to the debtor in good faith from the amount of the value of the asset transferred at the time of the transfer.

Assume the same facts as above, but instead of the value of the guitar staying unchanged from the date of the transfer to the time of trial, assume that at the time the petition was filed the guitar was worth only \$50. The result should be the same. That is, the fraudulent transfer tax to be paid by Andy is still \$50. This is true even under the present fraudulent transfer remedy scheme. When property depreciates in value after the transfer, the general rule is that the court orders a money judgment based on the value of the property at the time of the transfer, recognizing any good faith lien the transferee may have.

Now, let us assume the same facts as above, with one key variation. Andy has decided to give up his position as sheriff of Mayberry and has, instead, changed his name to Hershel Zimmerman and has taken up the task of becoming a folk singer. Hershel is gifted and begins to sell millions of records. He begins to acquire a myriad of loyal and die-hard fans. Fan clubs spring up all over the nation. Anything he touches becomes a valuable collector's item to his devoted fans. His guitar, the one he purchased for \$50 three years ago, is now worth \$50,000. Outside of a \$5 pick guard and a new set of strings, he has made no improvements to the guitar. The court must now fashion an equitable remedy. What should it be?

Under the general rule, the court would order Hershel to return the guitar to the debtor's estate, even though that at the time of the transfer the guitar was purchased by Hershel in good faith for \$50 and was worth



\$100. Of course, under Section 548(c), Hershel would be entitled to a lien against the guitar for \$50 and, under Section 550(d), would be entitled to a lien to the extent of the improvements made here. Considering that the guitar was worth \$50,000 at the time the petition was filed, the protections afforded by the Code are meager. Nevertheless, courts would justify this harsh and inequitable result (remember Hershel has acted in good faith all along) by resorting to a strained reading of Section 551. The courts have read Section 551 as a directive to fashion a remedy that is in the best interest of the estate. Section 551 is not a measure of damages or a crutch to justify inequitable results; rather, the section states for whose benefit—the benefit of the estate—the judgment is to be awarded.

The resolution (and inequity) of the last example is clear once one recognizes the purposes of fraudulent transfer law and the fact that any remedy must be tempered by equity. The purposes of fraudulent transfer law is to prevent the unjust diminution of the debtor's estate at the expense of general creditors. The guitar was worth \$100 when it was transferred. From a creditor's perspective, that fact means that if a general creditor proceeded to judgment and executed on the guitar, he would have received up to \$100 or his claim, whichever was less. At the time of the transfer, the guitar was not worth \$50,000. The debtor's estate was not diminished by \$50,000, but by \$100, the value of the guitar at the time of the transfer. Under the facts of this example, Hershel should be able to keep the guitar by paying a \$50 fraudulent transfer tax. To order a return of the guitar or worse yet, to order Hershel to pay \$49,950 because the guitar may now be in the hands of one of his loyal fans is outrageous. Granted, the result is in the best interests of the estate, but so is failing to recognize any defenses under Sections 548(c), 550(a), and 550(d). At what point does one stop ignoring time-honored principles of equity under the rubric of what one is doing is in the best interests of the estate?

### CONCLUSION

Greek legend tells of the greatest of Athenian heroes, Theseus, the son of King Aegeus. Like other mythological heroes, Theseus was very powerful. But unlike his contemporary, Hercules, the strongest and most powerful of the heroes, Theseus' power was tempered with keen senses of equity and reason.

The common threads running through the exploits of Hercules are raw, unmeasured power and the wielding of that power without discipline. Not so with Theseus. Certainly, Theseus possessed great power: he

rid the road to Athens of the treacherous bandits who preyed on travelers—Sciron, Sinis, and Procrustes; he successfully navigated the labyrinth, dealing a lethal blow to the Minotaur; and, of course, he was one of the men who sailed on the *Argo* to find the Golden Fleece. But Theseus' attributes, unlike Hercules, did not end there. When all others shunned Hercules after he killed his entire family in a crazed rage induced by the gods, Theseus stepped forward to embrace his friend, rejecting the idea that a man could be guilty of murder when he had not known what he was doing.

