The Latent Efficiency of Fraudulent Transfer Law

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I. Introduction

A creditor holding a claim against a debtor typically holds the right, subject to the debtor's default, to obtain a judgment against the debtor, liquidate the debtor's assets, and apply the proceeds against his claim. If the debtor's assets are insufficient to satisfy the creditor's claim, the creditor is usually, but not always, out of luck. Under limited circumstances, a creditor can reach property the debtor transferred to a third party and apply the value of such property to satisfy his claim. The creditor can undo the transfer and obtain the property or its value from the transferee as though the debtor had never transferred it.

The circumstances under which creditors can undo or "avoid" a transfer of the debtor's property, deprive the transferee of the value of the property, and apply such value to satisfy their claims are the subject of fraudulent transfer law.

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Section 548 of the Bankruptcy Code, the uniform state laws, and the common law rules collectively comprising fraudulent transfer law define the range of avoidable transfers similarly. Avoidable transfers fall into two classes: (1) those by which the debtor intends to "hinder, delay or defraud" its creditors, called "actually fraudulent" transfers; and (2) those that occur for less than reasonably equivalent value and when the debtor is insolvent, regardless of the debtor's intention, called "constructively fraudulent" transfers.

Which attributes of these two classes of transfers distinguish them from the universe of all investments the debtor may make remains something of a mystery. Commentators on fraudulent transfer law explain that these actually or constructively fraudulent transfers unjustly deprive creditors of assets that otherwise would be available to satisfy their claim and thus ought to be avoidable. Thus, a transfer ought to be avoidable whenever it is actually or constructively fraudulent, and a transfer is actually or constructively fraudulent because it ought to be avoidable. This explanation reveals a gap where the normative purpose of fraudulent transfer law should be.

During the last two decades, creditors have challenged intercorporate guarantees, leveraged buyouts, and foreclosure sales as avoidable, fraudulent transfers. Whether transfers of the debtor's property in these contexts ought to...
be avoidable has become the subject of debate among commercial law commentators. So far, no commentator has rendered a completely satisfying explanation of why creditors ought to be able to avoid certain transfers but not others.

The predominant view has a strong moralistic flavor. Its proponents understand fraudulent transfer law as achieving justice between unsecured creditors and reprobate debtors. But justice in complex, commercial transactions is a slippery fish, and provides no meaningful guidance as to whether a particular transfer ought to be avoided. Achieving justice for creditors comes at the expense of transferees who deserve justice as well.

The competing theory is economic. Its proponents, most notably Professors Douglas Baird and Thomas Jackson, focus on the nature of the contractual relationship between the debtor and his creditors. They contend that fraudulent transfer law ought to mimic the hypothetical bargain the affected parties would make regarding the allocation of loss from the debtor's insolvency if they could bargain costlessly with each other. To this end, they observe that creditors would not want the power to avoid all transfers that turn out unfavorably. At the same time, creditors would not want to give up all power to avoid a transfer. Although Baird and Jackson's economic approach is an important advancement over moralist theories, it is incomplete. It does not explain the transferee's role in the hypothetical bargain, or where along the continuum of possible avoidance rules the hypothetical bargain would be struck.

The purpose of fraudulent transfer law is to allocate loss caused by the debtor's insolvency to the party who could have avoided such loss more cheaply. Both creditors and transferees can acquire and act on information about the challenged transfer to avoid loss. In most circumstances, creditors can avoid loss more cheaply than transferees because creditors have a relative advantage in acquiring, processing, and acting on information about the likelihood and magnitude of loss if their claims become uncollectible. Under some circumstances, however, transferees can avoid loss more cheaply than creditors. The set of actually or constructively fraudulent and thus avoidable transfers should consist of those transfers for which the transferee was likely able to have avoided loss more cheaply than creditors. The statutory definitions of avoidable transfers, with their focus on value inequivalence on exchange and the insolvency of the debtor, actually do serve as a means of limiting avoidance to those transfers for which the transferee, not creditors, could have avoided loss for less.

Part II of this article sets out the fraudulent transfer rules and explains in basic terms how they work. It then examines and criticizes the prevailing normative explanations for fraudulent transfer law. Part III explains the

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respective abilities of creditors and transferees to avoid loss and the economic purpose of the rule that permits creditors to undo some transfers of the debtor's property at the expense of transferees. Part IV of this article reveals how the definitions of actually and constructively fraudulent transfers can be understood as identifying those transfers in which the transferee is likely to be able to avoid the loss more cheaply. Part V considers some implications of this economic perspective on fraudulent transfer law.

II. THE LIMITS OF MORALITY AS JUSTIFICATION FOR AVOIDANCE

A. DESCRIPTIVE CONTOURS

Fraudulent transfer law divides avoidable transfers into two general categories; those that are actually fraudulent and those that are constructively fraudulent. The actual fraud ground for avoidance has its roots in the Statute 13 Elizabeth. To establish actual fraud as a grounds for avoidance, a challenger must show that the debtor intended that the transfer "hinder, delay or defraud" his creditors.

Professor Peter Alces diplomatically notes that drafters of modern fraudulent transfer statutes have not been able to improve on the prohibition in the Statute 13 Elizabeth against those actually fraudulent transfers by which the debtor intended to "hinder, delay or defraud" creditors. The Bankruptcy Code incorporates virtually the same language into its avoidance statute. The trustee may avoid any transfer or assumption of an obligation "if the debtor voluntarily or involuntarily made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became ... indebted." The UFCA and the UFTA similarly preserve the Statute 13 of Elizabeth's language. The UFCA classifies as avoidable all conveyances made with the "actual intent, as distinguished from intent presumed in law, to hinder, delay, or defraud either present or future creditors." The UFTA provides that transfers made and obligations incurred by the debtor "with actual intent to hinder, delay, or defraud any creditor of the debtor" are avoidable.

It is not immediately apparent what relevance the debtor's attitude toward his creditors has on the ultimate allocative question. Nor is it clear, even after

6. See supra note 5. The origins of fraudulent transfer law may predate the Statute 13 of Elizabeth. See generally Glenn, supra note 1, at §§ 58-61(d); 1 Joseph Story, Commentaries on Equity Jurisprudence §§ 474-77 (14th ed. 1918).
7. See supra note 2.
9. 11 U.S.C. § 548(a)(1) (1994). It is beyond ken how even the most evil-hearted debtor could involuntarily transfer property with actual intent to hinder, delay, or defraud a creditor.
10. UFCA § 7 (1918).
12. See, e.g., Kennedy, supra note 2, at 335 (noting the irrelevance of the transferor's mental state).
centuries of litigation, what attitudes toward creditors are sufficiently malevolent
to constitute an intention to hinder, delay or defraud them. Any transfer that
the debtor intentionally undertakes that increases the risk of uncollectibility to
creditors indicates at least a general intention to hinder creditors. Courts
finding actual fraud on the part of a debtor have done so based on ad hoc,
subjective judgments about the debtor’s or transferee’s “good faith,” the
“adequacy” of consideration, and the debtor’s financial condition at the time of
the transfer.

Perhaps because the debtor’s subjective intention toward creditors is both
difficult to discern and unenlightening, courts have never required direct proof of
his intention to establish an actually fraudulent transfer. Beginning with
Twyne’s Case, fraudulant transfer cases reveal a pattern of circumstances that
courts treat as surrogate proof of the requisite debtor intent. These circum-

13. See Zaretsky, supra note 3, at 1170, 1172 n.28. Professor Zaretsky asks but does not
answer what it means to intend to hinder, delay or defraud creditors. It is not clear whether a
debtor’s generous intention toward a transferee also reveals intention to hinder, delay, or defraud
505, 509-11, 544 (1977) (observing the debtor’s “moral” obligation not to make gifts while
insolvent); Baird & Jackson, supra note 5, at 831-32; Robert K. Rasmussen, Comment, Guarantees

14. See Baird & Jackson, supra note 5, at 834 (“Every transfer [the debtor] makes that has the
effect of making an asset less like cash benefits the debtor at his creditors’ expense.”). For example,
suppose a farmer uses loaned capital to purchase chickens that later died. The investment of cash
for chickens increases the risk to the loaned capital and injures creditors. Although the farmer did
not intend that the chickens die, she harbored a general intention to hinder creditors because she
intended to purchase chickens notwithstanding the fact that the purchase would increase risk of
nonpayment to creditors.

15. Courts applying the actual fraud ground for avoidance typically proclaim that the outcome
turns on the facts and circumstances of each case. For example, in In re Duque Rodriguez, 77 B.R.
936 (Bankr. S.D. Fla. 1987), the court held that the debtor’s transfer two days prior to bankruptcy
was the product of actual intent to hinder, delay or defraud “by inference from the facts, particularly
the insolvency of the debtor, the impending pressure from his creditors, the absence of consideration,
the debtor’s relationship to the defendant/transferee and the pattern and timing of this and related
transfers made by the debtor.” Id. at 937. See also Kapila v. Hamouil (In re Gateway Invs. Corp.),
152 B.R. 354 (Bankr. S.D. Fla. 1993); White v. Lundby (In re McGuirt), 162 B.R. 630 (Bankr.

16. The statutory requirement that the debtor intend to defraud, hinder or delay his creditors
interposed the intractable problem inherent in all quests for subjective mental state. Only the rare
honest but malevolent debtor admits she intended the transfer in question to hinder, delay or defraud
creditors. See, e.g., Allison v. Mildred, 307 S.W.2d 447, 453 (Mo. 1968) (“Experience discloses that
[fraudulent] grantors and grantees do not openly admit the facts when called into court.”). But see
In re Stevens, 112 B.R. 175 (Bankr. S.D.Tex. 1989) (debtor testified that he renounced his inheritance
to prevent his unsecured creditors from recovering). See generally Kennedy, supra note 2, at 538.


(1919); UFTA Prefatory Note, 7A U.L.A. 639, 639 (1984); 4 Collier on Bankruptcy ¶ 548.02(5) (15th
ed. 1986).
stances have come to be known as the "badges of fraud." The badges are a list of characteristics that, in some combination, indicates "actual fraud." The fraud-indicating characteristics fall into four groups: (1) the existence of a familial or agency relationship between the transferor and the transferee; (2) the concealment of the transfer from creditors; (3) the receipt by the transferor of property on exchange less valuable than that the transferor gave up; and (4) the transferor's precarious financial condition or insolvency at or upon the transfer.

Modern fraudulent transfer statutes have created the second ground for avoidance which is independent of the debtor's subjective intention and known as "presumptive" or "constructive" fraud. These statutes define as avoidable those transfers of the debtor's property made: (1) "without a fair consideration" and (2) when the debtor was: (i) insolvent at the time of the transfer or became insolvent as a result of it; (ii) thinly capitalized; or (iii) intending not to pay his debts as they became due. The presence of the latter two characteristics of


20. See, e.g., UFTA § 4(b)(1) (1984) ("transfer ... to an insider"); (11) ("debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor").

21. See, e.g., UFTA § 4(b)(2) (1984) ("the debtor retained possession or control of the property transferred after the transfer"); (3) ("the transfer ... was ... concealed"); (6) ("the debtor absconded"); (7) ("the debtor removed or concealed assets").

22. See, e.g., UFTA § 4(b)(8) (1984) ("the value of the consideration received by the debtor was [not] reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred").

23. See, e.g., UFTA § 4(b)(4) (1984) ("before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit"); (5) ("the transfer was of substantially all the debtor's assets"); (9) ("the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred"); (10) ("the transfer occurred shortly before or shortly after a substantial debt was incurred").


25. Fair consideration is given for property or an obligation: (a) When in exchange for such property, or obligation, as a fair equivalent therefor, and in good faith, property is conveyed or an antecedent debt is satisfied, or (b) When such property, or obligation is received in good faith to secure a present advance or antecedent debt in amount not disproportionately small as compared with the value of the property, or obligation obtained.

UFCA § 3.

26. See UFCA §§ 4-8 (1918). The UFCA recognizes several forms of fraudulent transfers. A transfer is voidable if made: (1) with actual intent to hinder, delay or defraud an existing or subsequent creditor, § 7; (2) for an inadequate consideration by one who is, or is thereby made, insolvent, § 4; (3) for inadequate consideration by an inadequately capitalized business, § 5; (4) for inadequate consideration by one intending to incur or believing that he would incur debts beyond his ability to pay them as they mature, § 6. Section 8 creates a fifth type of fraudulent transfer in the
actual fraud, value inequivalence on exchange, and the transferor's insolvency, without proof of collusion or concealment, are sufficient to establish constructive fraud. The drafters of the UFCA justified the addition of constructive fraud as grounds for avoidance as a means of rectifying those decisions that stretched the Statute 13 Elizabeth to "cover all conveyances which wrong creditors, even though the actual intent to defraud does not exist." The Bankruptcy Code and the UFTA in turn adopted the UFCA's constructive fraud ground for avoidance.

