University of Chicago Law School
Chicago Unbound

Journal Articles | Faculty Scholarship

1985

Fraudulent Conveyance Law and Its Proper Domain

Douglas G. Baird

Thomas H. Jackson

Follow this and additional works at: https://chicagounbound.uchicago.edu/journal_articles

Part of the Law Commons

Recommended Citation
Douglas G. Baird & Thomas H. Jackson, "Fraudulent Conveyance Law and Its Proper Domain," 38 Vanderbilt Law Review 829 (1985).

This Article is brought to you for free and open access by the Faculty Scholarship at Chicago Unbound. It has been accepted for inclusion in Journal Articles by an authorized administrator of Chicago Unbound. For more information, please contact unbound@law.uchicago.edu.

Fraudulent Conveyance Law and Its Proper Domain

Douglas G. Baird & Thomas H. Jackson***

I. Introduction

In 1571 Parliament passed a statute making illegal and void any transfer made for the purpose of hindering, delaying, or defrauding creditors.[1] This law, commonly known as the Statute of 13 Elizabeth, was intended to curb what was thought to be a widespread abuse.[2] Until the seventeenth century, England had certain sanctuaries into which the King's writ could not enter. A sanctuary was not merely the interior of a church, but certain precincts defined by custom or royal grant. Debtors could take sanctuary in one of these precincts, live in relative comfort, and be immune from execution by their creditors. It was thought that debtors usually removed themselves to one of these precincts only after selling their property to friends and relatives for a nominal sum with the tacit understanding that the debtors would reclaim their property after their creditors gave up or compromised their claims. The Statute of 13 Elizabeth limited this practice.[3]

The basic prohibition of this statute, which prevents debtors from making transfers that hinder, delay, or defraud their creditors, has survived for over four centuries.[4] A debtor cannot manipulate his affairs in order to shortchange his creditors and pocket the difference. Those who collude with a debtor in these transac-

---

*Professor of Law, The University of Chicago. B.A. 1975, Yale College; J.D. 1979, Stanford University.

**Professor of Law, Stanford University. B.A. 1972, Williams College; J.D. 1975, Yale University. We thank Frank Easterbrook, Frank Kennedy, and Robert Rasmussen for their helpful comments on an earlier draft.

1. 13 Eliz., ch. 5 (1571).
2. *See* 1 G. Glenn, Fraudulent Conveyances and Preferences §§ 61-61e (rev. ed. 1940).
3. 13 Eliz., ch. 5 (1571). Because one-half of the property fraudulently conveyed was forfeited to the Crown, the statute was also in part a revenue measure.
4. 13 Eliz., cb. 5 (1571); *see* Twyne's Case, 76 Eng. Rep. 809 (1601). Today this basic prohibition is contained in § 7 of the Unif. Fraudulent Conveyance Act, 7A U.L.A. 205 (1918) and in 11 U.S.C. § 548(a)(1) (1982).

HeinOnline -- 38 Vand. L. Rev. 829 1985

tions are not protected either. An individual creditor who discovers his debtor's assets have been fraudulently conveyed can reduce his claim to judgment and have the sheriff levy on the property that is now no longer in the debtor's hands (as long as the property is not in the hands of a bona fide purchaser for value).[5]

The difficulty that courts and legislatures have faced for hundreds of years has been one of trying to define what kinds of transactions hinder, delay, or defraud creditors.[6] From very early on, common law judges developed per se rules, known as "badges of fraud," that would allow the courts to treat a transaction as a fraudulent conveyance even though no specific evidence suggested that the debtor tried to profit at his creditors' expense.[7] For example, common law judges assumed that an insolvent debtor who sold property but retained possession of it without any special reason (such as a need to complete unfinished goods) was up to no good.[8]

Over the past hundred years, there has been an increasing tendency to treat transfers of property of insolvent debtors in which the debtor received nothing or too little in return as fraudulent conveyances. The Uniform Fraudulent Conveyance Act, for example, contains a separate section that deems a transfer by an insolvent debtor made for less than "fair consideration" to be a fraudulent conveyance.[9] The most straightforward justification for this provision is the same as the justification for the Statute of 13 Elizabeth: it is a rule designed to set aside transfers by an insolvent debtor that are intended to hinder, delay, or defraud his creditors. This approach presumes mischief when an insolvent debtor voluntarily transferred property and got nothing or clearly too little in return[10] unless the debtor simply was paying off an antecedent

---

5. UNIF. FRAUDULENT CONVEYANCE ACT § 9, 7A U.L.A. 304 (1918). The protection for bona fide purchasers appears to be accorded to ensure the "negotiability" of goods. *See* Gilmore, *The Commercial Doctrine of Good Faith Purchase*, 63 YALE L.J. 1057, 1057 (1954).

6. *See, e.g.*, Twyne's Case, 76 Eng. Rep. 809, 810-11 (K.B. 1601) (announcing six "badges of fraud"); Philco Fin. Corp. v. Pearson, 335 F. Supp. 33, 40-41 (N.D. Miss. 1971) (applying "badges of fraud").

7. *See, e.g.*, sources cited *supra* note 6.

8. *See, e.g.*, Sturtevant v. Ballard, 9 Johns. 336 (N.Y. Sup. Ct. 1812). This rule still survives in many jurisdictions. *See, e.g.*, CAL. CIV. CODE § 3440 (West 1970) (sale of goods without immediate and continued change of possession conclusively fraudulent).

9. UNIF. FRAUDULENT CONVEYANCE ACT § 4, 7A U.L.A. 205 (1918); *see also* 11 U.S.C. § 548(a)(2)(A) (1982) (authorizing bankruptcy trustee to set aside conveyance within prior year as fraudulent conveyance if debtor received less than "reasonably equivalent value").

10. *See* Jackson, *Avoiding Powers in Bankruptcy*, 36 STAN. L. REV. 725, 777-86 (1984); *see also* McCoid, *Constructively Fraudulent Conveyances: Transfers for Inadequate Consideration*, 62 TEX. L. REV. 639, 656-57 (1983) (doubting that inadequate consideration alone justifies an inference of "intentional fraud or voluntary gift").

HeinOnline -- 38 Vand. L. Rev. 830 1985

debt.[11] Because it is a per se rule, it may treat some transactions in which a debtor was not trying to hinder, delay, or defraud his creditors as fraudulent conveyances. The number of cases in which an insolvent debtor gives away something for nothing but is not trying to hinder, delay, or defraud his creditors, however, may be sufficiently small that it is preferable to treat all these cases as fraudulent conveyances. The benefits of a rule may warrant its supplementing the standard. The costs to society of setting aside legitimate transfers should be offset by the elimination of costs associated with proving actual fraudulent intent in cases in which the chances of fraud are very high.

If one begins with the premise that the provision covering transactions made without fair consideration is simply a per se rule that embodies the more general standard that a debtor cannot transfer property if his purpose is to hinder, delay, or defraud his creditors, the provision carries with it the limits imposed by its origins. When the applicability of a statute is in doubt in a particular case, one must interpret its language in light of the purposes that underlie it. Hence, in determining whether a transaction falls within the prohibition of that part of the statute, one should ask first what the purpose of the "fair consideration" requirement is. If it is regarded as merely a per se rule that implements the general idea of a fraudulent conveyance, the next inquiry should be whether the transaction was one in which it was likely or even possible that the debtor intended to hinder, delay, or defraud his creditors. If it is not, one should conclude either that the per se rule is unavoidably overbroad or that the extension of the rule is unjustified.

This view of section 4 of the Uniform Fraudulent Conveyance Act, however, is incomplete. The drafters of that act intended to reach some transactions—such as gifts by insolvent debtors—quite apart from whether the debtor could be thought to have harbored any fraudulent intent.[12] They thought tbat an insolvent debtor who gives 1000 dollars to his mother makes a fraudulent conveyance, even if he has made a similar gift each year in the past and is

11. We cannot assume that a debtor is trying to shortchange creditors if he merely pays off one creditor without attendant circumstances such as a side deal that allows him to keep possession of the property he purports to transfer.