Unfortunately, the application of modern fraudulent transfer law more closely resembles the unfettered power of Hercules, rather than the reasoned power of Theseus. The fraudulent transfer power is a powerful avoidance tool that can legitimately extinguish state law entitlements such as ownership of a certain asset. Courts, not unlike Hercules, are wielding the powers of fraudulent transfer law without any meaningful limitations, other than the rhythmic refrain that whatever result is achieved is in the best interests of the estate. Unfortunately, the over-worn adage is often blinding, leading the courts to overlook or ignore the statutory and common law limits to the application of fraudulent transfer law. Ignoring the doctrines of estoppel and waiver may be in the best interests of the estate; so, too, may be ignoring all affirmative defenses. Both approaches are wrong.

In their seminal article on fraudulent transfer liability, Professors Baird and Jackson would categorically exempt many leveraged transactions from liability.<sup>461</sup> They contend that creditors should have no more rights concerning a leveraged buyout that precedes a debtor's collapse than they do with respect to any other business transaction that turns out poorly.<sup>462</sup> But as the court in *Vadnais Lumber Supply, Inc. v. Byrne (In re Vadnais Lumber Supply, Inc.)*<sup>463</sup> observed:

[A] transaction which at the outset gives the debtor no value and leaves it insolvent or with unreasonably small capital is quite different from one which merely turns out poorly in the end. The Baird and Jackson arguments are unconvincing in both their logic and their inconsistency with the express wording of the fraudulent transfer statutes. Most courts have rejected them.<sup>464</sup>

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<sup>461</sup> Baird & Jackson, *supra* note 5, at 831-34.

<sup>462</sup> *Id.*

<sup>463</sup> 100 Bankr. 127 (Bankr. D. Mass. 1989).

<sup>464</sup> *Id.* at 134-35 (and cases cited therein).

It is one thing to say that fraudulent transfer law applies to modern commercial transactions like leveraged buyouts. It is quite another thing to say that the applicability of fraudulent transfer law is without limitations. In our quest to understand fraudulent transfer liability, we often overlook its first principles. At its core, fraudulent transfer law is a debt-collection device and not a revenue-generating tool; its mission is to prevent the unjust diminution of the debtor's estate. But to say that these first principles are without limitation is to perpetuate a grave injustice to the vibrant and colorful history of fraudulent transfer law. In her article, Professor Smyser implores us not to forget the inherent limitations to the applicability of fraudulent transfer laws embodied in the causes of action themselves—the requirements of insolvency and a failure of reasonably equivalent value at the time of the transfer. I have labelled these the first-order limitations. Nor should we forget the second-order limitations embodied in the anatomy of the transfer under scrutiny. *Wieboldt, Kupetz*, and *Tabor Court Realty* teach us that where the parties' knowledge and intent diverge from the formal structure employed, we are to choose the former road in our travels. Furthermore, we must recognize the impressive efforts by Professors Carlson and Sherwin, along with Professor Glenn's monumental work, in articulating a workable standard regarding the statutory affirmative defenses. These saving statutes, coupled with the recognition and ability to assert equitable defenses such as waiver and estoppel, make up the third-order limitations. And last, the limitations on who is liable for a fraudulent transfer and at what price make up the fourth-order limitations.

Fraudulent transfer law is a scepter to some, a bauble to others. It is a multi-dimensional, complex body of law. To say what it is paints only half the picture. To say what it is not, to detail its limitations, allows one to properly focus on the nebulous contours of modern fraudulent transfer law. To say that a fraudulent transfer is a transfer made at the time the debtor is insolvent in exchange for something of less than reasonably equivalent value is no more helpful than to say an avoidable preference is a transfer that satisfies all of the elements of Section 547(b).<sup>465</sup> Such generalizations cannot help but be misleading. Just because all the elements of an avoidable preference under Section 547(b) are satisfied does not necessarily doom the transfer. To the contrary, even with the satisfaction of all the elements under Section 547(b), the defendant may nevertheless defeat the trustee's attempt at avoidance by proving an affirmative defense.