It is now beyond dispute that constructive fraud provides a ground for avoiding transfers where the debtor did not obviously intend malice toward his creditors, or at least did not resort to collusion, concealment or deceit. Both Bankruptcy Code section 548 and the UFTA define "transfer" to embrace involuntary transfers of the debtor's property such as those that occur at a judicial foreclosure sale. So defined, a transfer can be constructively fraudulent and thus avoidable not only without proof of the debtor's fraudulent intent, but without any involvement of the debtor at all. For this reason, relatively limited context of partnership transfers to partners. It treats a transfer of partnership property by an insolvent partnership to a partner as fraudulent regardless of the consideration given. UFCA § 8(a) (1918).

27. UFCA Prefatory Note. The drafters observed: "There are many conveyances which wrong creditors where an intent to defraud on the part of the debtor does not in fact exist. In order to avoid these conveyances, the courts have called to their assistance presumptions of law as to intent, and in equity have pushed presumption of fraud as a fact to an unwarranted extent; with the result that, while in the main the decisions under the facts do justice, the reasoning supporting them leaves much to be desired." 7A U.L.A. 427, 428 (1918). See also F.S. Wait, Fraudulent Conveyances and Creditors' Bills 440-41 (3d ed. 1897) (criticizing decisions that injured honest debtors and purchasers due to amorphous rules regarding weight of various badges of fraud).


29. The drafters of the UFCA explained the constructive fraud ground for avoidance as a means of reversing transfers that wrongly injured creditors even in the absence of debtor fraud. UFCA Prefatory Note. The drafters wrote: "There are many conveyances which wrong creditors where an intent to defraud on the part of the debtor does not in fact exist . . . . Certain conveyances which the courts have in practice condemned, such as a gift by an insolvent, are declared fraudulent irrespective of intent." 7A U.L.A. 427, 428 (1918).


constructive fraud has become the grounds of avoidance of choice especially in commercial transactions where concealment or deceit on the part of the debtor or collusion between the debtor and transferee cannot be proven. Actual fraud as a grounds for avoidance remains significant because it affords a means to avoid a transfer without proof of the transferor/debtor's insolvency or value inequivalence on exchange, but upon proof of collusion or concealment alone.32

B. Normative Theory

The function of fraudulent transfer law is to mediate the conflict between unsatisfied creditors on the one hand and those transferees to whom the debtor transferred property on the other. Unsecured creditors believe they are entitled to any positive difference between the hypothetical value ("true value")33 of the property at the time of the transfer and the price the transferee paid for the property ("transfer price"). In contrast, the transferee believes that he is entitled to retain the positive difference as the fruit of his dealings with the debtor. Call this difference the "transfer loss" from the perspective of creditors, and "transfer profit" from the perspective of transferees. For example, if a transferee paid $500 for the transferred property which creditors claimed had a true value of $1,000, the transfer would yield a transfer loss to creditors and a transfer profit to the transferee equal to $500.

Under conditions of perfect competition, there would be no positive difference between true value and transfer price. The true value for the property

32. See, e.g., Gendron v. Chicago & North Western Transp. Co., 564 N.E.2d 1207, 1214-15 (Ill. 1990); West Realty Corp. v. Commissioner, 418 F. Supp. 1274, 1279 (S.D. N.Y. 1976) ("Actual intent... to hinder, delay, or defraud either present or future creditors' is sufficient to render conveyances fraudulent, and even 'fair consideration' cannot save conveyances made under the circumstances prescribed."); Elliot v. Elliot, 365 F. Supp. 450, 454 (S.D. N. Y. 1973) ("Where this motivation is shown, (intent to hinder, delay, or defraud) the conveyance is fraudulent even though the grantor is solvent, and even if he receives fair and adequate consideration."). If the creditor can establish actual intent to defraud, the burden of proof shifts to the transferee to show that the fraud was harmless because the debtor's assets were not depleted. In re Acequia, Inc., 34 P.3d 800 (9th Cir. 1994); Gendron, 564 N.E.2d at 1215. Moreover, if the transferee received an actually fraudulent transfer, he must return all that he received from the debtor, rather than just the difference between what he paid and what he received. Id. See 11 U.S.C. § 548(c) (1994). Such a transferee does not "take for value and in good faith." The distinction between actually and constructively fraudulent transfers is also relevant on the issue of creditor standing. Both pre-transfer and post-transfer creditors have standing to seek avoidance of an actually fraudulent transfer. Under state law, post-transfer creditors can avoid constructively (but not actually) fraudulent transfers only upon proof that the debtor made the transfer with a view toward incurring liability beyond its ability to pay. See generally Alces, supra note 8, at 5-116. Under Bankruptcy Code section 548, the trustee can avoid transfers on behalf of the class of unsecured creditors regardless of whether they obtained their claims pre- or post-transfer. 11 U.S.C. § 548(a) (1994).

33. "True value" is coined to simplify discussion. It refers to the value of the property, usually determined in retrospect, against which the price on exchange (transfer price) is compared. Depending on the circumstances, true value can be fair market value, fair liquidation value, or any other measure of value at variance with the transfer price.
would be the market clearing price on exchange. The notion of transfer loss or profit is useful when a transfer occurs under conditions other than perfectly competitive market exchange, for example, when the parties act with other than complete information, or not at arms-length. It is in this imperfect realm that fraudulent transfer law operates.

Avoidance of a fraudulent transfer enables a challenging creditor to collect a debt the debtor cannot pay. But, unlike typical debt enforcement devices which enforce the credit agreement and impose loss on the debtor, fraudulent transfer law operates in the absence of private agreement to impose loss on transferees. It is useful to creditors only when the debtor cannot bear the loss his investments imposed on creditors, that is, when the debtor is insolvent or otherwise unresponsive.34

Notwithstanding the distinction between fraudulent transfer law and typical debt enforcement, a creditor's power to avoid fraudulent transfer has traditionally been understood as a creditor's remedy to enforce debt.35 This erroneous conception of fraudulent transfer law as a debt enforcement mechanism renders the impact of avoidance on transferees theoretically insignificant. Undeniably, however, when a creditor successfully avoids a transfer, the transferee loses the transfer profit. Fraudulent transfer law does, in some cases, reimburse certain qualifying transferees for the transfer price.36 But, even with such reimbursement, avoidance of a transfer does not leave the transferee indifferent.37 Upon avoidance, any transferee, even a donative transferee who incurred no out-of-pocket loss on the transfer (i.e., transfer price equals zero), loses the opportunity to exploit it. The value of this opportunity to exploit is reflected in the true value of the property. The creditor's recoupment on avoidance is equal to the transfer profit, which, in turn, is the measure of the transferee's loss.38

35. See, e.g., Jack Williams, Revisiting the Proper Limits of Fraudulent Transfer Law, 8 Bankr. Dev. J. 55, 80 (1991) ("The purpose of fraudulent transfer law is the preservation of the debtor's estate for the benefit of its unsecured creditors."). See also First Nat'l Bank v. Minnesota Ull. Contracting, Inc., 110 B.R. 414, 420 (D. Minn. 1990). Historically bankruptcy law has been understood as a law of collection. See James A. MacLachlan, Handbook of the Law of Bankruptcy 15 (1956); 2 Joseph Story, Commentaries on the Constitution of the United States § 1113, at 50 n.2 (4th ed. 1873). Professors Thomas Jackson and Douglas Baird have suggested an alternative approach. They evaluate bankruptcy laws for their capacity to achieve an efficient allocation of loss among affected constituencies. See, e.g., Thomas Jackson, Bankruptcy, Non-Bankruptcy Entitlements and the Creditors' Bargain, 91 Yale. L.J. 857 (1982); Baird & Jackson, supra note 5, at 835-36. This article adopts the latter approach. See infra part III.
36. Generally speaking, transferees of avoidable transfers who gave value in good faith are entitled to a lien against the transferred property or set off against the creditor's recovery equal to the value such transferee gave. 11 U.S.C. § 548(c) (1994). See infra notes 127-129 and accompanying text.
37. Baird & Jackson, supra note 5, at 842 (exposing the fallacy of the transferee's indifference).
38. Loss borne by the transferee is lost opportunity or, in the language of contract damages, lost expectation. See Fuller & Perdue, supra note 3, at 54. When a court determines that a transferee
Given the misunderstanding that fraudulent transfer law functions as nothing more than a creditor’s tool to enforce debt, it is not surprising that scholars paid little attention to its normative purpose. Courts explain fraudulent transfer law as a means of enlarging or preserving the debtor’s estate for the benefit of creditors. Scholars similarly justify the avoidance of transfers by reference to the “rights” of creditors to “fair” distribution of their debtor’s assets. Having invoked justice as the justification for avoidance, commentators typically relegate further inquiry into the purpose of fraudulent transfer law to the realm of the heretic.

Twenty years ago, Professor Robert Clark explained fraudulent transfer law as a kind of commandment promoting ideals of “Truth,” “Respect,” “Evenhandedness,” and “Nonhinderance.” He understands fraudulent transfer rules as a kind of natural law, not so much imposed by the statutes and cases but rather codified as “a part of normative custom.” The underlying moral domain of fraudulent transfer law is, in his view, universally axiomatic.

More recently, Professors Douglas Baird and Thomas Jackson approached the purpose of fraudulent transfer law in economic as opposed to purely moral terms. Their article appeared just as questions regarding the scope of acted in bad faith, the transferee cannot set off the price it paid against the value of the transferred property. 11 U.S.C. § 548(c) (1994). In these circumstances, the transferee loses more than just lost expectation. See infra notes 127-128 and accompanying text (re partial avoidance).


40. 1 Glenn, supra note 1, § 45, at 73; Kennedy, supra note 2, at 535; Williams, supra note 35, at 64 (proposing that fraudulent transfer law is justified by a “reasoned creditors” harm heuristic protecting creditors from “significant harm” unless the diminution is not “unjust”). But see Baird & Jackson, supra note 5 (proposing an economic justification for fraudulent transfer law as reflecting a hypothetical bargain among affected parties).

41. Professor Glenn noted that the purpose of fraudulent transfer law as protection for creditors of their collective right to a fair distribution of their debtor’s estate was so obvious as to need no exposition. 1 Glenn, supra note 1, at 73.

42. Clark, supra note 13, at 506-17. Professor Clark frankly views fraudulent transfer law in a moral dimension. He described fraudulent transfer rules as “standards of right and wrong in debtor-creditor relationships . . . . The relation between debtors and creditors is as old as civilization, is only slightly less significant than relationships among family members, social classes, and races, has always occupied a substantial portion of the resources of legal systems, and has always been regulated in the commercial context by attitudes and emotions of a decidedly moral sort.” Id. at 510 n.17.

43. Id.

44. Although Clark’s theory is decidedly moralistic, he suggests that his analysis is not necessarily in conflict with an economic justification for fraudulent transfer law. Clark, supra note 13, at 510 n.17, 542 n.98. See also Richard A. Posner, A Theory of Negligence, 1 J. Legal Stud. 29, 33 (1972) (where measures necessary to avert loss would have consumed excessive resources, the defendant cannot be condemned for not taking such measures).

45. Baird & Jackson, supra note 5, at 836.
fraudulent transfer law had come to the forefront in cases involving challenges to foreclosures of a debtor's equity of redemption and leveraged buyouts.46 They criticized what they perceived as an emerging trend to interpret the reach of fraudulent transfer law too broadly in favor of unsecured creditors.47

Baird and Jackson explained the relationship between creditors and equity claimants in economic terms. They observed that equity claimants prefer a fraudulent transfer law too broadly in favor of unsecured creditors. They then considered what fraudulent transfer law might look like if it were the product of an efficiency maximizing, hypothetical "creditors' bargain."50 Fraudulent transfer law "should be viewed as a species of contract law, representing one kind of control [over debtor conduct] that creditors generally would want to impose and that debtors generally would agree to accept."51 Baird and Jackson did not, however, articulate what the hypothetical bargain would look like among the range of possibilities.52

46. Baird & Jackson, supra note 5, at 833.
47. They noted: "[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. . . . [W]e believe this . . . principle is too broad." Id.
49. Baird & Jackson, supra note 5, at 834.
50. Id. at 835-36. See also Thomas Jackson, Avoiding Powers in Bankruptcy, 36 Stan. L. Rev. 725 (1984); Jackson, supra note 35 (elaborating Jackson's "creditors' bargain" theory underlying Jackson and Baird's conclusion in the 1985 article).
51. Baird & Jackson, supra note 5, at 836. Baird and Jackson's economic analysis of fraudulent transfer law focuses on the hypothetical bargain between creditors and the debtor. This Article adopts their evaluative premise. Fraudulent transfer law ought to mimic the hypothetical bargain of rational affected parties. The affected parties, however, are the challenging creditors and transferees.
52. See id. at 836-43; Elizabeth Warren & Jay Westbrook, The Law of Debtors and Creditors 148 (2d ed. 1992) (observing that Baird and Jackson "believe that there is a point up to which current law blocks more harmful transactions than good ones, but they do not identify that point or provide an approach to its identification, either analytically or empirically"). Baird and Jackson's analysis of the proper domain of fraudulent transfer law provoked strong reaction, particularly with respect to leveraged buyout transactions. They considered 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." Baird & Jackson, supra note 5, at 852. If so, they argued that a rule permitting creditors to avoid such a transfer would be consistent with the hypothetical bargain theory, and thus efficient. They concluded that, such leveraged financing transactions do not "seem to be clearly to the detriment of creditors." Id. at 853. Several commentators disagree. See, e.g., Williams, supra note 35, at 59; Kathryn V. Smeyser, Going Private and Going Under: Leveraged Buyouts and the Fraudulent Conveyance Problem, 63 Ind. L.J. 781, 784 (1988). See also Valdais Lumber Supply, Inc. v. Byrne, 100 B.R. 127 (Bankr. D. Mass. 1989).
Professor David Carlson, in an article promisingly entitled “Is Fraudulent Conveyance Law Efficient?,” bristled at Baird and Jackson’s suggestion that fraudulent transfer law may serve an economic purpose. Carlson concluded that efficiency analysis is unhelpful to understand fraudulent transfer law. But he did not address the possibility that it can be interpreted in a way that tends to minimize the total loss that creditors and transferees as a group bear upon the debtor’s insolvency and thereby create incentives for efficient conduct. Carlson, like Clark, prefers subjective notions of morality as justification for fraudulent transfer law. He contends that it “redistributes power from positionally strong debtors to positionally weak creditors on the principle that repayment of debt is privileged over the debtor’s freedom to alienate his property.”