12. A person who wisbes to be generous to a relative or friend does not necessarily have a bad state of mind toward creditors. *See* Clark, *The Duties of the Corporate Debtor to Its Creditors*, 90 HARV. L. REV. 505, 509-11, 544 (1977) (referring to a "moral" obligation not to make gifts while insolvent).

not motivated in the slightest by a desire to thwart creditors. The drafters deemed these fraudulent not because the transfers were too costly to distinguish from gifts by insolvents made with an intent to defraud,[13] but rather because they found them inherently objectionable. A birthday gift of cash by an insolvent debtor injures creditors just as much when his intentions are innocent as when they are not, and one can presume creditors would ban them if they could.

If fraudulent conveyance law is not limited simply to cases in which the debtor intended—or could be presumed to have intended—to hinder, delay, or defraud his creditors, what are its limits? Much of the case law under the Uniform Fraudulent Conveyance Act and federal bankruptcy law has concerned individual rather than corporate debtors and most of the transfers attacked as fraudulent conveyances have been between relatives, friends, or other insiders. If a case did not concern a transfer in which the possibility of a deliberate effort to hinder, delay, or defraud was high, typically it concerned a gratuitous transfer that never could have redounded to the benefit of the creditors and that the creditors would have prohibited given the opportunity. Most of the transactions that creditors sought to set aside were close either to the sham transfers that were at the heart of the Statute of 13 Elizabeth or to the gifts to relatives or friends that were addressed by the drafters of the Uniform Fraudulent Conveyance Act. For this reason, the reach of fraudulent conveyance law has not been an issue for much of this century.

The issue has become an important one in the 1980's, however.[14] Identifying the precise reach of fraudulent conveyance law

---

13. This point is made in Comment, *Guarantees and Section 548 (a)(2) of the Bankruptcy Code*, 52 U. CHI. L. REV. 194 (1985).

14. *See, e.g., In re* New Yorketown Assoc., 40 Bankr. 701, 706 (Bankr. E.D. Pa. 1984) (construing 11 U.S.C. § 548, holding that it "was enacted to correct the improper depleting of the debtor's assets. . . . This diminution may occur whether the debtor participates or not."). The basic question, however, was framed long ago. *See* Reade v. Livingston, 3 Johns. Ch. 481 (N.Y. Ch. 1818) (Kent, C.) (any voluntary conveyance for inadequate consideration by an indebted person is fraudulent); McCoid, *supra* note 10, at 649-56 (tracing the development from the opinion by Chancellor Kent in Boyd & Suydam v. Dunlap, 1 Johns. Ch. 478 (N.Y. Ch. 1815)). The *Reade* holding was rejected by the Supreme Court in Warren v. Moody, 122 U.S. 132 (1887), and is criticized in McLaughlin, *Application of the Uniform Fraudulent Conveyance Act*, 46 HARV. L. REV. 404, 407-09 (1933).

The issue was addressed by Congress last year. The Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, §§ 421(i), (j)(1), 463(a)(1), 98 Stat. 333, has amended the definition of "transfer" in 11 U.S.C. § 101(41) (1982) (renumbered as § 101(48)). These amendments appear to overrule the majority and concurring opinions in *In re* Madrid, 725 F.2d 1197 (9th Cir.), *cert. denied*, 105 S. Ct. 125 (1984) (holding that grant-

HeinOnline -- 38 Vand. L. Rev. 832 1985

is the crucial inquiry in several important legal disputes, such as whether a foreclosure of a debtor's equity of redemption[15] or a leveraged buyout[16] is a fraudulent conveyance. These cases are strikingly different from gratuitous transfers or transfers intended to defraud. It is not clear that permitting the debtor to engage in a leveraged buyout, for instance, is against the long-term interests of the creditors as a group. Because fraudulent conveyance law's use of "fair consideration" is not limited solely to cases in which fraudulent intent can be presumed, a view has recently gained currency that suggests the core principle of fraudulent conveyance law is that creditors should be able to set aside transfers by insolvent debtors that harm the creditors as a group. Under such view, this principle, which covers both transfers made with fraudulent intent and gifts, should inform construction of a section such as section 4 of the Uniform Fraudulent Conveyance Act.[17] But, just as a view of section 4 that treats it as a surrogate of section 7's intentional fraud standard is too narrow, we believe this competing principle is too broad.

To establish this, we start from a simple, but important, proposition. After a debtor has borrowed money, his interests conflict with those of his creditors. A debtor has an incentive to take

---

ing and recording of second deed of trust which occurred more than one year before suit constituted the only transfer and therefore the foreclosure sale itself could not be a fraudulent conveyance). Several months later, however, Senators Dole and DeConcini added to the Congressional Record a discussion between them in which they noted that the new language was originally part of a set of amendments that would affirm *Madrid.* They asserted that Congress intended to drop all amendments affecting *Madrid* and that "parties . . . who seek avoidance of prepetition foreclosure sales would find no support for their arguments in these amendments." *See* 130 CONG. REC. S13,771-72 (daily ed. Oct. 5, 1984).

15. *Compare In re* Hulm, 738 F.2d 323 (8th Cir. 1984); Abramson v. Lakewood Bank & Trust Co., 647 F.2d 547 (5th Cir. 1981), *cert. denied,* 454 U.S. 1164 (1982); Durrett v. Washington Nat'l Ins. Co., 621 F.2d 201 (5th Cir. 1980); *In re* New Yorketown Assoc., 40 Bankr. 701 (Bankr. E.D. Pa. 1984) *with In re* Madrid, 725 F.2d 1197 (9th Cir. 1984); *In re* Strauser, 40 Bankr. 868 (Bankr. N.D. Ohio 1984); *In re* Alsop, 14 Bankr. 982 (Bankr. D. Alaska 1981), *aff'd,* 22 Bankr. 1017 (D. Alaska 1982). *See generally* Alden, Gross & Borowitz, *Real Property Foreclosure as a Fraudulent Conveyance: Proposals for Solving the* Durrett *Problem,* 38 BUS. LAW. 1624 (1983) (concluding that a mortgagor may institute a bankruptcy suit to invalidate the secured lender's foreclosure sale of the mortgaged property); Coppel & Kann, *Defanging* Durrett: *The Established Law of "Transfer",* 100 BANKING L.J. 676 (1983) (disapproving of cases attacking foreclosure sales as fraudulent conveyances); Zinman, Houle & Weiss, *Fraudulent Transfers According to Alden, Gross and Borowitz: A Tale of Two Circuits,* 39 BUS. LAW. 977 (1984) (same).

16. *See, e.g.,* United States v. Gleneagles Inv. Co., 565 F. Supp. 556 (M.D. Pa. 1983). There is a similar problem with intercorporate guarantees. *See, e.g.,* Rubin v. Manufacturers Hanover Bank, 661 F.2d 979 (2d Cir. 1981).

17. Many of the cases construe 11 U.S.C. § 548 instead of the Uniform Fraudulent Conveyance Act. Subject to some exceptions, the issues tend to be the same.

HeinOnline -- 38 Vand. L. Rev. 833 1985

risks that he did not have before he borrowed. He enjoys all the benefits if a risky venture proves successful, but he does not incur all the costs if the venture fails.[18] Every transfer he makes that has the effect of making an asset less like cash benefits the debtor at his creditors' expense. Creditors rely upon existing legal rules and contractual terms to limit unwarranted risk-taking by their debtor. Creditors, however, do not want to place too many restraints on their debtor. Creditors lend money in the first instance because the debtor has entrepreneurial skills that they do not have. To take advantage of the debtor's skills, creditors must give their debtor a certain amount of freedom. To give the debtor the power to make correct decisions, creditors must to some extent give him the power to make wrong decisions. Allowing creditors to escape the consequences of their debtor's bad decisions after the fact has costs as well as benefits. To decide whether the benefits justify the rule, one must also be sensitive to the costs that rule brings.

