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Toward True and Plain Dealing: A Theory of Fraudulent Transfers Involving Unreasonably Small Capital

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Toward True and Plain Dealing: A Theory of Fraudulent Transfers Involving Unreasonably Small Capital

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I. INTRODUCTION

Fraudulent transfer law[1] is in the midst of a renewal and a revival. Ten years ago Congress rewrote the Bankruptcy Code section related to

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[1]There are at least five sources of fraudulent transfer law. The basic text for the last seventy years has been the Uniform Fraudulent Conveyance Act (UFCA), promulgated in 1918 by the National Conference of Commissioners on Uniform State Laws (National Conference). The UFCA is reprinted at 7A U.L.A. 427 (1985). The National Conference promulgated a new uniform act in 1984, calling it the Uniform Fraudulent Transfer Act (UFTA). It is reprinted at 7A U.L.A. 639 (1985). The third source is section 548 of the Bankruptcy Code (Code). The Code is codified at 11 U.S.C. §§ 101 *et seq.* (1982). The fourth source, relevant primarily in the interpretation of older cases, is section 67d of the now-repealed Bankruptcy Act of 1898 (Act). Like the Code, the Act contained its own section covering fraudulent transfers, which, for the most part, mirrored the UFCA. Act § 67d, 11 U.S.C. § 107d (1976) (repealed 1979). *See infra* note 103. Finally, fraudulent conveyance law was part of the common law received from England, and almost every state either adopted it through decisional law, or codified its own version by statute. *See, e.g.*, Molitor v. Molitor, 184 Conn. 530, 535, 440 A.2d 215, 218 (1981) (finding that the UFCA "is largely an adoption and clarification of the standards of the common law"); TEX. BUS. & COM. CODE ANN. § 24.02 (Vernon 1968) (repealed 1987).

An excellent and detailed account of the common law history of fraudulent conveyances can be found in 1 G. GLENN, FRAUDULENT CONVEYANCES AND PREFERENCES §§ 58-62b (Rev. ed. 1940). An equally excellent analytical account of the policy goals served by fraudulent transfer law can be found in Clark, *The Duties of the Corporate Debtor to Its Creditors*, 90 HARV. L. REV. 505 (1977).

such transfers,[2] and four years ago the National Conference of Commissioners on Uniform State Laws promulgated a new uniform act for state adoption.[3] During this period, both state and federal courts have invalidated, in the name of such fraudulent transfer laws, a broad range of transactions, including mortgage foreclosures[4] and leveraged buyouts.[5] These cases have been controversial;[6] indeed, many have been the animus for new legislation.[7]

The focus of this concern has been "constructively" fraudulent transfers. This branch of fraudulent transfer law scrutinizes transactions in which a person transfers property or incurs an obligation[8] without

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[2]11 U.S.C. § 548 (1982), *adopted* as part of Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978). The Code's effective date was October 1, 1979. *Id.* § 402.

[3]Uniform Fraudulent Transfer Act, *supra* note 1.

[4]*See, e.g.*, Durrett v. Washington Nat'l Ins. Co., 621 F.2d 201, 203 (5th Cir. 1980). *Durrett* unleashed a mammoth amount of academic writing and case law. A partial collection can be found in McCoid, *Constructively Fraudulent Conveyances: Transfers for Inadequate Consideration*, 62 TEXAS L. REV. 639, 639 nn.1-8 (1983).

[5]*See, e.g.*, United States v. Gleneagles Investment Co., Inc., 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 sub nom. McClellan Realty Co. v. United States*, 107 S. Ct. 3229 (1987); Kaiser Steel Corp. v. Jacobs (*In re* Kaiser Steel Corp.), 17 Bankr. Ct. Dec. (CRR) 911 (Bankr. D. Colo. 1988) (allowing fraudulent conveyance attack on $140,000,000 leveraged buyout to proceed). *See generally* Note, *Fraudulent Conveyance Law and Leveraged Buyouts*, 87 COLUM. L. REV. 1491 (1987); *see also infra* note 152.