The intrinsic wrongfulness, unreasonableness, or immorality of particular transfers of the debtor’s property remains an appealing justification for avoidance among commentators. A few years ago, Professor Jack Williams proposed a “reasoned creditors’ harm heuristic” to answer the question of which transfers ought to be avoidable. Avoidability should turn on whether the contemplated transfer “significantly harm[s] the unsecured creditors at a time when their debtor is in a precarious financial position . . . .” If so, the next inquiry should be

53. Carlson, supra note 34.
54. Carlson’s tone reveals a contempt for economic analysis of legal issues generally. E.g., id. at 644. See also Duncan Kennedy & Frank Michaelman, Are Property and Contract Efficient, 8 Hofstra L. Rev. 711 (1980), cited by Carlson, supra note 34, at 644 n.4 (citing as inspirational).
55. Carlson purports to evaluate the efficiency of fraudulent transfer law by comparing “a world in which the fraudulent conveyance remedy is part of debtor-creditor law . . . . to a world in which creditors are not permitted to pursue property in the hands of any third party.” Carlson, supra note 34, at 658. If the affected parties would choose a world with fraudulent transfer law, then, according to Carlson, we can assume that fraudulent transfer law is efficient. Carlson asks whether there would be a net efficiency loss if the state of affairs changed from a “fraudulent conveyance world” to a “no fraudulent conveyance world.” To answer the question, he compares “gains to debtors and donees against the losses to creditors and debtors” from such a move. Id. at 670. He concludes that “in a fraudulent conveyance world, the debtor or donee might have sufficient utilities to justify an economic argument for the repeal of fraudulent conveyance law . . . . [B]y no means can we assume that fraudulent transfer law would always be preferred in a perfect market.” Id. at 664.
56. Id. at 644.
57. Id. at 644 n.5. See also David G. Carlson, Leveraged Buyouts in Bankruptcy, 20 Ga. L. Rev. 73, 77-78 (1985).
58. See, e.g., Kennedy, supra note 2, at 562 (fraudulent transfer law condemns injurious transfers); Williams, supra note 35, at 59 (observing that “most commentators agree that the thrust of fraudulent transfer law is to protect [against] the unjust diminution of the debtor’s estate”).
59. Williams, supra note 35, at 64.
60. Id.
whether the diminution of the debtor’s estate was “unjust.” Williams candidly noted that the first inquiry is “scientific,” the second, “artistic.”

Most recently, Professor Barry Zaretsky revived Baird and Jackson’s economic thesis. Zaretsky recognized that fraudulent transfer law serves an economic function that is related to creditors’ efforts to control the debtor’s risk-taking activity. He justified fraudulent transfer law as a mechanism by which creditors ought to be able to avoid those of their debtor’s transfers that posed unreasonable risks. Zaretsky’s focus on the extent to which the challenged transfer imposed unreasonable risk on creditors restates Baird and Jackson’s observation that certain risky investments are most certainly reasonable from the creditors’ perspective, even if they turn out to be losers. Zaretsky explained that unreasonably risky investments are those that creditors cannot be presumed to have authorized ex ante.

Neither Zaretsky nor Baird and Jackson offer a means of distinguishing transfers that creditors would have authorized (and thus ought not be avoidable) from those that creditors would not have authorized. Zaretsky proposes a yardstick of “reasonableness.” He offers that an investment is unreasonably risky when “there is a high probability that the transaction will inhibit the debtor’s ability to pay its creditors.” Zaretsky’s emphasis on the reasonableness of risk as a means of differentiating avoidable from unavoidable transfers offers scant improvement on Clark’s naked notions of morality, without a consensus on how to identify those risks that are reasonable. Moreover, like Baird and Jackson, Zaretsky does not explain the allocative effect of fraudulent transfer law between creditors and transferees. Zaretsky asks but does not answer why fraudulent transfer law, in some cases, places the interests of the transferor’s creditors over the interests of an “innocent” transferee.

Even if a consensus regarding the fairness of particular transfers existed, fairness is an unstable basis on which to predicate commercial relations. A moral justification for fraudulent transfer law is a spanner in the works of capitalist profit maximization. Debtors do not typically act with charity or benevolence toward their creditors. Indeed, firm managers are generally obliged to maximize return on equity, not debt. Given the legal and economic

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61. Id.
62. Id.
63. Baird & Jackson, supra note 5, at 834 (“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.”).
64. Zaretsky, supra note 3, at 1174.
65. Id. at 1176. This definition has little value, because it is all-encompassing. It describes all investment activity that either increases the riskiness of the debtor’s enterprise or lowers the expected value of the debtor’s assets.
66. Id. at 1177 n.44.
67. See, e.g., William W. Bratton, Jr., The Economics and Jurisprudence of Convertible Bonds, 1984 Wis. L. Rev. 667, 731 (“no fiduciary duties directly arise between [a debtor] and its creditor because no agency or trust relationship exists between them”); Kham & Nate’s Shoes No. 2, Inc. v.
environment in which debtors and creditors operate, it is hypocritical to label
debtor self-interest as immoral or unjust.

The usefulness of commercial morality, if such a thing exists, to determine
the avoidability of transfers is further suspect because commercial morality is
subject to change, indeed rapid change. Traditional conceptions of debt
financing as an evil to be avoided have given way to a neutral view of
debt. The moral approbation associated with insolvency and bankruptcy has
eroded, leaving only a temporary blot on a credit record where ignominy and
ruin once were. Consider the impact of Article 9 of the Uniform Commercial
Code governing secured transactions on attitudes regarding the immorality of
"floating" and "blanket" liens. It is not surprising that the application of
fraudulent transfer law is controversial in the context of commercial transactions
that evoke competing moral conclusions.

The rules establishing the characteristics of an avoidable transfer, and the
consequences of avoidance on a transferee, are labyrinthian. But they can be

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First Bank of Whiting, 908 F.2d 1351, 1357 (7th Cir. 1990) (holding that loan contracts do not create
fiduciary relationships). Corporate directors owe the corporation obligations of care and loyalty. 3
rev. 1994). In discharging their duty of care, directors normally maximize the value of equity. See,
_e.g._, Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 176 (Del. 1986) (directors
should not inhibit bids for corporate shares). Corporation law recognizes the problem of controlling
divergent incentives upon the insolvency of the corporation. Courts typically observe that when a
transaction renders a corporation insolvent, the rights of creditors become paramount. _E.g._, Pepper
v. Litton, 308 U.S. 295, 60 S. Ct. 238 (1939); McCandless v. Furland, 296 U.S. 41, 56 S. Ct. 133
L. Rev. 1165, 1168 n.11 (arguing that fiduciary rights should be extended to public bondholders even
prior to the borrower's insolvency).

68. _See, e.g._, J. Fred Weston, _The Scope and Methodology of Finance_ 23-24 (1966) (firms
should incur long-term debt only when absolutely necessary and retire it as quickly as possible).

69. _See, e.g._, William W. Bratton, Jr., _Corporate Debt Relationships: Legal Theory in a Time
of Restructuring_, 1989 Duke L. J. 92, 164-65 ("Today's mainstream observers drop the moralism and
lessen anxiety by viewing debt as a neutral financing instrument, one of many devices that can
support low-cost production."). Debt is a claim against the firm and differs from equity in that it is
fixed and has a higher priority. Kenneth Lehn et al., _The Economics of Leveraged Takeovers_, 65
ratios arise because of differences in taxes and bankruptcy costs).

70. Economic theorists on corporate finance think of bankruptcy not in moral terms but rather
as a contractual problem caused by a cash shortfall. _E.g._, Lehn et al., _supra_ note 69, at 174-75.
Some commentators think that corporate reorganization under Chapter 11 of the Bankruptcy Code
has become a tool of corporate managers to extract value from the corporation for themselves. _E.g._,
Michael Bradley & Michael Rosenzweig, _The Untenable Case for Chapter 11_, 101 Yale L.J. 1043

71. _See UCC § 9-204, cmt. 2 (1996); 1 Grant Gilmore, Security Interests in Personal Property
§ 11.7 (1965).

72. Barry Zaretsky observed that fraudulent transfer law has, in recent years, been applied to
transactions that are "not generally objectionable." Zaretsky, _supra_ note 3, at 1177 nn.45-46.

73. _See generally_ Glenn, _supra_ note 1; Gerald K. Smith & Frank R. Kennedy, _Fraudulent
understood as a means of identifying the cheaper “loss avoider” between creditors and transferees over a wide range of circumstances. This perspective requires abandoning moral judgment regarding which party is more worthy or innocent. Instead, it focuses on the relative ability of creditors and the transferee to avoid loss.

III. THE ALLOCATIVE FUNCTION OF FRAUDULENT TRANSFER LAW

A. The Credit Agreement: Allocation of Loss Between the Creditor and Debtor

Assuming risk-neutrality for the sake of simplicity, the expected value of a creditor’s claim is equal to the present value of the claim discounted by the probability that the creditor will ultimately collect it. The present value of a claim is the most that the creditor can ever recover and is fixed by the credit agreement between the debtor and creditor. In contrast, equity claimants hold a variable residual interest in the debtor. Upon liquidation of the debtor, they are entitled to a distribution of any amount remaining after creditors have been paid in full. Thus, creditors are primarily interested in maintaining the likelihood that they will collect their fixed claim. Equity claimants are primarily interested in maximizing their residual return.

This distinction in priority between fixed and residual claims against the debtor create a divergence in incentives between creditors and equity claimants regarding the investment strategy of the debtor. The divergence is typical of relationships where one person or a group of persons (in this case, creditors) engages another person or group of persons (in this case, equity claimants and their agents, firm managers) to perform some service and delegates decision-making authority to such person or persons.

note 8. This Article does not reprise the exposition of fraudulent transfer law contained in these and many other works. Rather, it proposes a means of synthesizing this material by suggesting efficient allocation of loss as a first principle.

74. The expected return of an investment is the “arithmetic mean of the possible outcomes of an investment with each such outcome weighted by the probability of its occurrence.” Victor Brudney & William W. Bratton, Cases and Materials on Corporate Finance 57 (4th ed. 1993).

75. The most the creditor can ever recover is the aggregate of all payments due over the life of the credit, including interest payments.

76. Residual claimants against the firm are customarily referred to as owners of equity although stockholders are no more owners than are other claimants against the firm such as bondholders or employees. Frank H. Easterbrook & Daniel R. Fischel, Voting In Corporate Law, 26 J. L. & Econ. 395, 396 (1986); Nicholas Wolfson, The Modern Corporation 40-41 (1984).


In the particular context of a credit relationship, equity claimants want to maximize the positive payoff of the firm's assets without regard to the effect of the investment on the net present value of the firm. They prefer higher risk and higher return investments because as residual claimants they will capture all the net return if the project succeeds. If the project fails, however, equity claimants bear loss only to the extent of the value of equity. Creditors will bear all the remaining loss.

In contrast, creditors prefer investments that confine the risk that the firm will fail (and they will not be paid) to the level of risk for which such creditors have been compensated. Creditors know there is no return without risk. Creditors willingly undertake a risk that the debtor will be unable to repay the borrowed capital. They do not bear risk for free, however. They charge interest. The trick for creditors is to determine a rate of interest that will compensate them for bearing the maximum level of risk to which the debtor will put the borrowed capital over the life of the loan.