A creditor would not want to impose all possible restraints upon a debtor, even if the absence of a restraint exposes the creditor to the risk that the debtor will injure it. Fraudulent conveyance law is a restraint that the law imposes upon debtors for the benefit of creditors by giving creditors the power to void transactions. The power of creditors to set aside transactions after the fact limits the ability of debtors to engage in the transactions in the first instance. This power is unobjectionable if the transaction—such as a gift by an insolvent debtor—always injures creditors. But often the transaction—such as a leveraged buyout—might or might not injure creditors. If one applies fraudulent conveyance law to leveraged buyouts, one might protect some creditors who were injured after the fact, but one might work counter to the interests of those creditors who, before the fact, would have wanted their debtor to have the power to enter into such transactions.

Treating transfers by a debtor that make creditors as a group worse off as fraudulent conveyances is overbroad because many ordinary transfers that a debtor makes do this. Like any other creditor remedy, fraudulent conveyance law must have some limits. Indeed, in considering a legal rule such as fraudulent conveyance law, overbroad rules may be more pernicious than underbroad rules. It is easier for creditors to contract into prohibitions on conduct by a

18. *See generally* Baird & Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97 (1984) (discussion of different incentives when assets owned by diverse people with different rights).

HeinOnline -- 38 Vand. L. Rev. 834 1985

debtor than it is to contract out. If fraudulent conveyance law does not cover a certain kind of activity, yet creditors want to prohibit it, it can be prohibited contractually. Myriad restrictions in loan agreements, for example, perform this function. If certain activity is prohibited by a few large creditors, other creditors (including nonconsensual creditors) may be able to profit by the monitoring of the debtor undertaken by those whose contracts do prohibit such activity. Yet, contracting *out* of a rule that prohibits conduct, such as fraudulent conveyance law, is much harder. To be effective, the consent of *all* creditors must be reached. And in the unlikely case that all creditors *did* so agree, the trustee in bankruptcy could still seek to upset the transfer under section 548 of the Bankruptcy Code.[19]

Thus, we believe, one must be careful in deciding where to place the reach of fraudulent conveyance law. In establishing its limits, one must recognize that the debtor-creditor relationship is essentially contractual.[20] A creditor acquires certain rights to control its debtor's actions. The more rights the creditor acquires, the lower its risk and the lower the interest rate it enjoys. Not all the rights that the creditor wants, or that the debtor would agree to give it, however, can be bargained for explicitly. Sometimes these rights (such as priority rights with respect to a debtor's assets) affect third parties as well and should be subject to legal constraints. The ambition of the law governing the debtor-creditor relationship, including fraudulent conveyance law, should provide all the

---

19. 11 U.S.C. § 548; *see* Kindom Uranium Corp. v. Vance, 269 F.2d 104 (10th Cir. 1959) (making that point). The normative desirability of such a result is questioned in Jackson, *supra* note 10, at 779.

20. Many claimants are, of course, nonconsensual, but we think that fact is unimportant in discussing the bases of fraudulent conveyance law. In the first place, we think that debtor-creditor law should presumptively give all creditors the set of rights they would bargain for if they could, and if they had the time and sophistication to do it. "Nonconsensual" creditors, be they tort or tax, would not necessarily want different limits of restraint than would consensual creditors. Indeed, in many respects, their interests in controlling the debtor are identical. As a result, the limits that consensual creditors would impose on investments by a debtor also largely will protect nonconsensual claimants because of the congruence in their interests. To be sure, their interests are not always congruent. For example, certain actions by a debtor (such as safety measures) may affect only tort claimants directly. In those cases, other legal rules might be desirable to place monitoring burdens on the consensual creditors. *See, e.g.*, Note, *Tort Creditor Priority in the Secured Credit System: Asbestos Times, the Worst of Times*, 36 STAN. L. REV. 1045 (1984). These controls, however, are not likely to be imposed via fraudulent conveyance law. Finally, to focus on the protections nonconsensual creditors would want is a species of a larger inquiry, which implicates, inter alia, questions such as whether limited liability for corporations should apply to nonconsensual creditors.

parties with the type of contract that they would have agreed to if they had had the time and money to bargain over all aspects of their deal. Fraudulent conveyance law, in other words, should be viewed as a species of contract law, representing one kind of control that creditors generally would want to impose and that debtors generally would agree to accept.[21]

II. Debtor Misbehavior and the Creditors' Bargain

Hundreds of different mechanisms have evolved—from net worth and accounting requirements to security interests and default clauses—that also guard against the risk of unacceptable debtor behavior.[22] These contract provisions have evolved in the context of a tension between debtor freedom and creditor protection. Complete deference to creditor protection in fashioning legal rules makes no more sense than complete deference to debtor freedom. Any device that protects creditors inevitably brings costs as well as benefits. We typically presume that a firm's investment decisions should be made by its managers even though that freedom necessarily conflicts to some extent with creditor security. This conflict motivates creditors to bargain for limitations on the ability of a debtor to engage in certain activities.[23] The function of legal rules in this area should be either to constrain deals between debtors and creditors that affect third parties or to provide preformulated provisions that the parties usually would contract for anyway.

21. Fraudulent conveyance law thus becomes a species of a "preformulated" or "off the rack" rule. *See* Brudney & Clark, *A New Look at Corporate Opportunities*, 94 Harv. L. Rev. 997, 1003-04 (1981); Easterbrook & Fischel, *Corporate Control Transactions*, 91 Yale L.J. 698, 700-03 (1982); Goetz & Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 Colum. L. Rev. 554, 588 n.87 (1977). Professor Clark notes that this rationale explains tbe probibition on gratuitous transfers by insolvent debtors. *See* Clark, *supra* note 12, at 544 ("[E]very contract creditor has a fundamental right to expect that sucb transfers will not be made, and treating this rigbt as a ground rule that need not be expressed undoubtedly cuts down bargaining costs.").

22. *See generally* Clark, *supra* note 12 (discussing fraudulent conveyance law, equitable subordination doctrine, dividend restraint statutes, piercing the corporate veil, and the interrelations between the doctrines).

23. In practice, creditors can and do bargain for many conditions, the violation any one of which will accelerate all of the debtor's obligations. *See* D. Baird & T. Jackson, Cases, Problems, and Materials on Security Interests in Personal Property 798-99 (1984); Ryan, *Defaults and Remedies Under International Bank Loan Agreements with Foreign Sovereign Borrowers—A New York Lawyer's Perspective*, 1982 U. Ill. L. Rev. 89, 90-100; Smith & Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. Fin. Econ. 117, 151 (1979).

HeinOnline -- 38 Vand. L. Rev. 836 1985

It is in this context, we believe, that one must approach fraudulent conveyance law. It should not be construed to reach all transfers that benefit a debtor at the creditors' expense because such a principle is unlimitable and conflicts with the general notion that the debtor should make investment decisions. Any time that a creditor lends his debtor 100 dollars and the debtor converts the cash into an asset the value of which is less certain, then the creditor is worse off, in the same way it would be worse off if the debtor used the 100 dollars to buy a lottery ticket that has a one-in-ten chance of paying 1000 dollars. The value of the lottery ticket is 100 dollars. But the creditors are not indifferent between a debtor with 100 dollars cash and a lottery ticket worth 100 dollars. Creditors never will recover more than 100 dollars, even if the lottery ticket is a winning one, and they will recover nothing in the nine cases out of ten in which the lottery ticket is a losing one. Converting the funds into a drill press or raw materials or using them to pay wages is different only in degree. It may be very likely that the investment will produce more than 100 dollars in the end, but there is a chance it will not. If the investment does return more than 100 dollars, the debtor enjoys the benefit; if it returns less, the creditors bear most of the loss. Thus, one should not construe a prohibition on transfers for less than "fair consideration" by asking simply whether the investment leaves the creditors with as much as they had before. At a minimum, the concept of "fair consideration" needs to be analyzed from the perspective of the debtor and creditors taken as a unit.