[6]With respect to mortgage foreclosures, see Alden, Gross & Borowitz, *Real Property Foreclosure as a Fraudulent Conveyance: Proposals for Solving the* Durrett *Problem*, 38 BUS. LAW. 1605, 1613 n.22 (1983); Zinman, Houle & Weiss, *Fraudulent Transfers According to Alden, Gross and Borowitz: A Tale of Two Circuits*, 39 BUS. LAW. 977, 979 (1984). With respect to leveraged buyouts, see Kupetz v. Continental Ill. Nat'l Bank and Trust Co. of Chicago, 77 Bankr. 754, 759-60 (C.D. Cal. 1987) (questioning applicability of fraudulent transfer laws to leveraged buyouts), *aff'd sub. nom.* Kupetz v. Wolf, 845 F.2d 842 (9th Cir. 1988); Baird & Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829, 850-54 (1985).

[7]The foment caused by *Durrett* and the various legislative reactions are reviewed in Kennedy, *The Uniform Fraudulent Transfer Act*, 18 U.C.C.L.J. 195, 206-08 (1986). *See also* 130 CONG. REC. S7617 (daily ed. June 19, 1984) (amendment effectively overruling *Durrett*, deleted due to lack of ability to debate merits); CAL. CIV. CODE § 3439.08(e)(2) (West Supp. 1988) (transfer not voidable if it results from "[e]nforcement of lien in a non-collusive manner and in compliance with applicable law . . . ."); Comment (5) to Proposed Section 3439.08 of the CAL. CIV. CODE, *Report of Assembly Comm. on Fin. and Ins. on S.B. 2150, reprinted in* CAL. ASSEMBLY J. 8569, 8568 (July 8, 1986) [hereinafter CAL. ASSEMBLY J.] (explicitly rejecting *Durrett*).

[8]The original target of fraudulent conveyance laws was transfers of tangible property to avoid execution, levy and seizure by the transferor's creditors. *See* G. GLENN, *supra* note 1; Baird & Jackson, *supra* note 6. The common law later came to the view that a creditor's incurrence of certain obligations could also offend, in that they would force a debtor's legitimate creditors to share distributions with individuals whose claims might be suspect. Accordingly, the UFCA enabled creditors to set aside not only conveyances, but also obligations, if they were not exchanged for a fair consideration and made while the transferor or obligor was in a condition of financial stringency. UFCA §§ 3, 4 & 6.

receiving a corresponding and reasonably equivalent benefit, such as in gifts[9] or accommodation guaranties.[10] If the transferor is also left in a specified and defined condition of financial stringency, a "constructively" fraudulent transfer exists.

Creditors of the transferor can, among other things, seek to set aside the "constructively" fraudulent transfer, without regard to the state of mind or intent of the parties.[11] In short, the "fraudulent" transfer need not be made with any intent to defraud; indeed, it can even have been made with the purest of motives. Nevertheless, as long as it depletes the transferor's assets and leaves the transferor with what the law deems insufficient remaining assets, the transfer may be set aside.

Constructively fraudulent transfers exist if two conditions are present. The first is the transferor's failure to receive fair consideration or

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Section 5 of the UFCA, *supra* note 1, which covers conveyances which leave the transferor with unreasonably small capital, however, only extends to conveyances. Obligations are not within its scope. UFCA § 5. The Code and the UFTA, have eliminated this distinction. 11 U.S.C. § 548(a)(2)(B)(ii) (1982); UFTA, *supra* note 1, § 4(b)(i).

[9]*See* Hyman v. Porter (*In re* Porter), 37 Bankr. 56 (E.D. Va. 1984); Reade v. Livingston, 3 Johns. Ch. 481 (N.Y. Ch. 1818).