Once the creditor and the debtor agree on an interest rate, the debtor has an incentive to expose the borrowed capital to greater risk than the level fixed for purposes of calculating interest. As the debtor increases the riskiness of investment, the debtor increases his chance of positive return. Where the interest rate on borrowed capital does not vary perfectly with the riskiness of the debtor's enterprise, the debtor can take additional risk without paying creditors for bearing additional risk.

Debtors would love to behave in this opportunistic way, but most of the time they cannot get away with it. Creditors control the incentive of equity claimants to take risk greater than their ex ante estimated maximum level of risk by way of limitations on the debtor's conduct in the credit agreement. By a variety

80. Investment risk is independent of expected return. Consider two investments: Project A which will return between 5 and 15% with an expected return of 10%; and Project B which will certainly yield an expected return of 7%. Project B is less risky than Project A, even though Project B has a lower expected return than Project A. Mark Seldenfeld, Microeconomic Predicates to Law and Economics 70 (1996); Brudney & Bratton, supra note 74, at 57.
81. See Jensen & Meckling, supra note 78, at 334-37.
83. See Posner, supra note 82, at 503. Posner observed that a creditor will anticipate changes in the probability of default over the life of a loan and reflect such changes in the interest rate or, the lender may offer a short term or amortized loan (balance declines as a function of time). Id. at 503-04.
84. Baird & Jackson, supra note 5, at 834.
85. See, e.g., Baird & Jackson, supra note 5, at 835-36 ("[T]he debtor-creditor relationship is essentially contractual."); Posner, supra note 82, at 503-04; Steven L. Schwarz, Rethinking A Corporation's Obligations to Creditors, 17 Cardozo L. Rev. 647, 651 (1996). The costs of controlling the equity owner's divergent incentives are called agency costs. Jensen & Meckling,
of techniques, the debtor and creditor agree on the range of risks to which the debtor may expose the borrowed capital and create incentives for the debtor to honor that agreement. This conduct is known as "monitoring." Borrowing a term from the law of agency, the creditor authorizes the debtor to engage in a particular range of investment activity. If the debtor undertakes unauthorized investment activity, the credit agreement internalizes the loss to the debtor to the extent the debtor can absorb loss.

Suppose an individual, Debtor, borrows $10,000 from Creditor with the understanding that Debtor will invest the money in a piano that Debtor proposes to refurbish and sell and then repay Creditor at the end of one year. The piano refurbishment project has a 50% chance of yielding $18,000 and a 50% chance of yielding $9,000. If a single entity held all claims against the piano refurbishment project, that entity would calculate the expected value of the project to be $13,500. Assume Creditor charges Debtor interest that Debtor pays in advance in a lump sum sufficient to make the expected value of Creditor's claim against Debtor $10,000. Debtor, as holder of a residual claim, calculates the expected value of the piano refurbishment project based on what he expects will be left after he pays Creditor back, in this case, $3,500.

Now, suppose Debtor obtains an opportunity to trade the piano refurbishment project for a lottery ticket. The lottery ticket is riskier than the piano refurbishment project. It has a 10% chance of paying $252,000 but a 90% chance of resulting in a loss of the price of the ticket, which in this case is the expected value of the piano refurbishment project, $13,500. The expected value of the lottery ticket is thus $13,050, $450 less than the piano refurbishment project.

Even though foregoing the piano refurbishment project in favor of the lottery ticket reduces the expected value of Debtor's assets, Debtor has an incentive to buy the lottery ticket. The expected value of the lottery ticket to Debtor, as

\[ \text{Expected Value} = 0.5 \times 18,000 + 0.5 \times 9,000 = 13,500 \]

**supra note 78, at 308.** Jensen and Meckling note that agency costs arise in any situation involving cooperative effort, including the co-authoring of their paper, regardless of the existence of a formal agency relationship. Id.


87. Baird & Jackson, supra note 35, at 835. Jensen & Meckling, supra note 78, at 308, 337-39. Monitoring activity includes obligations imposed on the debtor to provide information, or that restrict its ability to engage in certain activities. It also includes observation and evaluation that creditors undertake themselves.

88. For example, a prospective purchaser of the piano refurbishment project would calculate its expected value as the sum of its expected outcomes—\( 0.5(18,000) + 0.5(9,000) = 13,500 \).

89. The amount of interest Creditor would charge would be an amount sufficient to compensate it for: 1) the risk that the piano refurbishment would fail to return the loaned capital (in this hypothetical, a 50% chance that Creditor will lose $1,000 or $500); 2) the time value of money; and 3) a competitively determined rate of return.

90. \( 0.1(252,000) + 0.9(-13,500) = 13,050 \).
holder of the residual claim, is $21,050. By investing in the lottery ticket, Debtor increases the value of his residual interest by $17,550. On the other hand, the expected value of Creditor’s claim falls by $9000. With the piano refurbishment project, the expected value of Creditor’s claim was $10,000. With the loaned capital invested in the lottery ticket, Creditor has only a 10% chance to recover $10,000, for an expected value of $1,000.

Creditors and debtors anticipate this problem of divergent incentives. Debtors agree to circumscribe their ability to act on their divergent incentive in exchange for reduction in the interest rate the creditor will otherwise charge. Indeed, debtors agree to limitations on their conduct up to the point that the cost of the limitation (expected lost opportunity) is no greater than the gain from a reduction in the interest rate creditors will charge reflecting the reduced risk. How much and what types of limitations debtors will undertake thus depends on the costs of the particular types of limitations and the reduction in risk of loss the limitation yields.

By promising not to engage in unauthorized risk taking, a debtor exposes himself to liability in the event of his breach. The effect of a debtor’s promises to limit his risk taking to the authorized level in the credit agreement is to shift to the debtor the risk of loss associated with his conduct and reduce the incentive for the debtor to engage in such conduct.

For example, returning to the foregoing hypothetical, suppose Debtor had promised Creditor he would not invest the loaned capital other than in the piano refurbishment project. If Debtor breaches that agreement by purchasing the lottery ticket, Creditor will declare the loan in default and ultimately foreclose on the lottery ticket to satisfy his claim. In this case, Debtor’s only asset is a lottery ticket with an expected value of $13,050. Assuming it can be sold costlessly for this amount, after satisfying Creditor’s claim Debtor will receive $3,050. Creditor’s ability to foreclose on Debtor’s assets in the event of Debtor’s default affects Debtor’s incentive to undertake risky investments. In this hypothetical, Debtor is $450 worse off having breached than he would have been if he stuck with the piano refurbishment project. The expected value of Debtor’s interest in the piano refurbishment project was $3,500 whereas his take after foreclosure on the lottery ticket would be $3,050.

The assertion that creditors can and do control the ability of their debtor to undertake risky investment strategies assumes that creditors have an opportunity to bargain with prospective debtors before extending credit. Of course, not all creditors are so fortunate. For example, tort claimants and tax and regulatory

91. The expected value of the lottery ticket to Debtor is the sum of the expected outcomes.
\[0.1(252,000 - 10,000) + 0.9(-3,500) = 21,050.\]

92. The expected value to Debtor of the piano refurbishment project is $3,500, whereas the expected value of the lottery ticket to Debtor is $9,900 for a difference of $6,400.

93. Costs of information about the riskiness of the debtor’s enterprise, and costs to supervise the debtor once the authorized range of risk is fixed vary among creditors. Moreover, the debtor can unilaterally alter those costs by act or omission. Posner, supra note 82, at 508.
authorities obtain fixed claims against the debtor, but these are not obtained by agreement. For these creditors, the costs of monitoring the debtor's risk taking by agreement are prohibitively high—they do not know who their debtor will be until it is too late to bargain about the allocation of loss from risky debtor conduct.\footnote{See, e.g., United States v. Tabor Court Realty Corp., 803 F.2d 1288, 1297 n.2 (3d Cir. 1986), cert. denied, 483 U.S. 1005, 107 S. Ct. 3229 (1987) (noting that involuntary creditors probably cannot contractually protect themselves).}

The presence of involuntary creditors does not, however, change the analysis of the debtor's extra-risky investment activity. If involuntary creditors could bargain with the debtor regarding his investment strategy, there is no obvious reason to believe that they would desire more control than voluntary ones. Involuntary creditors would prefer a rule that creates an efficient incentive for those creditors who can monitor against unauthorized debtor conduct to do so.\footnote{For a discussion of the significance of the presence of involuntary creditors to the hypothetical bargain analysis, see Baird & Jackson, supra note 5, at 835 n.20. Baird and Jackson note that the interests of consensual and involuntary creditors may not be entirely congruent. Certain actions by the debtor may disproportionately affect tort claimants (such as failing to take accident prevention measures). They note that in those instances, other legal rules as opposed to fraudulent transfer law may be better suited to impose monitoring burdens on voluntary creditors. Id. They also note that the issue of the peculiar interests of nonconsensual creditors is "a species of a larger inquiry" implicating a host of issues such as whether shareholder limited liability is appropriate against involuntary creditors. Id.}

If creditors could shift to equity claimants all risk of loss from opportunistic conduct, there would be no fraudulent transfer law. Creditors' resort to rights against the debtor, such as foreclosure, reduce equity claimants' incentive to engage in unauthorized risk-taking, but only to the extent that equity claimants can absorb loss. Creditors' ability to control equity claimants' incentive to take unauthorized risk diminishes as equity claimants have less to lose by breaching the credit agreement, that is, as the debtor approaches insolvency.

Insolvency of the debtor raises the familiar incentive problem of moral hazard.\footnote{See, e.g., Mark V. Pauly, The Economics of Moral Hazard: Comment, 58 Am. Econ. Rev. 531 (1968). See also Susan Rose-Ackerman, Inalienability and the Theory of Property Rights, 85 Colum. L. Rev. 931, 949-51 (1985) (characterizing fraudulent transfer law as a "modified property rule" solving a problem arising in principal-agent relationships).} Equity claimants, by virtue of the debtor's insolvency, are immune to losses arising from their investments. Thus, they have virtually no incentive to avoid such loss.\footnote{Owners of even insolvent debtors have some incentive to limit risk taking. Although they have no financial stake in the enterprise, equity claimants may attach value to their reputations as borrowers. This value remains at stake after the equity claimants' pecuniary interest is zero.} Moreover, equity claimants' immunity to loss occasioned by the debtor's insolvency may increase the probability that loss will occur.\footnote{Jensen & Meckling, supra note 78, at 334.}

Typical of moral hazard situations, equity claimants' incentive to undertake an investment that actually depletes the expected value of the debtor depends on...
their ability to externalize the loss to creditors.\textsuperscript{99} As long as the value of equity is positive and creditors can foreclose on the assets of the firm in the event the debtor engages in unauthorized risk-taking, the equity claimants bear loss in value to the firm to the extent of the value of their investment. Equity claimants against an insolvent debtor\textsuperscript{100} have an incentive to make an investment that has even the slightest chance of paying more than the outstanding debt regardless of the negative expected value to the debtor of the investment.\textsuperscript{101} If the investment succeeds, equity claimants increase the value of their interest from zero to some positive amount. If the investment fails, creditors absorb all the loss. To the extent that the equity claimants' stake in the firm before the investment is less than the total expected loss to the debtor from the investment, creditors cannot completely shift loss from the investment to equity claimants by way of foreclosure.

As the value of equity declines and the debtor approaches insolvency, the creditors' threat of default and foreclosure becomes an increasingly ineffective means of controlling unauthorized risk taking. Equity claimants can breach the credit agreement with virtual impunity. They have an incentive to act this way not because they are inherently evil or immoral, but because they are immune from loss.

Moral hazard is a two-edged sword. Although it presents an opportunity for equity claimants, the opportunity creates a contractual problem. Equity claimants' inherent ability to externalize risk to creditors as the debtor approaches insolvency increases the cost of credit. Because of moral hazard, the debtor cannot effectively confine the creditors' risk (and the cost of credit) by undertaking contractual promises. Creditors and debtors try to overcome the problem of moral hazard posed by the debtor's insolvency by a variety of techniques. For example, a creditor may obtain personal guarantees from shareholders or affiliated entities. But no monitoring device completely controls the divergent incentive of equity claimants. In other words, the probability of uncollectibility to creditors is always positive. After implementing all cost-

\textsuperscript{99} Commentators on fraudulent transfer law have observed this general phenomenon but have not identified the problem as one of moral hazard. See, e.g., McCoid, supra note 34, at 657 (an insolvent debtor, while hoping to pay his creditors, is "gambling with [his creditors'] money").

\textsuperscript{100} When the liquidation value of equity is zero, the assets of the firm are insufficient, or at most just sufficient, to pay the firm's debt obligations. For purposes of this discussion, a debtor in this condition is considered insolvent. On insolvency, see infra notes 142-151 and accompanying text and Alces, supra note 8, at 5-47-5-58.