What, then, of an argument about investments that simply are *bad*? Section 4 of the Uniform Fraudulent Conveyance Act and similar statutes do not reach all transactions by an insolvent debtor that reduce the recovery of creditors, but only those that are made for less than "fair consideration" or "reasonably equivalent value." Therefore, one might choose to justify these statutes not on the overly broad ground that creditors should be able to set aside all transfers that make them worse off, but rather on the narrower ground that creditors should be able to set aside transfers that are bad even if there were no conflicts between the debtor and his creditors. A risk-neutral person who has no creditors would be indifferent between receiving 100 dollars and a lottery ticket that offers a one-in-ten chance of winning 1000 dollars. But this person would not be indifferent if the lottery ticket offers a one-in-ten chance of winning 500 dollars. One can argue that a creditor should be able to set aside its insolvent debtor's deal only

HeinOnline -- 38 Vand. L. Rev. 837 1985

if it is bad from a neutral perspective. An insolvent debtor might choose to go beyond merely taking risks—he might take unwise ones.

Using the fraudulent conveyance remedy to undo bad deals, however, can be justified only if its benefits are greater than the costs of the uncertainty such a rule brings. Often one cannot determine with any certainty whether a debtor was insolvent at a particular time or whether a particular transaction at that time was a good deal or a bad deal.[24] Even if a definite determination could be made, creditors still might not bargain for the right to set such transfers aside after the fact because of the effects such a right would have on third parties and, ultimately, on the debtor's investment decisions. A creditor who lends a debtor money is taking advantage of the debtor's comparative advantage in using that money productively. A creditor necessarily defers to the debtor's skill in converting the money into other assets. The risk that both the creditor and debtor take is that the use the debtor makes of the money will benefit both parties. The creditor provides the capital, the debtor provides the know-how. The creditor is relying on the debtor's skill and judgment when it makes the loan. Only by giving the debtor discretion can the creditor hope to profit. Giving a debtor discretion, however, necessarily gives him the ability not only to make good decisions, but bad ones as well.

Of course, creditors do place limits on a debtor's ability to make bad decisions. A creditor might insist, for example, that the debtor use the funds only to open a shoe store. The debtor would not have the freedom to use the money to open a store that sold nothing but popcorn. The creditor may bargain for the right to call the loan if the debtor violates such a restriction. Indeed, a creditor may bargain for the right to call the loan at any time it pleases. It is unlikely, however, that a debtor's creditors ever would agree that the creditors could veto all the debtor's decisions after the fact. If the debtor were insolvent, the creditors collectively could file a bankruptcy petition and assert control over the assets themselves. But they would not insist on being able to set aside transactions that their debtor entered into in good faith and at arm's length, unless the cost of distinguishing such transactions from one in

24. For purposes of fraudulent conveyance law, "insolvency" typically is defined as the status existing when "the present fair salable value of [a person's] assets is less than the amount that will be required to pay his probable liability on his existing debts as they become absolute and matured." UNIF. FRAUDULENT CONVEYANCE ACT § 2(1), 7A U.L.A. 176 (1918).

HeinOnline -- 38 Vand. L. Rev. 838 1985

which the debtor did not act in good faith was thought to be too great. If such control were given to creditors, too many third parties would be deterred from doing business with the debtor. These third parties would know that if the deal turned out to be a bad one for them and a good one for the debtor, they would bear the loss. They also would know that if the deal turned out to be a good one for them and a bad one for the debtor, the creditors might be able to set aside the transfer. Third parties would have nothing to gain and something to lose by dealing with an insolvent (or possibly insolvent) debtor whose creditors could second-guess his decisions. Third parties would pay less to debtors bound under such terms.[25] Their reluctance to deal with the debtor would make the debtor (and indirectly, the creditors) worse off.

Creditors can expect their debtor to enter into favorable deals with others only if they expose themselves to the risk that the debtor will enter into unfavorable deals. That is part and parcel of the reason for making the investment in the first place—to use the debtor's comparative advantage in entrepreneurial or investment skills. A fraudulent conveyance law that protects creditors from all bad deals a debtor enters into gives the creditors too much. Such creditor protection is unlikely to be a right that all interested parties would agree to if they were able to bargain explicitly.[26] The effect of such protection is to reduce risky investments. But risk-taking may be in the best interests of all the parties concerned. Therefore, a preformulated rule should not protect creditors from bad investments.

To be sure, it may be difficult for creditors to monitor the debtor closely enough to know when his financial condition is sufficiently perilous that they should step in before the debtor, through action or inaction, compromises their interests. But even if creditors were not able to prevent the debtor from engaging in improvident actions, they probably would bargain for rights other than a general right to undo bad deals. Creditors, for example, might prefer to have the power to upset any transaction (or transaction for

25. *See In re* Madrid, 725 F.2d 1197, 1202 (9th Cir.), *cert. denied,* 105 S. Ct. 125 (1984); Abramson v. Lakewood Bank & Trust Co., 647 F.2d 547, 550 (5th Cir. 1981) (Clark, J., dissenting); McCoid, *supra* note 10, at 658-63. A similar argument has been made by Professor Brudney in a different context. Brudney, *The Bankruptcy Commission's Proposed "Modifications" of the Absolute Priority Rule,* 48 AM. BANKR. L.J. 305, 331-35 (1974).

26. Professor Clark makes a similar point about deeming small initial capitalization as a legal "wrong." He is uncertain that contract creditors would want a clause prescribing such a result, and he believes that with respect to tort claimants, better alternatives may exist. Clark, *supra* note 12, at 544.

less than fair consideration) made while the debtor was insolvent if the transferee did not give them advance notice of the transaction so that creditors could act. Creditors would have the burden of drafting default clauses and other provisions that would enable them to limit the debtor's freedom to act, but the transferee would have the burden of informing the creditors that something was in the works. This is the basic rationale behind bulk sales laws.[27]

Such a regime stands a much better chance of allocating burdens between creditors and transferees in a cost-effective way than a general standard that did little to channel the conduct of the parties before the fact. A broad fraudulent conveyance rule does not provide an incentive for creditors to do the monitoring they are capable of doing.[28] If creditors always can undo transactions afterwards, they have every incentive to wait and upset only those transactions that turn out unfavorably from their perspective.

Bulk sales laws, to be sure, are hardly the success stories of American commercial law. One sensibly could argue that they are out of step with the way business is conducted today, that the burdens they impose are too onerous, and that the good they do is too intangible.[29] But bulk sales laws are more discrete and less intrusive than fraudulent conveyance laws. Extending fraudulent conveyance law beyond preventing sham transactions and gratuitous transfers by insolvents is a step that should be taken only with caution.

These problems are all in addition to the enormous practical problem of determining whether a debtor is insolvent at any given time. Consider the following situation. Debtor is a small high-tech company that is developing two different computers. The success of each computer turns in large measure on whether another manufacturer can make the electronic chip each computer will need. In January 1983, Debtor needs additional cash. At that time it has 2 million dollars in debt. Debtor decides to take one of the computers it is developing and sell it (and the software and research and development associated with it) to Buyer for 1 million dollars and to concentrate on bringing the other computer to market. Two years later, Debtor files a bankruptcy petition. The retained com-

---

27. *See* U.C.C. art. 6 (1978).

28. The problem of finding appropriate monitors, and providing them with incentives to monitor, is discussed in a somewhat different context in Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls,* 93 YALE L.J. 857 (1984).

29. For a discussion of the problems of bulk sales laws, see A. SCHWARTZ & R. SCOTT, COMMERCIAL TRANSACTIONS: PRINCIPLES AND POLICIES 503-06 (1982).

HeinOnline -- 38 Vand. L. Rev. 840 1985

puter turned out to be worthless because the required chip could not be made. The computer that Buyer bought from Debtor, on the other hand, was a dramatic success. Buyer resold the rights to the computer to another manufacturer for 500,000 dollars more than its investment in the machine. Buyer's success with the computer was due almost entirely to the use of a new chip. At the time the computer was being designed (and at the time of the sale to Buyer), no one knew whether this chip (or the one for the computer that was kept) could be manufactured successfully.