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<sup>465</sup> 11 U.S.C. § 547(b) (1988).

These affirmative defenses can be found in Section 547(c) (including contemporaneous transfers) or as court-made defenses such as the earmarking doctrine.<sup>466</sup>

What this article attempts to do is portray the fraudulent transfer action in a light similar to its distant cousin, the preference.<sup>467</sup> To say the *prima facie* elements of a fraudulent transfer have been met should not end the analysis. To the contrary, there presently exists a disjointed body of law delineating the proper limitations of fraudulent transfer law as applied to modern transactions. Equipped with the knowledge that a fraudulent transfer is one that unjustly diminishes the debtor's estate, one can readily define the contours of that seemingly expansive standard by focusing on the statutory and common law limitations. This article discusses four groups of limitations. They are supported by common sense

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<sup>466</sup> For a discussion of the earmarking doctrine, see *Coral Petroleum, Inc. v. Banque Paribas-London*, 797 F.2d 1351, 1361 (5th Cir. 1986).

<sup>467</sup> Second only to the riddle of the Sphinx is the dilemma faced by trustees, more often than they care to admit: is the transfer under scrutiny a fraudulent transfer or an avoidable preference?

In *Butz v. Sohigro Servs. Co. (In re Evans Potato Company, Inc.)*, 44 Bankr. 191 (Bankr. S.D. Ohio 1984), the trustee sought to recover an alleged voidable preference made by the debtor to Sohigro. Essentially, the facts were that a principal of the debtor opened a personal account with Sohigro. Earlier, Sohigro had closed the debtor's account due to unfavorable credit reports. *Id.* at 192. Within 90 days of the filing of the petition in bankruptcy, Sohigro sold goods to the debtor's principal who immediately transferred the goods to the debtor for the debtor's use. *Id.* The debtor paid Sohigro directly for the goods. These payments were the alleged preferential transfers. *Id.*

The court held that by applying for a personal line of credit with Sohigro, the debtor's principal had acknowledged that he alone would be responsible for the ensuing debts. Because it was he who arranged for the purchase of the goods, it followed that it was he who was responsible for their payment. *Id.* at 192-93. The court further observed that the fact that the individual apparently had the goods delivered to the debtor and arranged for the debtor to pay Sohigro directly did not affect the nature of the debt owed by the individual. Therefore, the court concluded that because the debtor had no account and was not liable on the individual's account, the debtor owed nothing to Sohigro. *Id.* at 193. Based on these facts, the court concluded that no preference existed because there was no debtor/creditor relationship between the debtor and Sohigro. *Id.* (and cases cited therein).

The remaining portion of the *Evans Potato* opinion is strange. After dispensing with the avoidable preference argument, the court, *sua sponte*, addressed the issue of whether the transfers were fraudulent under § 548(a)(2). *Id.* at 193. Naturally, the court addressed the many cases explicating the general rule that payment of or assumption of a third party's debt by an insolvent is a transfer without reasonable equivalent value and thus fraudulent. *Id.* at 193-94. The court noted that the general rule did not apply. *Id.* at 194. Although the debtor was not contractually liable for payment for the goods provided, it nevertheless received reasonably equivalent value in exchange for the payments. One factor the court embraced in support of its conclusion that reasonably equivalent value did exist was that the debtor had exclusive use of the goods sold by Sohigro. *Id.*; see also *Kindom Uranium Corp. v. Vance*, 269 F.2d 104 (10th Cir. 1959) (involving a creditor's late recording of a deed). The facts in *Kindom Uranium* paint the classic avoidable preference scenario; however, the court analyzed the late deed recording as a fraudulent transfer. *Kindom Uranium*, 269 F.2d at 108. The case is resoundingly criticized in Jackson, *supra* note 19, at 784-86.

and are consistent with and accommodate the first principles of fraudulent transfer law. Armed with the first principles and their limitations, one can more comfortably undertake the struggle of applying a sixteenth century law to a twentieth century transaction.