\textsuperscript{101} Once the debtor has no stake in the firm, it has an incentive to make investments that actually deplete total wealth. See William A. Klein & John C. Coffee, Jr., Business Organization and Finance 255-58, 355-57 (5th ed. 1993); Smith & Warner, supra note 78, at 118-19. An investment that reduces the expected value of debt claims more than it increases the expected value of equity claims is inefficient in the sense that the owners of equity and debt taken as a group are worse off than they would have been had the investment not been made. For a numerical example, see Bebchuk & Fried, supra note 82, at 873-74. Bebchuk and Fried do not recognize the key condition of the debtor's insolvency in their hypothetical illustration of inefficient investment.
effective techniques to limit the likelihood of insolvency (and thus the moral hazard problem), creditors are left with unavoidable residual risk. Creditors will either invest in the acquisition of information to enable them to quantify and charge debtors for bearing such risk, or forego lending in situations where the costs of estimating and pricing for such risk outweigh the expected benefits.102

B. The Hypothetical Bargain: Allocation Between Creditors and Transferees

Why would a transferee, even hypothetically, ever agree to bear loss that, in the absence of an avoidance rule, creditors would bear? Putting aside for the moment who ought to bear loss caused by the debtor's inability to pay his debt, both creditors and transferees can take action to avoid or insure against such loss. The foregoing discussion explained how creditors can avoid loss by a variety of techniques that shift loss to equity claimants and thereby reduce equity claimants' incentive to undertake loss-producing transfers.

Transferees can also avoid loss. They can take into account the risk that a transfer will be avoided in the price they are willing to pay for transferred property. The risk that a transferee will have to surrender the transferred property at the insistence of disappointed creditors is like any other risk prospective purchasers assess in the process of determining the value of property to them. Transferees demand compensation for bearing such risk in the form of a reduction in the transfer price for the debtor's property.103 A transferee who knows he will have to surrender the transferred property if the transfer turns out favorably for him (and unfavorably for creditors) will be unwilling to pay anything for the property and will not undertake the transaction.

Suppose that an avoidance rule would nearly always impose loss on transferees. That is, creditors could easily avoid transfers of the debtor's property that turn out unfavorably for the debtor. The easier it is for creditors to avoid transfers, the more risky transfers become from the perspective of potential transferees. Of course, the riskier transfers are to transferees, the less risky loans are to creditors. Recall that creditors control risk by agreement with the debtor. They charge the debtor interest for bearing the residual risk. As creditors' risk declines, so too will the cost of credit to the debtor decline.

102. See Rose-Ackerman, supra note 96, at 950 (absent fraudulent transfer law, "[e]x ante the volume of loans would be inefficiently low and interest rates inefficiently high to take account of this possibility of hiding assets from creditors"); Posner, supra note 82, at 504 (debtor and creditor will find it difficult "to adjust the interest rate or other terms of the loan to reflect the possibility of the borrower's deliberately increasing the lender's risk"); Zaretsky, supra note 3, at 1174-75.

103. The risk that creditors can avoid a transfer after it occurs is like the risk that a parcel of real property might be zoned unfavorably to the purchaser after the transfer. The transferee in each case takes into account the risk in determining the value of the property at the time of the sale. See generally Charles J. Goetz & Robert E. Scott, Enforcing Promises: An Examination of the Basis of Contract, 89 Yale L.J. 1261, 1292-93 (1980).
Where an avoidance rule draws the line determines who, between creditors and transferees, will bear the loss equity claimants cannot. In addition to this distributive function, the location of the line affects the total amount of loss. A loss-minimizing, wealth-maximizing distribution allocates loss to the party who can bear it at the least cost.

If creditors and transferees could bargain expressly and costlessly for an avoidance rule, they would choose a rule that allocated loss to the party who could bear it more cheaply. A transferee would, hypothetically, be willing to bear loss in those circumstances where his costs were lower than the creditors’ costs. Such an agreement would minimize total loss (by optimizing precaution against loss), and maximize gains, which creditors and transferees would happily (albeit hypothetically) split among themselves.

Put another way, an avoidance rule requires transferees to insure creditors against some types of losses. If a covered loss occurs (one caused by an avoidable transfer), the transferee will bear the loss that creditors would otherwise bear. Returning to the hypothetical bargain, a transferee has an incentive to sell, and the debtor has an incentive to purchase from transferees, transfer insurance for the benefit of his creditors whenever the premium transferees charge is less than the value to the debtor of the reduction in interest rate creditors offer in response to the reduced risk. The premium transferees charge will be lower than the reduction in interest rate whenever transferees can bear risk more cheaply than creditors.

IV. FRAUDULENT TRANSFER LAW’S CAPACITY FOR EFFICIENT ALLOCATION

Fraudulent transfer law has endured since Elizabethan times. Perhaps its endurance is due to its capacity to allocate loss to the cheaper avoider. Fraudulent transfer rules define an avoidable transfer by reference to indicators of actual fraud and constructive fraud. This section first addresses the economic function of requisites common to both types of avoidable transfers—value inequivalence on exchange and the debtor’s insolvency. For avoidance on actual fraud grounds, these two requisites are sufficient but not necessary. For avoidance on constructive fraud grounds, they are both necessary and suffi-
Later, this section explains the economic significance of concealment or collusion in connection with a transfer. Concealment or collusion is a sufficient requisite for avoidance on actual fraud grounds, even in the absence of proof of value inequivalence or the debtor’s insolvency at the time of exchange.

A. Value Inequivalence

To establish that a transfer is avoidable on constructive fraud grounds, or as two of the badges of fraud relevant for proof of actual intent to defraud, a challenger must show that the transfer occurred: (1) in exchange for less than a reasonably equivalent value; and (2) at a time when the debtor was in or approaching a state of financial distress. A subsidiary element, the good faith of the transferee, is a lens that illuminates the first criterion, value inequivalency of the exchange. Additionally, the good faith, or lack thereof, of the transferee figures in the remedy available to a creditor who establishes that a transfer is otherwise avoidable.

The first element, the absence of reasonably equivalent value in exchange for the transferred property, requires a comparison between the value of the property transferred and that received in exchange. One value must be the reasonable equivalent of the other. If it is not and the debtor was insolvent at the time of the transfer, the transfer is constructively fraudulent and thus avoidable.

The traditional justification for the requirement of value inequivalence on exchange is to identify those transfers that unfairly injure creditors. A transfer for less than reasonably equivalent value, simply said, leaves creditors worse off than they were prior to the transfer and unable to satisfy their claims by resort to the debtor’s remaining assets. In application, the test for reasonable value equivalence on exchange is not the least bit simple.

The economic purpose of limiting avoidance to those transfers made in exchange for less than reasonably equivalent value is to identify those transfers

107. See supra notes 24-28 and accompanying text.
108. See infra notes 120-125 and accompanying text.
109. See infra notes 127-129 and accompanying text.
110. See, e.g., BFP v. Resolution Trust Corp., 511 U.S. 531, 536, 114 S. Ct. 1757, 1760 (1994) (determining whether amount of debt to senior lienholders, satisfied by foreclosure sale was the “reasonable equivalent” of “the worth of the real estate conveyed”). For a discussion of judicial interpretation of “reasonably equivalent value,” see Williams, supra note 35, at 79-82. Williams concludes that case law on reasonably equivalent value is “hopelessly confused.” Id. at 82.
111. See, e.g., 1 Glenn, supra note 1, § 195, at 348. Glenn identifies the purpose of the test for value equivalence as a means of determining “whether as a result of the debtor’s operations on the title to his property the creditor loses by reason of finding less to seize and apply to his claim.” Id. See, e.g., First Nat’l Bank in Anoka v. Minnesota Util. Contracting, Inc., 110 B.R. 414, 420 (D. Minn. 1990) (Purpose of value equivalence requirement is to conserve the debtor’s estate for the benefit of creditors).
which reduce the expected value of the debtor. Recall that equity claimants can externalize to creditors the loss from opportunistic investment strategy to the extent that the total loss in value of the debtor from the investment exceeds the value of equity claims. The requirement that the debtor be insolvent or rendered insolvent at the time of the transfer evaluates equity claimants' capacity to externalize loss to creditors. The requirement of value inequivalence tests whether the transfer reduced the value of the debtor in the first place.

For example, suppose a debtor transfers $10,000 cash for a silo of corn trading on the spot market at $6,000. The transferee knows that after the transfer the debtor is less wealthy by $4,000, and the transferee is wealthier by that amount. The transferee, and no doubt the reader, can identify this transfer as one which equity claimants are not likely to undertake if equity claimants will absorb all the loss.

When a transfer results in a loss to the transferor, the transferee is on notice that the transferor is not trading normally. More precisely, when such a transfer occurs, the transferee is on notice that the transferor is either acting altruistically, (i.e., giving away his own wealth), or opportunistically (giving away someone else's wealth because he can externalize the resulting loss to a third party).

Thus, value inequivalence on exchange indicates to the transferee that the transfer might be occurring under conditions of moral hazard, when equity claimants can externalize loss to creditors. But value inequivalence on exchange can be the product of altruism where the debtor is solvent and equity claimants absorb all the resulting loss.

Knowledge of value inequivalence without knowledge that the debtor can externalize loss does not clearly render the transferee the cheaper cost avoider. Accordingly, fraudulent transfer law requires proof of both value inequivalence and the debtor's insolvency.

In any event, the transferee's relative loss-avoiding advantage depends in part on the transferee's cheap access to information about the value-depleting consequence of the transfer. If the transfer turns out to be value-depleting later on, but the transferee could not have known it at the time, the value inequivalence provides no signal to the transferee and he has no such advantage. Or, if the transfer appeared to be an arms' length, mutually beneficial exchange at the time, but due to facts hidden from the transferee the value of the debtor declined as a result of the transfer, the transferee had no loss-avoiding advantage. Those transfers that are not for "reasonably equivalent value" should thus consist of the subset of transfers that deplete the value of the debtor in a manner obvious to a transferee.

112. See supra notes 96-101 and accompanying text.
113. When all expected gains and losses are internalized by the traders, the fact of an actual exchange between the parties constitutes the most reliable indicator of value equivalence. See, e.g., Melvin Aron Eisenberg, The Bargain Principle and Its Limits, 95 Harv. L. Rev. 741, 743-47 (1982); Richard A. Epstein, Why Restrain Alienation?, 85 Colum. L. Rev. 970, 972 (1985).
114. A creditor can control a solvent debtor's generosity by terms in the credit agreement that render gifts or dividends an event of default, thus imposing any loss on equity claimants.
As a threshold matter, this perspective clears confusion regarding whose opinion on value equivalence or inequivalence of the properties exchanged in the challenged transfer ought to prevail. Traditionally, value equivalence has been viewed from the perspective of creditors. But the creditors' view of relative value diverges from that of equity claimants. Moreover, both views diverge from that of the transferee, who can observe value equivalence only in relation to the effect of the transfer on the debtor, which is measured as the combined value of equity and debt claims. The transferee's view of value equivalence or inequivalence is the relevant one.

Because the incentives of creditors and equity claimants diverge, the "value" of property transferred, and that acquired in exchange, depends on who is making the inquiry. Creditors do not value the possibility that an investment will yield a huge payoff in the same way that equity claimants do. So, when creditors complain about a decline in value brought about by a transfer, they may be referring to an increase in riskiness and decrease in expected value of their claims, or a decline in expected value of the debtor (where the value of the debtor is the combined value of debt and equity claims), or both.

When a transfer reduces the expected value of the debtor, it necessarily increases the expected loss to creditors because creditors' claims become riskier. But not all transfers that increase expected loss to creditors also decrease the value of the debtor. A transfer can increase the riskiness of creditors' claims but have no effect, or even a positive effect, on the value of the debtor.

Return to the hypothetical transfer of the piano refurbishing project in exchange for the lottery ticket. Hold the odds constant but change the payoff on the lottery ticket so that Debtor has a 10% chance of winning $1,000,000 (instead of $252,000) and a 90% chance of losing the ticket price of $13,500. With this new, much higher payoff, the expected value of the ticket to a single holder of it would be $87,850. The trade of the piano refurbishment project for the lottery ticket would increase the expected value of Debtor from $13,500 to $87,850. Nonetheless, Creditor would still prefer the piano refurbishment project to the lottery ticket. Because Creditor has no interest in the potential payoff from the ticket in excess of $10,000, Creditor does not take that potential into account in his expected value calculation. The transfer of the piano refurbishment project for the lottery ticket merely increases the riskiness of Creditor's $10,000 claim and, therefore, reduces his expected value from $10,000 to $1,000. From the perspective of a single claimant, the transfer would increase the value of Debtor's assets. Because the transfer increased the risk of uncollectibility but did not change the magnitude of Creditor's claim, it decreased the expected value of Creditor's claim.