Now assume Debtor's creditors (through the trustee in bankruptcy) argue that the sale of the machine to Buyer was a fraudulent conveyance and that Buyer thus should be allowed to keep only what is actually paid for the machine (1 million dollars) and remit 500,000 dollars to Debtor. The trustee will argue that Debtor was insolvent at the time of the sale because it had only two assets (the two computers), one worthless and the other worth 1.5 million dollars. The fair value of Debtor's assets, therefore, was less than its 2 million dollars in liabilities. The trustee then will argue that the transfer was a fraudulent conveyance because Debtor traded away something worth 1.5 million dollars for 1 million dollars.

Meeting either of these arguments will be difficult. Debtor was solvent at the time of the sale only if the computer it kept had a positive value. But at the time of the bankruptcy petition, the retained computer clearly had no value. It would have value only if the chip it was to use could be manufactured successfully, and everyone at the time of the petition knew that it could not be.

Nevertheless, valuations necessarily involve uncertainty. How much a piece of property is worth depends both on when the valuation is made and on how much is known by the person making the valuation. The two computers in this example are like lottery tickets in a situation in which the drawing intervenes between the sale and the bankruptcy petition. A determination of whether Debtor was solvent in January 1983 should turn on how much the assets were worth then, which, in turn, depends on how much was known then. Just as the value of a lottery ticket before the drawing turns on the likelihood of winning, not on whether it eventually proved to be the winning number, the value of the computer Debtor retained should reflect the likelihood in January 1983 that the chip could successfully be manufactured, not the fact that it later turned out that it could not be. But this does not end the inquiry. The chances that the chip would be unavailable might have been better known to some than to others. Therefore, one

HeinOnline -- 38 Vand. L. Rev. 841 1985

must decide whose knowledge is relevant.

Similarly, in deciding whether Buyer acquired the computer for less than fair consideration, one must value the computer at the time of sale based on then-present knowledge. The computer turned out to be worth 1.5 million dollars, but if it was equally likely that it would be worth only 500,000 dollars, then 1 million dollars well might have been a fair price for it. Debtor may have acted as any reasonable businessman would. He sold the computer because having 1 million dollars in cash seemed to be better than keeping the computer. Buyer, however, presumably bought the computer believing it would be better to have the computer than the 1 million dollars. The creditors presumably invested in Debtor because they wanted Debtor to make some judgment calls on which assets to keep and which assets to sell.

Monday morning quarterbacking is easy. It will be easy to argue that an astute businessman would have to know in January 1983 that the 1.5 million dollar computer was worth 1.5 million dollars and the worthless computer was worthless. It will be more difficult to argue that the worthless computer, which, in retrospect, never had any chance of success, was valuable as of January 1983 and that the ultimately successful computer was not so valuable as of that time. It is also too easy to fall into the trap of thinking that Buyer is not made worse off if he is deprived only of his profits from the transaction.[30] Debtor's creditors would never exercise their right to overturn the sale and reacquire the computer for its original price if the value turned out to be less than what Buyer paid. If Buyer cannot keep the gains if the deal turns out favorably, he will not be compensated for the risk that the deal will turn out unfavorably. Even if judges do not have the bias that usually accompanies valuations after the fact, the process of valuing assets is an uncertain one. This uncertainty imposes costs on the parties, which somehow must be offset by the gains from reexamining closed deals.

As we have seen, however, that principle itself is suspect. The fallacy of imposing a general duty on those who transact with a

30. *See, e.g.*, UNIF. FRAUDULENT TRANSFER ACT § 8 (Proposed Official Draft 1984). This fallacy occasionally reasserts itself in bankruptcy law. *See, e.g.*, § 7-303(3) of the Proposed Bankruptcy Act of 1973, contained in REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, JULY 1973, H.R. Doc. No. 137, 93d Cong., 1st Sess., Part II, at 241 (1973) (proposal for a "second look"); Bittner v. Borne Chem. Co., 691 F.2d 134 (3d Cir. 1982) (accepts valuation below present probability of success on ground that otherwise creditor might have too much voice).

HeinOnline -- 38 Vand. L. Rev. 842 1985

debtor who is later determined to have been insolvent to pay fair consideration or be at risk for the difference stems from the notion that a rule permitting creditors to overturn bad deals is needed when the debtor is insolvent to prevent him from acting against the interests of the creditors. But this proves too much. A debtor's incentives almost never parallel his creditors' interests. Incentives change when a creditor enters the picture because then more than one person claims rights in assets.[31] An individual who owns all his assets outright bears all the losses and enjoys all the benefits from any transaction he enters. If he borrows money or otherwise obtains credit, his incentives become skewed. He enjoys all the residual benefits but, given the limited liability of corporations and the availability of a discharge in bankruptcy, he does not bear all the losses. If the transaction by which the computer was sold was not actively hidden from the creditors and did not bear other suspicious attributes such as retention of possession, then the transfer should not be voidable. The remedy is needlessly crude and does not work to the creditors' long-term interest.

III. Foreclosure Sales

All debtors have an incentive to take risks that are not in the interest of either the creditors or the creditors and debtor collectively. There are any number of devices that respond to this basic agency-cost problem, such as security interests.[32] Fraudulent conveyance law can be understood as a response to the incentives for advantage-taking that exist whenever a debtor-creditor relationship arises. It is only a partial response, however, and in determining its proper scope, one must decide how this type of rule can reduce the agency-cost problem in a way that is cost-effective and in the interests of all the creditors. The application of fraudulent conveyance doctrine to foreclosure sales and leveraged buyouts illustrates the difficulties in this inquiry.

The inconsistency between an expansive ban on transfers of property of insolvent debtors for less than fair consideration, whether voluntary or involuntary, and the rules governing creditors' remedies is apparent from the recent controversy over whether to treat some foreclosure sales as fraudulent convey-

---

31. Baird & Jackson, *supra* note 18, at 104-09.

32. *See generally* Jackson & Kronman, *Secured Financing and Priorities Among Creditors*, 88 Yale L.J. 1143 (1979) (discussion of security interests as responding to creditor monitoring concerns).

HeinOnline -- 38 Vand. L. Rev. 843 1985

ances.[33] Assume Bank lends 100,000 dollars to Debtor and takes a security interest in an undeveloped piece of real estate that Debtor recently bought for 150,000 dollars. Several years later, Debtor's business collapses, and he becomes insolvent and defaults on his obligation to Bank. Bank exercises its default rights and eventually there is a foreclosure sale, at which the property is sold to a third party for 100,001 dollars. Six months later, Debtor files a bankruptcy petition. Debtor's trustee moves to set aside the foreclosure sale as a fraudulent conveyance. The argument he makes is as follows: Debtor was insolvent at the time of the sale, the sale was a transfer (albeit an involuntary one) either, simply, of Debtor's property or, somewhat more subtly, of Debtor's equity of redemption (his right to get the property back if he repaid Bank the 100,001 dollars), and the sale was for less than fair consideration or reasonably equivalent value. The last part of the argument turns on whether the property was in fact worth more than 100,001 dollars at the time of the foreclosure sale, but a foreclosure sale often brings less than what the debtor thinks it should. Finding an expert who will agree with the trustee on this point, thereby preventing summary judgment for Bank, should not prove difficult.

If one adopts the view that the prohibition on transfers for less than fair consideration—commonly termed section 4 fraudulent conveyances because of the Uniform Fraudulent Conveyance Act—merely implements, in rule fashion, the principle embodied in the prohibition on transfers intended to hinder, delay, or defraud creditors, then the problem of whether to treat foreclosure of a debtor's equity of redemption as a fraudulent conveyance is quite straightforward. Such foreclosure cannot be a fraudulent conveyance. Bank has given the world notice of its interest and merely is exercising rights that every other creditor knows Bank already has. Because Debtor was insolvent, Debtor may not have paid as much attention to the sale of the property as he would have if the chances were greater that he, rather than his creditors, would enjoy the difference between the price paid for the property and the amount of Bank's lien. Nonetheless, this is evidence of only debtor-passivity, not collusion between Debtor and Bank,[34] and debtor-passivity does not seem to be the stuff from which one can presume an intent on the part of Debtor to hinder, delay, or defraud his creditors.

---

33. *See* sources cited *supra* note 15.

34. *See* Jackson, *supra* note 10, at 780-83.