[10]Although the issue was "left to case law" under the Code, REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. No. 137, 93d Cong., 1st Sess., Part II, at 177 (1973) [hereinafter COMMISSION REPORT], current cases have found accommodation guaranties to be lacking in reasonably equivalent value as required by section 548(a)(2)(A). Consove v. Cohen (*In re* Roco Corp.), 701 F.2d 978 (1st Cir. 1983); Whitlock v. Max Goodman & Sons Realty, Inc. (*In re* Goodman Indus., Inc.), 21 Bankr. 512 (D. Mass. 1982). *See also* Chase Manhattan Bank v. Oppenheim, 109 Misc. 2d 649, 440 N.Y.S.2d 829 (N.Y. Sup. Ct. 1981) (applying New York version of UFCA). *But cf. In re* Xonics Photochemical, Inc., 841 F.2d 198 (7th Cir. 1988) (suggesting that affiliate may derivatively obtain sufficient value from intercorporate guaranty).

[11]Under the UFCA, a creditor holding a "matured" claim has the following options with respect to remedies: it can seek to set aside, to the extent necessary to satisfy the creditor's claim, the transaction deemed fraudulent, or it may ignore the conveyance and seek to levy upon the property in the hands of the transferee. UFCA, *supra* note 1, § 9. By contrast, holders of "unmatured" claims may also seek to set aside the claim, but may not levy execution. Instead, they are given equitable remedies to enjoin further disposition of the property fraudulently conveyed. *Id.* § 10. One major advance of the UFCA over the common law was that it eliminated the necessity for a creditor to reduce its claim to judgment, or to have its execution returned unsatisfied, as a predicate for maintaining an action. *See also* American Surety Co. v. Conner, 251 N.Y. 1, 166 N.E. 783 (1929).

Remedies under the UFTA are similar, except that the UFTA eliminates distinctions between matured and unmatured claims. UFTA, *supra* note 1, § 7. In addition, the UFTA offers an option of adding the provisional remedy of attachment. *See* Prefatory Note to UFTA, 7A U.L.A. 639 (1985).

The Code allows the bankruptcy trustee or debtor in possession to "avoid" the transfer. 11 U.S.C. § 548(a) (1982). This, in turn, permits the entity avoiding the transfer to "recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property . . . ." 11 U.S.C. § 550(a) (1982).

reasonably equivalent value in exchange for the transfer or the obligation.[12] The second is the presence of a predefined adverse financial condition, either before the questioned transaction or because of it;[13] in short, the law requires debtors to be just before they are generous.[14] In this regard, the classic type of precarious financial condition has been balance sheet insolvency, and most constructively fraudulent transfer cases explore this concept.[15]

The common law and its statutory codifications, however, recognize at least one other adverse financial condition. Under all forms of fraudulent transfer laws, a voluntary transfer or one for inadequate consideration will be set aside if it leaves the transferor with "unreasonably small capital."[16] Although not the subject of a vast body of case law,[17] the origins of this type of fraudulent transfer run deep, and the recent legislative reformations may have increased its potential as a creditor's remedy.

This article reviews the origins of the unreasonably small capital branch of fraudulent transfer law. It then traces its development and its various formulations under the Uniform Fraudulent Conveyance Act (UFCA) and the Bankruptcy Act of 1898 (Act). After reviewing recent cases and the changes made by the Bankruptcy Code of 1978 (Code) and the new Uniform Fraudulent Transfer Act (UFTA), it then criticizes two lines of cases which are contrary to the action's historical antecedents and the goals of modern fraudulent transfer law. It concludes by suggesting unifying themes linking the historical origins of the action with current case law.

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[12]11 U.S.C. § 548(a)(1) (1982); UFCA, *supra* note 1, §§ 4-6; UFTA, *supra* note 1, § 4(a)(1).

[13]These conditions are: insolvency, 11 U.S.C. § 548(a)(2)(B)(i); UFCA, *supra* note 1, § 4; UFTA, *supra* note 1, § 5; a knowing incurrence by the transferor of debts beyond the transferor's ability to repay them, 11 U.S.C. § 548(a)(2)(B)(iii); UFCA, *supra* note 1, § 6; UFTA, *supra* note 1, § 4(a)(2)(ii); and the topic of this article, unreasonably small capital or assets, 11 U.S.C. § 548(a)(2)(B)(ii); UFCA, *supra* note 1, § 5; UFTA, *supra* note 1, § 4(a)(2)(i).