Without dispute, creditors are worse off when the expected value of their claims decline due to an increase in risk even though the expected value of their

115. See, e.g., UFTA § 3 cmt. 2 (1984) ("Consideration having no utility from a creditor's viewpoint does not satisfy the statutory definition of 'value'.").
116. .1($1,000,000) + .9(-$13,500) = $87,850.
debtor’s assets do not. Creditors do not necessarily resort to fraudulent transfer law to control this type of loss. As the foregoing discussion explains, creditors can control owners’ incentive to shift risk to creditors as long as equity claimants have a sufficient equity interest to absorb the loss. When an investment increases creditors’ risk of loss but does not decrease the value of their debtor, creditors are worse off, but they are as well-situated to shift their loss to equity claimants as they were prior to the transfer. Thus, for risk-increasing but not value-reducing transfers, creditors are not at a loss avoiding disadvantage relative to transferees. At least they are not at a disadvantage because of the transfer, absent collusion or concealment.

Fraudulent transfer law does in fact observe the significance of value disparity as a source of information to the transferee by requiring an examination of the “good faith” of the transferee as a part of the determination of value inequivalence on exchange. The UFCA defines “fair consideration” on exchange as requiring proof of the transferee’s “good faith.” “Good faith,” the critical subjective element, is itself undefined.

Both Bankruptcy Code section 548(2) and the UFTA drop the reference to the transferee’s good faith embodied in the UFCA definition of “fair consideration.” Instead, section 548(a)(2) and UFTA § 4(a)(2) require that the

117. The extraordinary circumstances are concealment, deceit or collusion or other events that increase the cost to creditors of detecting or responding to the transfer. See infra notes 154-155 and accompanying text.

118. See supra notes 88-93 and accompanying text. Baird and Jackson observed that “fair consideration” ought to be measured from the perspective of the debtors and creditors taken as a unit. Baird & Jackson, supra note 5, at 837. They did not explain why this should be so.

119. Creditors may be at a disadvantage vis-à-vis transferees in avoiding loss from risk increasing, but not value reducing, transfers if the debtor and transferee collude, or conceal the transfer from creditors. Such conduct increases creditors’ costs of detection of loss relative to transferees. See infra notes 154-155 and accompanying text.

120. In a note to the section defining “fair consideration,” the drafters remarked that cases weighing the sufficiency of consideration rendered in exchange turned on whether value disparity indicated fraudulent intent on the part of the transferor or collusion on the part of the transferee. The drafters 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.” National Conference of Commissioners on Uniform State Laws, Proceedings of the Twenty-Eighth Annual Meeting 352 (1918). See McCoid, supra note 34, at 644. See generally Note, Good Faith and Fraudulent Conveyances, 97 Harv. L. Rev. 495 (1983).

121. See supra note 25.

122. The legislative history is unhelpful as to why Congress adopted this change in language. The change to “reasonably equivalent value” from “fair consideration” effectively overturned cases decided under prior law that rendered otherwise unavoidable preferential transfers avoidable on fraudulent conveyance grounds solely because the transferee lacked good faith. See, e.g., Inland Sec. Co. v. Estate of Kirshner, 382 F. Supp. 338 (W.D. Mo. 1974); Burroughs v. Fields, 546 F.2d 215 (7th Cir. 1976). These cases both involved transfers to insiders during the period more than 90 days but less than one year prior to the filing of the bankruptcy petition. The Bankruptcy Reform Act expanded the avoidability of preferential transfers to encompass such transfers to insiders within one year prior to the petition. 11 U.S.C. § 547(b)(4)(B) (1994).
transferor receive "less than reasonably equivalent value in exchange for such transfer . . . "123 Notwithstanding the statutory deletion, the transferee’s good faith, or lack of it, remains relevant. Several courts have noted that characterization of value in exchange as a reasonable equivalent depends on a variety of factors, including the good faith of the transferee, the ratio of transfer price and fair market value, and whether the sale was an arms-length transaction between a willing buyer and a willing seller.124 These courts implicitly recognize that value disparity provides cheap information to transferees about the value depleting effect of the transfer on the debtor, which information is in turn relevant to transferees' cost to avoid loss.125

Whether a transfer actually depleted the value of the debtor is frequently difficult to determine, especially when the determination is made retrospectively, after the occurrence of the transfer. For example, suppose a debtor transfers a cow for a handful of magic beans. Whether the transfer of cow for beans depleted the value of the debtor depends on the respective expected values of the cow and the beans to the transferor and transferee at the time of transfer. Determination of the expected value of a project requires an estimation of the possible outcomes from the project and the probability that each outcome will occur.126 This information is costly to acquire. Moreover, costs of acquiring such information vary among valuers.

Fraudulent transfer law has developed a confusing response to those cases where what the transferee knows or should know about the transfer is ambiguous because either one or both of value inequivalence and moral hazard was costly for the transferee to determine.

123. In BFP v. Resolution Trust Corp., 511 U.S. 531, 114 S. Ct. 1757 (1994), the Supreme Court characterized the phrase "reasonably equivalent value" as "entirely novel," and a "neologism." 511 U.S. at 537, 114 S. Ct. at 1761. Section 548(d)(2)(A) defines "value" 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." 11 U.S.C. § 548(d)(2)(A) (1994). Section 3(a) of the UFTA defines value similarly: "Value is given for a transfer or an obligation if, in exchange for the transfer or obligation, property is transferred or an antecedent debt is secured or satisfied, but value does not include an unperformed promise made otherwise than in the ordinary course of the promisor's business to furnish support to the debtor or another person." UFTA § 3(a) (1984).


125. In Bonded Fin. Serv. v. European Am. Bank, 838 F.2d 890, 897 (7th Cir. 1988) (Easterbrook, J.), the court recognized that a transferee's "good faith" turns on whether the transferee had enough knowledge to prompt a reasonable person to investigate. See also Walbrun v. Babbitt, 83 U.S. 577, 582 (1872) (the transferee acts in bad faith if he "choos[es] to remain ignorant of what the necessities of his case required him to know").

126. For example, the expected value of the cow will depend on the likelihood that the cow can produce milk, offspring, meat or other products and the magnitude of gain in the event she so produces them. See Sherwood v. Walker, 33 N.W. 919 (Mich. 1887) (the case of Rose 2d of Aberlone, the famous not so barren cow).
Under the Bankruptcy Code, a transferee who did not acquire the transferred property "for value and in good faith" loses both the transfer profit and the transfer price on avoidance. 127 A transferee who acquired property in bad faith retains nothing but an unsecured claim against the debtor's estate for the price. A transferee who acquired property in good faith, even if the transfer is avoidable, is entitled to a lien against or a set off in the amount of the transferred property. 128 Thus, a transferee who did not exchange a "reasonably equivalent value" for the property, but who acquired the transferred property "for value and in good faith," may retain as against the challenger the value the transferee actually gave (adjudged to be less than a "reasonable equivalent") plus some out-of-pocket expenses. 129 The result is a compromise that returns the transfer profit for the benefit of unsecured creditors subject to a prior lien or set-off in favor of the transferee for the transfer price.

The statutory language assumes the possibility that a transferee could have been sufficiently in-the-know such that the value it gave was not a "reasonable equivalent," but sufficiently in-the-dark so that it otherwise acted "in good faith and for value." 130 This statutory compromise might be explained economically

127. 11 U.S.C. § 548(c) (1994). A bad faith transferee is entitled to an unsecured claim for the transfer price against the debtor's estate. Buffum v. Peter Barceloux Co., 289 U.S. 227, 53 S. Ct. 539 (1933). An unsecured claim against the debtor's estate is obviously less desirable than the set-off afforded a good faith transferee for value under § 548(c).

128. 11 U.S.C. § 548(c) (1994). The UFTA provides similar protection for a good faith transferee of an avoidable transfer. "If the judgment . . . is based upon the value of the asset transferred, the judgment must be for an amount equal to the value of the asset at the time of the transfer, subject to adjustment as the equities may require." UFTA § 8(c) (1984). See also UFTA § 8 cmt. 3 (1984). Under the UFCA, the extent to which a creditor may avoid a constructively fraudulent transfer and recover against a transferee depends on whether the transferee possessed "actual fraudulent intent." UFCA § 9(1), 9(2) (1918). The UFCA's set-off for the good faith transferee for value is inartfully drafted and has been widely criticized on this ground. See, e.g., Alces, supra note 8, at 5-122-123. If the transferee gave "less than a fair consideration" but "without actual fraudulent intent," then the transferee may deduct the consideration he paid from the amount he must turn over to the creditor. UFCA § 9(2) (1918). If a transferee gave less than fair consideration with knowledge of the fraud, the creditor is entitled to recover the property or its value without set-off. See, e.g., Merchants Discount Co. v. Esther Abelson, Inc., 9 N.E.2d 528 (Mass. 1937).

129. 11 U.S.C. § 550(c) (1994). Section 550 sets out rules to account for post-transfer increases in the value of the property. Section 550(e)(1) gives the transferee an additional lien to secure the lesser of: "(A) the cost, to such transferee, of any improvement made after the transfer, less the amount of any profit realized by or accruing to such transferee from such property; and (B) any increase in the value of such property as a result of such improvement, of the property transferred." 11 U.S.C. § 550(e)(1) (1994). A transferee can, in essence, obtain reimbursement from the trustee for some expenses incurred in reliance on the transfer. To the extent that an improvement failed to pay for itself by generating income at least equal to its cost, the transferee may set-off the unrecovered cost against the trustee's recovery. But the transferee cannot recover more than the amount by which the improvement increased the value of the transferred property. Section 550 also governs the liability of subsequent transferees. 11 U.S.C. § 550(b) (1994). See Bonded Fin. Serv. v. European Am. Bank, 838 F.2d 890 (7th Cir. 1988).

130. See generally Kennedy, supra note 2, at 541 n.44; McCoid, supra note 34, at 652-56 (discussing so-called "partial avoidance").
as a means of identifying a transferee who should have known it was the cheaper
avoider, as distinct from the transferee who received clear signals from the
transfer and did know it could have avoided loss more cheaply than the creditors.
The compromise treats the "negligent" transferee more leniently than the
knowing transferee, reflecting the difference in their costs of avoiding loss.

Recently, the Supreme Court resolved a persistent and controversial question
regarding the meaning of "reasonably equivalent value" in Bankruptcy Code
Section 548 in a context that implicated problems of value indeterminance. In
BFP v. Resolution Trust Corp.,131 the Court ended over a decade of uncertainty
over whether a debtor-in-possession132 can avoid, as a constructively fraudulent
transfer under Bankruptcy Code § 548(a)(2), a pre-petition sale of real property
at a non-collusive, judicial foreclosure sale.1 BFP defaulted on a mortgage
on residential real property. The mortgagor arranged for the property to be sold
at a foreclosure sale where an unrelated transferee purchased it for $433,000.
BFP, who petitioned for bankruptcy relief shortly after the sale, moved as debtor-in-possession to set aside the sale as a fraudulent transfer. It claimed that the
property was actually worth $725,000 when sold and, thus, was not transferred
for "reasonably equivalent value."134

The Court, in an opinion by Justice Scalia, held that the purchase price
achieved at the non-collusive, regularly conducted foreclosure sale of real
property constituted the reasonably equivalent value of the property, thus
insulating the transfer from avoidance on constructive fraud grounds.135 In a
five-to-four opinion, the Court held that the relevant value comparison was not
between the foreclosure sale price and the fair market value of the property.
Rather, "reasonably equivalent value" required a comparison between the
foreclosure sale price and the value of the property at the time of the sale, taking
into account the price-depressing attributes136 of state law permitting a creditor

132. Typically, challenges to a pre-petition foreclosure sale on fraudulent transfer grounds are
brought by a debtor-in-possession in a Chapter 11 case. The debtor-in-possession possesses the
133. In Durrett v. Washington Nat. Ins. Co., 621 F.2d 201 (5th Cir. 1980), the Fifth Circuit held
that a foreclosure sale of the debtor's real property constituted a "transfer" notwithstanding the
absence of participation by the debtor. Moreover, the sale price of 57% of a hypothetically
determined fair market value was not a fair equivalent. The court held that the debtor in possession
could avoid the sale as a fraudulent transfer under a provision of the old Bankruptcy Act analogous
to Section 548(a)(2). In dicta, the Fifth Circuit held that any foreclosure sale price less than 70% of
the fair market value of the property was unreasonably inequivalent value. Following Durrett, the
circuit courts split on the avoidability of foreclosure sales. See BFP v. Resolution Trust Corp., 511
134. BFP, 511 U.S. at 534, 114 S. Ct. at 1759.
135. Id. at 545, 114 S. Ct. at 1764. In the context of a transfer in the form of a foreclosure sale, the
debtor is virtually certain to be insolvent. The only relevant issue is whether the value received at the
136. "[P]roperty...sold...[at forced sale] is simply worth less. No one would pay as much
to own such property as he would pay to own real estate that could be sold at leisure and pursuant
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to subject the property to sale on a non-collusive, forced sale market.\footnote{137} A non-collusive, regularly conducted foreclosure sale price thus yields a "perfectly equivalent value" for the property sold, given state-imposed constraints on the market for such property.\footnote{138}