HeinOnline -- 38 Vand. L. Rev. 844 1985

But section 4 does more than function as a per se rule derived from section 7. Therefore, deciding whether a foreclosure sale can be a fraudulent conveyance when there has been only debtor-passivity requires identifying the principles underlying fraudulent conveyance law. It might be argued, as it increasingly has been, that debtor-passivity alone should be enough to trigger the provision. This approach would interpret the notion of a "transfer by the debtor" broadly and include within it transfers that involved no active participation by the debtor.[35] Before the foreclosure sale, Debtor had an asset that was worth 50,000 dollars to him. (He could pay Bank 100,000 dollars and obtain rights to a piece of property worth 150,000 dollars.) After the sale, the asset vanished and Debtor gained nothing in return. The injury to the creditors is the same regardless whether Debtor actively colluded with Bank or whether he simply did nothing while the foreclosure sale was taking place. Under this view, the foreclosure sale should be set aside because the extinguishing of the debtor's right of redemption (and the vesting of all rights in the real estate in the purchaser) is a "transfer" of property that disadvantages the creditors as a group. This transaction is different from a repayment of one of Debtor's obligations to which the other creditors could not object because a simple preference does not diminish the assets available to the creditors as a group. The difference is that in this case the property Debtor is losing is more valuable than the debt that is being repaid. Hence the total amount received by the creditors as a group diminishes.

Yet this approach suffers from several problems. As we have shown, a rule that looks simply to whether the creditors are as well off after a transfer as before is, as a principle, overbroad and must be articulated in some narrower fashion. Moreover, this transaction historically was not considered a fraudulent conveyance in the absence of collusion between Bank and Debtor.[36] Section 4 of the Uniform Fraudulent Conveyance Act and the analogous provisions of the Bankruptcy Code are subject to the interpretation that fore-

---

35. The Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, §§ 421(i), (j)(1), 463(a)(1), 98 Stat. 333, amended 11 U.S.C. § 101(41) (now § 101(48)) to pick up involuntary transfers. Proposed UNIF. FRAUDULENT TRANSFER ACT § 1(12) (Proposed Official Draft 1984) also expressly covers involuntary transfers. This is criticized in Jackson, *supra* note 10, at 780-83.

36. *See* Michel v. J's Foods, Inc., 99 N.M. 574, 661 P.2d 474 (1983); 1 G. GLENN, *supra* note 2, § 214a, at 366-68 (discussion of "collusive" foreclosure); *cf.* Ozias v. Renner, 78 Ohio App. 164, 64 N.E.2d 326 (1945) (mere inadequacy of price at public sale insufficient to set aside transaction).

HeinOnline -- 38 Vand. L. Rev. 845 1985

closure of a debtor's equity of redemption might be a fraudulent conveyance, but one easily can argue that that would be an incorrect interpretation. Neither statute's language compels the interpretation. In the case of section 4, one can argue that there is not a "transfer" because the extinguishment of Debtor's contingent property interest is not a "transfer" of that interest[37] any more than the failure to exercise an option or the termination of a lease is a transfer of property from one person to another.[38] Under both section 4 and section 548 of the Bankruptcy Code, one can argue that the price realized at a properly conducted foreclosure sale is always for "fair consideration" or "reasonably equivalent value."[39]

Choosing between the two possible interpretations (as well as deciding how to amend either the Uniform Fraudulent Conveyance Act or the Bankruptcy Code) should begin with an inquiry into why a foreclosure sale ever should be subject to judicial scrutiny after the fact. The problem is a well-known one. The price realized at a foreclosure sale often is well below the price that might have been obtained if someone had invested energy in courting buyers and dickering with them. But protecting the rights of the debtor in a foreclosure sale through fraudulent conveyance law may be counterproductive. One effect of a rule that subjects all foreclosure sales to the possibility of being set aside at some later time may be to depress the price realized at these sales still further. Potential buyers at foreclosure sales will be afraid that a low-priced sale will cause a court to find a fraudulent conveyance. Anyone who buys at foreclosure sales in a world in which such sales are fraudulent conveyances when a court after the fact finds the price too low will pay even less for the property. He can no longer be sure that he will be able to enjoy any appreciation in its value.[40]

Rules governing the sale of collateral are a compromise between facilitating secured credit and protecting the interests of the

---

37. *See In re* Madrid, 725 F.2d 1197, 1200-01 (9th Cir. 1984). Because of a 1984 amendment to the Bankruptcy Code, it may be difficult to argue this under 11 U.S.C. § 548. *See* Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, § 421(i), 98 Stat. 333. *But see supra* note 14 (discussion of legislative history of 1984 amendments).

38. *See* UNIF. FRAUDULENT TRANSFER ACT § 8(f)(1) (Proposed Official Draft 1984). *But see In re* Ferris, 415 F. Supp. 33 (W.D. Okla. 1976) (holding that a lease cancellation might be a fraudulent conveyance).

39. *See In re* Madrid, 21 Bankr. 424 (Bankr. 9th Cir. 1982), *aff'd on other grounds*, 725 F.2d 1197 (9th Cir.), *cert. denied*, 105 S. Ct. 125 (1984); *In re* Strauser, 40 Bankr. 868 (Bankr. N.D. Ohio 1984). This is the approach of the UNIF. FRAUDULENT TRANSFER ACT (Proposed Official Draft 1984). *See id.* § 3(b) & comment 4.

40. *See* sources cited *supra* note 25.

HeinOnline -- 38 Vand. L. Rev. 846 1985

debtor and those who have claims against him. Part 5 of Article 9, which establishes the procedure that secured creditors must follow, is a good example of one type of compromise. The gist of Article 9 seems to be that a secured creditor who repossesses collateral and jumps through the proper procedural hoops need not worry about second-guessing over whether the price realized was sufficient.[41] The assumption is that an adequate price follows from adequate procedures—including public sale requirements—often enough so that more is to be lost than gained from litigating the adequacy of the price after the fact. This is especially true given the uncertainty that such litigation might cast over the entire transaction and the resultant effect that uncertainty itself will have on the sales price.

One can argue whether the conclusion in Article 9 is correct. These rules may provide too little protection to a debtor and his other creditors. But particularly given the rules themselves, it seems unlikely that fraudulent conveyance statutes ever were intended to be a part of this balance between a secured creditor on the one hand and the debtor and his other creditors on the other.[42] Hence, it seems unwise to conscript those laws for this purpose now. They are not part of the off-the-rack terms that govern the problem. Most fraudulent conveyance statutes were passed long before rules governing the sale of collateral were created, and the statutes never applied to noncollusive foreclosure sales until decades after the sale-of-collateral rules were adopted. There is no evidence in the interim that creditors thought this kind of problem warranted the fraudulent conveyance remedy. There is no evidence of a need for such a preformulated rule. Introducing a broad prohibition on transfers for less than fair consideration in this case extends a general standard into an area in which a specific rule already has been promulgated without any evidence that creditors think such a prohibition is worth its costs. A careful balance already has been struck that is designed to address *exactly* the same problems it is now argued should be attacked through fraudulent conveyance laws.

To be sure, the costs that foreclosure sales impose on creditors of an insolvent (and often passive) debtor might be substantial.

41. U.C.C. § 9-504 (1978). A number of courts, however, are unable to accept this principle and use § 9-507 to reexamine the fairness of the price. This trend is criticized in Schwartz, *The Enforceability of Security Interests in Consumer Goods*, 26 J. L. & ECON. 117 (1983).

42. *See* 1 G. GLENN, *supra* note 2, § 214a; Jackson, *supra* note 10, at 777-86.

These costs are of two sorts. First, a foreclosure sale, like any other action that repays a particular creditor, results in fewer assets being available for others. Assume Debtor has 100 dollars in assets and owes two creditors 100 dollars each. If Debtor repays Creditor *A* 100 dollars or if Creditor *A* repossesses the assets or reduces its claim to judgment and has the sheriff levy on the assets, Creditor *B* is made worse off (although the creditors as a group are not). Preferring one creditor over another, without more, however, is not a fraudulent conveyance.[43]

Such a transfer does "delay" and "hinder" those creditors who remain unpaid. The debtor has received nothing for having made the transfer, and the remaining creditors are less likely to be paid in full. But a simple preference of one creditor over another cannot be a transaction that one creditor can set aside. As long as no collective proceeding has been commenced, each creditor must look after his own interests. If Debtor owes 100 dollars to Creditor *A* and 100 dollars to Creditor *B* and has a piece of property worth 100 dollars, the creditor who will be paid is the one that acts the swiftest. If Creditor *A* recovers 100 dollars, it makes no sense to treat the transaction as a fraudulent conveyance and to allow Creditor *B* to levy on the asset. As long as no legal rule forces creditors to cooperate, there is no reason to protect Creditor *A* or *B*. Outside a compulsory, collective proceeding, treating simple preferences as fraudulent conveyances would not prevent one creditor from being paid at the expense of the other. It merely would prefer the creditor who was second in time rather than the one who was first.[44] A simple preference makes some creditors worse off, but it does not make the debtor better off nor does it necessarily disadvantage the creditors as a group. Preferences do undermine collective proceedings, and, accordingly, it is clear why preferences generally are prohibited only in bankruptcy or other collective proceedings.

---

43. *See* 1 G. GLENN, *supra* note 2, at 1 ("[T]he preference materially differs from the fraudulent conveyance, because it sins, not against the single creditor's right of realization, but only against the collective right, of the creditors as a class, that arises when their debtor becomes insolvent."). *Compare* Jackson Sound Studios, Inc. v. Travis, 473 F.2d 503 (5th Cir. 1973) (late filing of security interest by mother of debtor's president constituted a fraudulent conveyance) *with* Epstein v. Goldstein, 107 F.2d 755 (2d Cir. 1939) (preferential transfer to wife not a fraudulent conveyance, even if husband intended to defraud other creditors). *But cf.* UNIF. FRAUDULENT TRANSFER ACT § 5(b) (Proposed Official Draft 1984) (deeming preferences to insiders when the debtor is insolvent to be fraudulent conveyances).

44. *See* Smith v. Whitman, 39 N.J. 397, 402, 189 A.2d 15, 18 (1963); Shelley v. Bootbe, 73 Mo. 74 (1880).

HeinOnline -- 38 Vand. L. Rev. 848 1985

Individual creditor remedies, however, make other creditors worse off for another reason besides the fact that money which might have gone to them is transferred to someone else. This second and frequently neglected cost is the expense and wastefulness of the individual creditor remedies themselves. Assume in the above example that Debtor's assets are worth 150 dollars. Regardless of whether Creditor *A* reduces its claim to judgment or exercises its Article 9 self-help remedies, Debtor and Creditor *B* are made worse off because Creditor *A*'s efforts to obtain 100 dollars will deplete more than 100 dollars of Debtor's assets. Debtor may spend resources resisting Creditor *A*'s collection efforts. He may be bound to pay Creditor *A*'s costs of enforcing its claim. Debtor and Creditor *A* may spend too few resources trying to obtain the highest possible value for the assets.[45] Finally, even if Creditor *A* takes only 100 dollars worth of assets, the remaining assets may no longer be worth 50 dollars. This would be the case, for example, if Creditor *A* had a security interest in a machine worth 100 dollars and Debtor had 50 dollars worth of dies that were tailor-made for that machine. Although Debtor or Creditor *A* might have been able to sell the entire package of the machine and the dies for 150 dollars, the dies without the machine might be worth only 10 dollars.

The costs of these individual debt-collection devices are largely independent of whether Creditor *A* is secured or unsecured and of whether Creditor *A* obtains payment by repossession or by judicial process. These costs exist whether Debtor actively cooperates or is completely passive. When these costs are large enough, a bankruptcy proceeding is in order. Indeed, these costs justify the bulk of bankruptcy laws.[46] But the imposition of these costs on a debtor and his other creditors is part and parcel of a legal regime in which individual creditors are permitted to and, indeed, must safeguard their own interests. In this regime, other creditors are exposed to two types of risks: the risk that others will be preferred and the risk that the act of preferring another will increase their costs. The fraudulent conveyance remedy—voiding the transaction—is not the appropriate one for this problem. If either cost looms too high, the remedy of the creditors is to file a bankruptcy petition and collectivize the process.

Foreclosure of a debtor's equity of redemption and the sale of

---

45. *See* Jackson, *supra* note 10, at 781.

46. *See* Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857, 859-71 (1982).

HeinOnline -- 38 Vand. L. Rev. 849 1985

property at a sheriff's sale following levy and execution impose identical costs on an insolvent debtor's other creditors. Neither transaction is a fraudulent conveyance because the preference cost and the collection cost they impose are necessary when individual creditors must pursue their own remedies. If the conditions are ripe for a collective proceeding when the foreclosure sale is to take place, the debtor should be put into bankruptcy. But if the conditions are not ripe, the transactions that take place under an individual debt-collection regime should be respected as long as they are properly conducted under the specific rules that govern them.[47] In a world such as this, general creditors have a greater burden of monitoring their debtor so that they can act (either by pursuing individual remedies or by joining with other creditors in a bankruptcy petition) than they would if a general standard protected them and put others at risk of a debtor dissipating his assets. But monitoring a debtor and his general financial condition is precisely what general creditors are able to do effectively. Those that cannot monitor effectively have other alternatives available to them, such as taking a security interest.[48]

IV. The Leveraged Buyout

Assume that Firm owes its general creditors 4 million dollars and has no secured debt. Firm's managers decide to acquire it, and the old shareholders agree to sell their shares for 1 million dollars. The managers put up 200,000 dollars of their own money and borrow 800,000 dollars from Bank. They agree to give Bank a security interest in all of Firm's assets to support the loan. The managers then proceed to use that money to buy the stock in the hands of all the shareholders. When the transaction is over, the managers own all the stock, the old shareholders are cashed out, and Firm has 4.8 million dollars in debt. The general creditors take a second priority position to Bank. As a result, the pool of assets available to satisfy their loans is 800,000 dollars smaller.

There are any number of ways to structure the transaction so that the money the managers borrow actually goes to Firm and never actually is in the hands of the managers. For example, one

47. Unif. Fraudulent Transfer Act § 6 (Proposed Official Draft 1984) similarly would pick up late recordings of mortgages and delayed perfection of security interests as fraudulent conveyances. We think that this change is unsound. The transfer might be preferential, but it should not he fraudulent. *See* Jackson, *supra* note 10, at 783-86.

48. *See* Jackson & Kronman, *supra* note 32, at 768-77; Schwartz, *supra* note 41, at 124-39.

HeinOnline -- 38 Vand. L. Rev. 850 1985

could divide the transaction into three separate deals: (1) The managers acquire a few shares of Firm's stock; (2) Firm borrows 800,000 dollars; and (3) Firm reacquires all the stock in the hands of the nonmanager shareholders. Under this approach, one could argue that Firm received 800,000 dollars in return for incurring an 800,000 dollar secured obligation. Courts, however, typically have had no difficulty construing such a segmented transaction as one deal. Courts will not allow the labels that interested parties place on their own transactions to control the rights of third parties. Firm has incurred an obligation (it has promised Bank 800,000 dollars) and made a transfer (it gave Bank a security interest in all its property) without getting anything in return (the 800,000 dollars went to the old shareholders).

Even under the narrowest view of fraudulent conveyance law, the leveraged buyout may be a fraudulent conveyance.[49] The managers and the old shareholders are made better off (by virtue of having a highly leveraged investment) and the general creditors are made worse off. The transaction "hinders" the creditors in the sense that it leaves them with fewer assets than before, and this may be the intent behind the transaction. In that case, the transaction could be attacked using section 7 of the Uniform Fraudulent Conveyance Act. But before determining whether a leveraged buyout should be treated as a section 7 fraudulent conveyance, which requires a messy inquiry into intent, the transaction should be examined to see whether it falls within any of the other existing sections. There are two sections containing per se rules that might lead to the characterization of the leveraged buyout as a fraudulent conveyance. One, embodied in section 4 of the Uniform Fraudulent Conveyance Act, provides that any transfer made by a debtor while insolvent without receiving fair consideration is a fraudulent conveyance. In a better world, a leveraged buyout never would run afoul of this provision. If the old shareholders and managers were informed fully (which, of course, they are not), the price paid for the stock would be the difference between the value of all the assets of the firm and all the liabilities. If the assets were worth less than the liabilities, the managers would not be willing to pay a positive price for Firm.