Although Justice Scalia did not explain his opinion in economic terms, the holding can be understood as a determination that the challenged transfer (the foreclosure sale) did not reduce the value of the debtor in a manner detectable by the transferee. The property brought a price at the foreclosure sale equal to its value, given state regulation of forced sales of collateral.\footnote{139}

The Court observed, however, that if a foreclosure sale is collusive, or deviates from state regulations, transferees may be on notice that the transfer depletes the value of the debtor to the extent of the difference between a hypothetical non-collusive foreclosure sale price and the tainted foreclosure sale price.\footnote{140}

B. The Debtor’s Financial Condition

A party seeking to avoid a transfer must establish that the debtor was insolvent or otherwise headed for financial collapse at or immediately following the challenged transfer. The debtor’s financial condition must satisfy one of three descriptive tests commonly called: (1) the “insolvency” test; (2) the “unreasonably small capital” test; or (3) the “incurring debts beyond ability to

to normal marketing techniques.” \textit{BFP}, 511 U.S. at 539, 114 S. Ct. at 1763. The Court drew an analogy between a secured creditor’s right to force sale of property and zoning regulations with regard to their respective effects on the value of property. “[I]t is no more realistic to ignore that characteristic of the property (the fact that state foreclosure law permits the mortgagee to sell it at forced sale) than it is to ignore other price-affecting characteristics (such as the fact that state zoning law permits the owner of the neighboring lot to open a gas station).” \textit{Id.}

\footnote{137} Id. at 539, 114 S. Ct. at 1762. The Court justified its holding in part on grounds of federalism. It expressly declined to interpret “reasonably equivalent value” within 11 U.S.C. § 548(a)(2) to permit federal second guessing of the effectiveness of state law foreclosure procedures in returning a “fair” amount to the debtor’s estate for property sold at foreclosure. “To specify a federal ‘reasonable’ foreclosure-sale price is to extend federal bankruptcy law well beyond the traditional field of fraudulent transfers, into realms of policy where it has not ventured before.” \textit{Id.} at 540, 114 S. Ct. at 1763.

\footnote{138} Id. expressly limited the safe harbor created by its opinion to judicial foreclosures of real estate. \textit{Id.} at 537 n.3, 114 S. Ct. at 1761 n.3. It offered no insight on what factors or characteristics would justify different conclusions about the “reasonable equivalence” of prices at which the debtor’s property changes hands at other types of foreclosure and forced sales.

\footnote{139} \textit{Id.} at 538, 114 S. Ct. at 1762.

\footnote{140} If a subject foreclosure sale was not non-collusive or regularly conducted, then the sale price would not enjoy “conclusive force.” \textit{Id.} at 546, 114 S. Ct. at 1765. In such case, the trustee could avoid the transfer by showing that the price achieved at the foreclosure sale was not “reasonably equivalent to the property’s actual value at the time of the sale (which we think would be the price that would have been received if the foreclosure sale had proceeded according to law).” \textit{Id.} This approach is analogous to the scheme that regulates a secured party’s sale of collateral under UCC Article 9. See UCC §§ 9-504(3), 9-507 (1994).
pay” test. The latter two tests, in most respects, repeat the test for insolvency, so the focus of this discussion will be on insolvency.

The UFCA, § 548, and the UFTA each have a different definition of “insolvency.” Under the UFCA, a person is “insolvent” when the “present fair salable value” of his “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.” The fair salable value of assets is not their book value. Rather, it is a hypothetical figure equal to the amount that “could be obtained if the assets are liquidated with reasonable promptness in an arms-length transaction in an existing and not theoretical market.” The UFCA defines “assets” as property that creditors can reach by legal process. Only assets with “fair salable value” count in the insolvency calculation. Assets for which there is no ready market do not count.


142. Only a few cases have construed the non-insolvency tests of the debtor’s financial condition. Some courts have held that the unreasonably small capital test is indistinguishable from the insolvency test. E.g., United States v. Glenmore Distilleries Co., 565 F. Supp. 556 (M.D. Pa. 1983), aff’d sub nom. United States v. Tabor Court Realty Corp., 803 F.2d 1288 (3d Cir. 1986), cert. denied, 483 U.S. 1005, 107 S. Ct. 3229 (1987) (the same transactions that leave a debtor with unreasonably small capital render a debtor insolvent). Other courts have interpreted it to require a lesser showing than for insolvency. E.g., In re Vadnals Lumber Supply, Inc., 100 B.R. 127, 137 (Bankr. D. Mass. 1989) (“Unreasonably small capitalization . . . encompasses difficulties which are short of insolvency in any sense but are likely to lead to insolvency at some time in the future.”). In Spanier v. United States Fidelity & Guaranty Co., 623 P.2d 19 (Ariz. 1980), the court held that business creditors could use the “unreasonably small capital” measure of financial instability but personal, nonbusiness creditors must establish that the debtor was actually insolvent. The third test appears largely redundant with the actual fraud grounds for avoidance. Under the UFCA and 11 U.S.C. § 548(a)(2), a creditor satisfies the third test if it establishes that the debtor intended or believed he would incur debts beyond his ability to pay. UFCA § 6 (1998), 11 U.S.C. § 548(a)(2)(B)(ii) (1994). If a creditor can establish this intent on the part of the debtor, he probably could also establish that the debtor actually intended to defraud creditors (specifically, the ones whose claims he intended not to pay). See UFCA § 7 (1918), 11 U.S.C. § 548(a)(1) (1994). The UFTA recast the third test in objective terms so that a creditor can satisfy it upon proof that the debtor “reasonably should have believed” that he would incur debts beyond his ability to pay. UFTA § 4(2)(ii) (1984).

143. UFCA § 2(1) (1918).


145. UFCA § 1 (1918).


147. E.g., Glenmore Distilleries Co. v. Seideman, 267 F. Supp. 915 (E.D. N.Y. 1967) (breach of contract claim of debtor was "inchoate, uncertain and contested" and, thus, had no present fair salable value); In re Franklin Nat’l Bank Sec. Litig., 2 B.R. 687, 712 (E.D.N.Y. 1979), aff’d, 633
Under section 548, a debtor is "insolvent" when "the sum of such entity's debts is greater than all of such entity's property at fair valuation." The UFTA definition of insolvency is the same but adds a rebuttable presumption of insolvency upon proof that a debtor "is generally not paying his [or her] debts as they become due ...." The drafters of the UFTA incorporated the presumption of insolvency to respond to practical problems that attend proof of insolvency. Given the range of techniques available to measure both asset value and magnitude of liability, it is not surprising that whether and when a person or entity is insolvent for fraudulent transfer purposes is awash in uncertainty.

What efficiency related purpose is served by limiting creditors' ability to avoid transfers to those that occur at or after the debtor's insolvency? The debtor's insolvency at or immediately following the transfer screens for those loss-producing transfers that occur under circumstances where a creditor's costs of shifting loss to equity claimants, by way of foreclosure or another technique, are likely to be extremely high. A rule that limits creditors' ability to avoid transfers to those that occur at or near the debtors' insolvency thus creates an incentive for creditors to shift loss from equity claimants' opportunism to the debtor whenever they can do so at a relatively low cost.

Because equity claimants are in effect immune from the negative consequences of their investment activity near and after insolvency, creditors face a moral hazard problem that makes expected loss from post-insolvency risk taking expensive to assess for risk pricing. Thus, as the debtor approaches insolvency and afterwards, the presumption that the creditor is the cheaper bearer of loss is less likely to be accurate. Fraudulent transfer law recognizes this and permits creditors who can establish that a transfer occurred near or after

F.2d 204 (2d Cir. 1980) (common stock in bank received for transfer had no value because "realistically speaking" there were no purchasers or bidders for the bank).
149. UFTA § 2 (b) (1984).
151. E.g., Brown v. Riley (In re Omni Mechanical Contractors, Inc.), 114 B.R. 518, 530 (Bankr. E.D. Tenn. 1990) ("The equity insolvency test is not a bright line test. ... Various factors and judgments will determine whether the ... test has been met."). See generally Daniel T. Murphy, Equity Insolvency and the New Model Business Corporation Act, 15 U. Rich. L. Rev. 839 (1981) (describing analyses used under analogous equity insolvency test).
152. Professor Kathryn Smeyser argued that creditors do not view pre-insolvency depletions in the value of the firm as "extremely serious." Smeyser, supra note 52, at 793. She concludes that creditors do not need fraudulent transfer law to protect themselves from pre-insolvency, value depleting transfers because such transfers do not seriously hurt them. Id. She is wrong that creditors "are not likely to have a strong interest in deterring pre-insolvency value depleting transactions." Id. Creditors do have a strong incentive to control such transfers and do so by bargaining for and enforcing default and foreclosure rights and other bilateral, loss shifting arrangements with the debtor. She is right, however, that creditors do not need fraudulent transfer law to accomplish the deterrence they desire as long as the debtor can bear the loss from its conduct.
153. See supra notes 96-101 and accompanying text.
insolvency to avoid it upon proof that the debtor made the transfer for "less than reasonably equivalent value." A transfer that satisfies both of these conditions is highly likely to be the product of debtor opportunism unchecked (and uncheckable) by creditors except at extremely high cost, relatively higher than the transferee's costs of avoiding the same loss.

C. Collusion or Concealment

The insolvency of the debtor at or near the time of the transfer is not the only condition that indicates a high likelihood that creditors' costs of loss avoidance are high relative to the transferee's. Recall that creditors may avoid a transfer the debtor made with "actual fraudulent intent" regardless of whether the debtor was insolvent at the time of the transfer.\(^{154}\) This rule makes economic sense if proof of actual fraudulent intent requires proof that the debtor colluded with the transferee, concealed the challenged transfer from creditors, or otherwise acted to raise the costs to creditors of: (1) detecting unauthorized diversion of assets, or risk taking; and (2) acting on such information to shift loss to equity claimants.

To illustrate, consider the classic example of a transfer avoidable on actual fraud grounds. A debtor transfers Blackacre to his mother in consideration for her love and affection. The debtor does not record the transfer, nor does he relinquish possession of Blackacre to his mother. Assume that the transfer did not render the debtor insolvent, but by the time his creditor seeks to enforce his claim the debtor's remaining assets have become worthless. By failing to record the transfer and by retaining possession of Blackacre, the debtor concealed from his creditors the fact of the transfer. This had the effect of preventing them from discovering both the fact of the transfer and the concomitant diminution in the expected value of their claims.\(^{155}\) In the absence of proof of the debtor's insolvency, evidence that the debtor concealed the transfer from his creditors and thereby made the transfer expensive for creditors to detect supports an inference that the creditors' costs of avoiding loss by shifting it to equity claimants in the ordinary way were extremely high.

V. IMPLICATIONS OF AN ECONOMIC THEORY OF FRAUDULENT TRANSFER LAW

Because the underlying commercial and interpersonal relationships in transactions are complex and diverse, generalizations about which group is the cheaper bearer of loss for a given type of transfer are suspect. Some observations,

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154. See supra notes 8-11 and accompanying text.
155. The debtor's concealed transfer created a "secret lien" in favor of the transferee. The public perfection requirements of UCC Article 9, and the strong-arm avoiding powers of the trustee in bankruptcy can be explained as allocating to the recipient of secret liens, loss from the debtor-grantor's insolvency otherwise borne by deceived creditors.
however, are possible. A transfer ought to be avoidable where the transferee's cost of bearing loss is lower than the creditors' cost of bearing it. A transferee's cost of bearing loss is lower than the creditors' only in the relatively unusual case where the transferee, at the time of the transfer, had inexpensive access to information that revealed: (1) loss to the debtor was likely to occur; and (2) creditors' cost to shift loss to equity claimants was unusually high.

Thus, two facts are relevant: (1) the transfer depletes the value of the debtor; and (2) equity claimants can externalize the loss to creditors. The two facts are related in the sense that the presence of one fact indicates a likelihood of the presence of the other. When a transfer depletes the value of the debtor, the chances are good that the debtor is externalizing some or all of the loss to creditors, especially when the transfer is not plainly motivated by debtor generosity. Conversely, when the debtor can externalize loss to creditors, the time is ripe for equity claimants to engage in a risky investment strategy even if it depletes the value of the debtor.

Although the two facts, value depletion and ability to externalize loss, are related, the presence of one does not alone establish another. The difficult fraudulent transfer cases are those in which the transfer reveals one fact to the transferee, but not the other fact, or when the transferee's information on both facts is ambiguous.