In a world in which information is imperfect, however, it may not be clear whether Firm is solvent. Indeed, even if liabilities exceed assets at fair valuation, the stock still might trade for a posi-

49. *See* United States v. Gleneagles Inv. Co., 565 F. Supp. 556 (M.D. Pa. 1983).

HeinOnline -- 38 Vand. L. Rev. 851 1985

tive price because of the possibility that the value of the assets might prove larger than expected or the liabilities less.[50] If the managers are mistaken and buy out the shareholders of Firm when it is insolvent, the leveraged buyout seems to fall within section 4.

Another per se rule, embodied in section 5 of the Uniform Fraudulent Conveyance Act, may reach the leveraged buyout, even when the transaction does not render Firm insolvent but simply leaves it with "an unreasonably small capital." Assume that before the buyout, Firm has assets of 5 million dollars and liabilities of 4 million dollars (as the purchase price of 1 million dollars suggests). After the transaction, Firm still has assets of 5 million dollars, but now it has liabilities of 4.8 million dollars. A firm that is this highly leveraged arguably is too thinly capitalized.

As a matter of sound practice, lawyers must ensure that a firm acquired in a leveraged buyout is not insolvent or rendered insolvent and that managers and others put up enough capital so that the firm is not too thinly capitalized.[51] An important conceptual question is whether a leveraged buyout in fact presents fraudulent conveyance problems or comes under a per se rule that turns out to be overbroad as applied to this particular case. A firm that incurs obligations in the course of a buyout does not seem at all like the Elizabethan deadbeat who sells his sheep to his brother for a pittance.[52]

The question, in other words, is whether a corporate debtor that incurs additional debt in a leveraged buyout can be presumed either to be engaging in a manipulation by which it (or its shareholders) will profit at its creditors' expense or in some other transfer that its creditors would almost always want to ban. At one level, the answer to this question is straightforward. This transaction does hinder the general creditors of Firm. After the transaction, the general creditors are less likely to be paid. Before the

50. For example, if Firm owed its creditors $100 and its only asset was a lottery ticket that had a one chance in ten of paying $200 and nine chances in ten of paying nothing, Firm wonld he insolvent (it has an asset worth $20 and liabilities of $100), but its total stock still would trade for $10 because there is a one-in-ten chance that all the creditors will be paid off and $100 will be left over.

51. Lawyers also face obstacles imposed by other legal principles. For example, various state corporation codes forbid distributions to shareholders while a firm is insolvent. *See, e.g.*, CAL. CORP. CODE § 501 (West 1977) (prohibiting distributions to shareholders if the corporation is, or is likely to become, unable to meet its liabilities as they mature). While such rules do not affect the rights of Bank, they might not allow the old shareholders to keep the money they receive from the transaction.

52. *See* Clark, *supra* note 12, at 544 (comment on thin capitalization).

HeinOnline -- 38 Vand. L. Rev. 852 1985

transaction, a 1 million dollar cushion protected the general creditors. After the buyout, the general creditors had only a 200,000 dollar cushion. If Firm lost only a few hundred thousand dollars, the general creditors would discover that they would not be repaid in full.

Moreover, Firm, or more precisely, its owners (the old and new shareholders), benefit to the extent that the general creditors are disadvantaged. Before the transaction, the shareholders as a group had invested 1 million dollars to enjoy the profits of a firm with assets worth 5 million dollars. After the transaction, the shareholders as a group have 200,000 dollars at risk (instead of 1 million dollars), yet they still enjoy the profits generated by assets of 5 million dollars.[53] Their investment of course is riskier, but a portion of these risks has been passed on to the general creditors. To the extent that the general creditors are made worse off by facing a riskier secured loan, the beneficiaries must be the shareholders.

It thus might seem a good thing that these transactions appear to trigger sections of existing fraudulent conveyance statutes. But we doubt this is the case. These transactions do not seem to be clearly to the detriment of creditors, nor did we always see creditors treating such transactions as events of default in their loan agreements, even before the issue was moved to the domain of fraudulent conveyance law. With the buyout may come more streamlined and more effective management. Among other things, a going-private transaction may save the costs of complying with relevant federal securities statutes.

A leveraged buyout is analogous to the simple case in which the firm issues new preferred debt and then uses the proceeds as a dividend for the existing shareholders. Debt instruments commonly control this conduct. If in a particular case those creditors who were in a position to control this conduct did not, one might conclude that these creditors should not be able to set this transaction aside. If they had the knowledge and the sophistication to control such conduct, but did not, there seems to be little reason for fraudulent conveyance law to control it for them. Indeed, as long as these creditors were not controlling this kind of debtor misbehavior through other kinds of monitoring devices, one might infer that none of the other creditors should be able to set it aside

53. Because of higher debt service, the profits of the firm will be somewhat less, but this reduction is almost certain to be offset by the shareholders' investment being so much smaller.

HeinOnline -- 38 Vand. L. Rev. 853 1985

either. Although they may not actually have confronted the issue, their interests and those of other, better positioned creditors ought to coincide. As long as the creditors who could bargain and prevent the buyout do not (or do not ensure that they are cashed out when the buyout takes place), one might infer that the fraudulent conveyance remedy did not advance the interests of all the creditors.

If creditors who bargained did limit the ability of the debtor to incur preferred debt to create dividends for shareholders, one might argue that the fraudulent conveyance remedy is an appropriate off-the-rack term that creditors should presumptively have. A difficulty with this approach, however, is that the fraudulent conveyance remedy is very hard to contract out of. Even if it were in the interests of everyone that the leveraged buyout take place, a debtor would not be able to ensure that the transaction would be immune to a fraudulent conveyance attack. In bankruptcy, the trustee has the power to set aside the entire transaction, even if at the time of the actual transaction every existing creditor waived its right to set the transaction aside.[54] It may make sense for the trustee to have the power to set aside fraudulent conveyances without looking to the rights of any actual creditors. The costs of establishing the rights of actual creditors may not be worth the benefits of having a rule that is more finely tuned. Nevertheless, the inability of creditors to contract around the fraudulent conveyance remedy when it is in their interest may suggest that fraudulent conveyance law should be applied in bankruptcy to a narrow range of cases in which there is little chance that creditors would find the transfer in their interest. In those cases in which it is not clear whether creditors would want to prevent the activity, all the creditors may be protected if a single one prohibits the transaction. The fraudulent conveyance remedy is far easier to contract into than it is to contract out of.

V. Conclusion

Ultimately, it is the inability of parties to opt out of fraudulent conveyance law that leads us to think that its reach should be limited. Fraudulent conveyance law should never apply to arms-length transactions, even if it appears after the fact that the debtor's actions injured the creditors. A broader rule than this one might pick up more cases of fraudulent behavior by debtors and

54. 11 U.S.C. § 548; *see* Kindom Uranium Corp. v. Vance, 269 F.2d 104 (10th Cir. 1959).

HeinOnline -- 38 Vand. L. Rev. 854 1985

might allow fewer transactions that creditors would want to prohibit, but it would do so only at the cost of preventing some desirable transactions from taking place. A broader rule subjects parties who bargain noncollusively and in good faith to the risk that a court later will find that the buyer paid too little. The uncertainty such a rule imposes makes debtors and creditors as a group worse off. When an individual engages in a financial transaction with multiple parties (as in the case of an insider guarantee or a leveraged buyout), the transaction generally should not be viewed as a fraudulent conveyance provided that the transferee parted with value when he entered into the transaction and that the transaction was entered in the ordinary course.[55]

55. This conclusion is reached with respect to insider guarantees in Comment, *supra* note 13.

HeinOnline -- 38 Vand. L. Rev. 856 1985