When the transfer occurs in the ordinary course of the debtor's business, at arms-length, or under circumstances where the exchange appears to the transferee to be non-donative and mutually beneficial, the transferee receives no information from the fact of the transfer itself regarding the potential-value depleting effect of the transfer on the debtor. Regardless of the transferee's knowledge of the debtor's insolvency, absent knowledge that equity claimants are indeed expropriating value and externalizing loss to creditors, the transferee has no loss avoiding advantage over creditors.156 A rule that allocates loss from these types of transfers to transferees would induce transferees either to engage in costly information gathering to prevent loss or to discount the value of the debtor's property as compensation for bearing the risk of loss in the event of avoidance. This conduct would waste social resources to the extent that creditors' costs of preventing or bearing loss were lower.

On the other hand, when the transferee knows both that the transfer will deplete the value of the debtor and that the owners of equity can externalize the resulting loss to creditors, the transferee is likely to be the cheaper avoider. In these cases, the transferee has cheap access to information that distinguishes a particular transfer from the pack of transfers. Armed with this information, a transferee is likely to be able to avoid loss more cheaply than creditors.

156. See, e.g., BFP v. Resolution Trust Corp., 511 U.S. 531, 114 S. Ct. 1757 (1994) discussed supra notes 131-140 and accompanying text; In re Morris Communications NC, Inc., 914 F.2d 458 (4th Cir. 1990) (absent evidence of irregularity in the exchange, bankruptcy court was clearly erroneous in finding lack of reasonably equivalent value).
This distinction between so-called "ordinary course" transactions and those that the transferee knows are unusual and value depleting is more easily made in theory than in practice. Consider a pair of cases in which a trustee in bankruptcy challenged certain transfers individual debtors made shortly before filing for bankruptcy relief. In the first case, the debtors made a series of contributions to their church. In the second, the debtors placed bets at their casino and sustained net losses. In each case, the trustee sought to avoid the transfers for the benefit of unsecured creditors, contending that they were made for less than reasonably equivalent value at a time when the debtors were insolvent. In both cases, the evidence established that the debtors were insolvent at the time of the challenged transfers and the transferees were unaware of the debtor's financial condition.

In the church contribution case, the district court struggled with whether the debtors' contributions to their churches were in exchange for "value" or "property" and concluded it was not. Even assuming the debtors received a reasonably equivalent value from the church, the court held that the debtors did not receive property in exchange for their contributions. Notwithstanding several contrary decisions which found sufficient value in exchange for a charitable contribution, the court held that the challenged contributions were constructively avoidable transfers. On appeal, the eighth circuit held that although the contributions were avoidable under 11 U.S.C. § 548, avoidance would violate the Religious Freedom Restoration Act of 1993; thus, the church/transferee was entitled to keep the contributions.

In the casino gambling case, the sixth circuit held that the debtors placed bets in exchange for reasonably equivalent value and thus the transfers were not avoidable. The court declined to measure the value the debtors received exclusively from the perspective of the creditors. Thus, the "psychic and other intangible values" the debtors received from their casino bets were entitled to the same respect as the enjoyment restaurant patrons receive in exchange for

159. Young, 152 B.R. at 945-46. See 11 U.S.C. § 548(d)(2)(A) (defining value 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").
160. Young, 152 B.R. at 949. The church argued that the debtors received a tax deduction "in exchange" for their contribution. The court rejected this argument citing Hernandez v. C.I.R., 490 U.S. 680, 109 S. Ct. 1568 (1989) (charitable contribution is deductible only if it is without adequate consideration).
163. In re Chomakos, 69 F.3d 769, 772 (6th Cir. 1995).
164. Id.
an expensive dinner. The sixth circuit did not explain why gamblers' psychic benefits qualify as "value" in exchange, but congregants' spiritual well-being does not. It did note that the gamblers' relationship with the casino was arms-length in that the casino was subject to state regulation and competition from nearby casinos.

These decisions illustrate the infinite malleability of "reasonably equivalent value" as a defined concept without a normative grounding. Perhaps the best explanation for divergent outcomes lies in the idiosyncratic nature of value. In the religious contribution case, investigation of value on exchange requires court inquiry into one of the most personal and constitutionally protected activities—religious expression. This activity occurs almost exclusively in "non-market" transactions where no externally observable, non-idiosyncratic measure of value is available. Unless courts are willing to evaluate the relative merits of inherently personal expression (religious or otherwise) without the aid of market benchmarks, they must adopt a position at one of the extremes—either all gratuitous transfers are for reasonably equivalent value or none are. The former position would turn centuries of fraudulent transfer law on its head. In contrast, the non-pecuniary value the debtor receives in exchange for a wager has a "shadow" value equal to the difference between the market price of the wager and its expected value. The externally observable market price of a wager is an average value that serves as a surrogate for idiosyncratic value to the gambler. To the extent that no market price or surrogate value is observable, as in the case of spiritual benefits received from tithing, or to the extent that the surrogate is unreliable, as in the case of collusive or isolated sales, "reasonably equivalent value" ceases to be a meaningful limit on avoidability.

In another application of fraudulent transfer law, a number of commentators have opined that leveraged buyouts ought or ought not be avoidable transfers. These commentators justify their conclusions on moral grounds, weighing the relative fairness of the transaction to unsecured creditors. An economic understanding of fraudulent transfer law sheds some light on the relevant considerations regarding avoidability of the transfers at issue in leveraged buyouts.

165. Id.
166. Id. The Sixth Circuit asserted that charitable contributions are distinguishable from casino bets on the grounds that contributions never benefit creditors whereas bets, if successful do. Id. This distinction is at odds with the court's later observation that value on exchange ought not be measured exclusively from the creditors' perspective. Id. See supra note 164 and accompanying text.
The typical fraudulent transfer action arising from a leveraged buyout challenges the debtor's secured promise to pay a financier for a loan that enabled new management to buy a controlling share of equity. The central issues are whether the debtor's promise to pay, secured by his assets, was given in exchange for "reasonably equivalent value" and whether the creation of the secured obligation rendered the debtor "insolvent." Courts faced with these questions and unarmed with a normative understanding of fraudulent transfer law have struggled to give content to the technical definitions.

A court consciously seeking to create a rule of avoidability that allocates loss to the party who could have avoided that loss more cheaply will understand the elements of value inequivalence and the debtor's insolvency not as definitional ends in themselves, but rather as indicators of relative capacity to avoid loss. Such a court will determine whether the transferee knew or should have known that the transfer was an exercise in opportunism on the part of the owners of equity under moral hazard conditions.

A financier in a leveraged buyout transaction knows that the transfer in question increases the riskiness of unsecured creditors' claims. But this information alone does not clearly render the transferee the cheaper bearer of loss. The economic function of the requirement of value equivalence on exchange is to screen for those transfers which signal to the transferee a depletion of value of the debtor. An increase in risk to creditors does not necessarily indicate to the transferee that the transfer decreases the expected value of the debtor.

If the leveraged buyout increases risk but does not decrease the value of the resulting firm, then arguably creditors, not transferees, have the loss avoiding advantage. Creditors determine the range of risk they are willing to bear in exchange for interest at the time they extend credit and bargain for the means to

168. The suspect transfer in a leveraged buyout is the grant of a security interest in the assets of acquired debtor in favor of the selling shareholders (or third party financier of the equity buyout). Typically, the security interest the debtor grants is a blanket one, covering all its assets. The debtor receives no obvious monetary benefit in exchange for the grant of the security interest. The loan proceeds are paid to the selling shareholders, not the debtor. After the acquired firm fails, challenging creditors seek to avoid it on fraudulent transfer grounds, and thus subordinate the secured claim of the selling shareholders. Unsecured creditors contend that the grant of a security interest was "for less than reasonably equivalent value." They contend that the grant of such a blanket security interest either occurred while the debtor was insolvent, or rendered the debtor insolvent, in the sense that the debtor's obligations exceed the value of its assets. See generally Carlson, supra note 57, at 80-83 (describing alternative structures for leveraged buyouts).


171. See discussion supra notes 115-116 and accompanying text.
control equity claimants' incentive to increase that risk unilaterally. A rule that imposes on creditors the loss from transfers that increase riskiness but do not decrease the expected value of the debtor creates an efficient incentive for creditors to protect themselves by bilateral agreement with the debtor. After the leveraged takeover, creditors who are dissatisfied with the new higher level of risk can renegotiate the interest on their credits to reflect the additional risk. Alternatively, they can declare default and foreclose on the debtor's assets. If the challenged transfer did not reduce the expected value of the firm, the debtor's assets are at least as valuable as they were prior to the buyout and creditors are not disadvantaged in their efforts to internalize the increased risk to creditors.

Some leveraged buyouts may decrease the expected value of the debtor, but value tends to be idiosyncratic in this context. In a leveraged buyout, the property the debtor transfers is its obligation to pay, secured by a subordinate lien on the debtor's assets. This type of property has no ready market value. Moreover, the property the transferee gives in exchange for the debtor's secured obligation has no ready market value. The property the debtor receives in exchange is the value of a reconstituted capital structure, whose value, like the magic beans in the previous hypothetical, is unquestionably difficult to quantify. Absent collusion or other irregularity, the financier may not know or have reason to know that the transfer reduced the value of the firm, measured as the sum of equity and creditor claims. The question remains whether the transaction is like the casino bet, arguably entitled to a presumption that price on exchange equals value, or like the charitable contribution as to which value inequivalency is presumed.

In a leveraged buyout case, proof of the debtor's insolvency need not be merely an elaborate accounting exercise. A court will consider the debtor's financial condition at and after the transfer as one element of its determination of the creditors' capacity to shift loss to equity claimants, by default and foreclosure or otherwise, and the transferee's access to information about such capacity. The debtor's precarious financial condition indicates that equity claimants had both motive and opportunity to increase the value of their claims at the expense of creditors. A financier who knows or has reason to know that the transfer radically increased the riskiness of creditors' claims at a time when it also knew the debtor was insolvent has a loss-avoiding advantage over creditors, even if it cannot be certain that the transfer reduced the value of the firm.

Leveraged buyout transactions are difficult fraudulent transfer cases because the complexity of the transfer makes the transferee's knowledge on the relevant

172. Indeed it usually does not appear on the debtor's balance sheet. The financier pays the loan proceeds directly or indirectly to the selling shareholders.

issues difficult to discern. Typical in all avoidance actions, but perhaps more pronounced in leveraged buyout cases, is the problem of valuation in retrospect. An assessment of information available to the transferee at the time of the transfer is difficult to insulate from knowledge of what actually transpired. Moreover, the values of the property transferred and the values of the property remaining with the debtor are elusive because of the layers of contingencies surrounding the respective expected value calculations. Economic theory does not eliminate these problems, at least not yet.

VI. CONCLUSION

The foregoing discussion explained the function of fraudulent transfer law as a rule that allocates loss caused when the value of the debtor declines below the value of creditors' claims. As their stake in the enterprise declines, the owners of equity are able to externalize loss from risky investment strategies. Creditors, through their bilateral agreements with the debtor, can control the incentive of the equity claimants to dissipate the value of the debtor for their own gain at creditors' expense. Once equity claimants have nothing to lose, however, bilateral controls fail. In some cases, transferees can detect that a proposed transfer will reduce the value of the debtor under conditions that make it extremely costly, if not impossible, for creditors to impose the loss on equity claimants. When a transferee knows or has reason to know that a transfer is the product of such uncontrollable opportunism, the transferee is able to prevent loss more cheaply than creditors could. A rule that allocates loss to a transferee in these cases creates an incentive for the cheaper loss avoider to take action to prevent or insure against the loss. In so doing, the rule achieves a value maximizing allocation that mirrors the bargain creditors, debtors, and transferees would have reached had they been able to bargain expressly.

Understanding fraudulent transfer law in economic terms does not eliminate controversy, nor does it resolve all questions regarding its application. An economic theory of fraudulent transfer law does, however, recast the issues in terms other than moral ones.

Normative justifications of fraudulent transfer law that turn on preventing injustice to creditors or deterring debtor fraud flounder, particularly when the intrinsic morality or justice of a transfer is ambiguous. Moralistic justifications also fail to account for the morally neutral incentive of equity claimants to maximize the value of their residual claim at the expense of creditors. Equity claimants who direct investment strategy that is riskier than their creditors would prefer are not misbehaving. They are behaving normally. Moreover, moralistic theories fail to explain how preventing injustice to creditors is just to transferees. As to this question, efficiency as a normative goal equates justice with wealth maximization. An allocative outcome is fair if the party who could have borne the loss more cheaply ends up bearing it.

Efficiency analysis has all the annoying qualities of any approach to understanding law. An economic perspective on the purpose of fraudulent
transfer law does not itself simplify the dynamics among creditors, equity owners, and transferees. Nor does it eliminate problems of valuation under imperfect market conditions. Any analysis, including an economic one, must take these conditions as it finds them. Understanding the function of fraudulent transfer law within these commercial relationships, and adopting efficiency as a normative goal, opens the door for reasoned decisionmaking, increased predictability, and reduced transaction costs.