[14]*See* Claflin v. Mess, 30 N.J. Eq. 211, 212, (1878); Black v. Sanders, 46 N.C. (1 Jones) 67, 68 (1854).

[15]The Uniform Laws Annotated requires 29 pages to list the annotations for constructively fraudulent transfers involving insolvency. 7A U.L.A. 479-504, nn.9-91 (1985) & 78-9, nn.10-91 (Supp. 1988).

[16]The UFTA changes this formulation to "unreasonably small *assets*." UFTA, *supra* note 1, § 4(a)(2)(i). The change was meant to "focus attention on whether the amount of all the assets retained by the debtor was inadequate, *i.e.*, unreasonably small, in light of the needs of the business or transaction in which the debtor was engaged or about to engage." UFTA, *supra* note 1, § 4, comment 4.

[17]While the casenote annotations for the insolvency section of the UFCA cover 29 pages, *see supra* note 15, the annotations for the unreasonably small capital section take up barely five pages. 7A U.L.A. 504-507 (1985) & 80 (Supp. 1988).

II. A BRIEF HISTORY OF FRAUDULENT CONVEYANCE LAWS

A. Common Law Origins

American fraudulent transfer laws date from the Statute of Elizabeth, enacted in 1571.[18] Designed as a penal statute, with the English crown receiving as its penalty fully one-half of all property recovered,[19] it prohibited conveyances made with the "intent to delay, hinder or defraud creditors and others of their just and lawful actions."[20] The statute saw such conveyances as contributing to "the overthrow of all true and plain dealing . . . without which no commonwealth or civil society can be maintained or continued."[21]

Defrauded creditors soon turned this penal statute to their personal ends. Since such transfers were illegal, and thus presumable void, creditors reasoned that they could ignore the conveyance and follow the transferred property into the hands of the party receiving the goods.[22] In short, passage of title was ignored, and the party receiving the goods had to give them up if the debt was just.[23] Courts adopted this reasoning,[24] and in 1603 Parliament followed suit and made fraudulent conveyances a part of the English bankruptcy laws.[25] In 1623 Parliament completed the process and made these laws civil in nature.[26]

The exact language of the statute, however, seemed to require proof of "actual" fraudulent intent. Yet one who fraudulently transfers prop-

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[18]13 Eliz., ch. 5 (1571), *repealed by* The Law of Property Act, 15 Geo. 5, ch. 20, § 172 (1925).

Roman law had recognized as a nominate tort an action *fraus creditiorum* similar in purpose and effect to the Statute of Elizabeth. *See* 1 G. GLENN, *supra* note 1, § 60; Radin, *Fraudulent Conveyances in California and the Uniform Fraudulent Conveyance Act*, 27 CALIF. L. REV. 1, 1-2, nn.1-2 (1938); Radin, *Fraudulent Conveyances at Roman Law*, 18 VA. L. REV. 109 (1931).

[19]Parties who knowingly participated in the conveyance "incurr[ed] the penalty and forfeiture of one years value of the said lands . . . and the whole value of the said goods . . . ." 13 Eliz., ch. 5, § 2 (1571). Of this amount, "one moitie whereof"—that is, one-half—went to the crown and the other half went to the "party or parties aggrieved." *Id.* A prison term of one half year "without bail" was also provided. *Id. See also* 1 G. GLENN, *supra* note 1, § 61a.

[20]13 Eliz., ch. 5, § 1 (1571).

[21]*Id.*

[22]Mannocke's Case, 3 Dyer 204b, 73 Eng. Rep. 661 (Q.B. 1571). The famous decision in Tywne's Case, 3 Coke 80b, 76 Eng. Rep. 809 Star. Ch. (1601) did not involve a private action. Rather, it was the crown's action to receive its one-half share of the goods transferred.

[23]Bethel v. Stanhope, 78 Eng. Rep. 1037, 1038 (Q.B. 1599).

[24]*Id.*

[25]1 Jac. 1, c. 15 (1603).

[26]21 Jac. 1, c. 19, § 7 (1623).

erty can hardly be expected to step up and admit it. Common law lawyers and judges thus developed bridges from questionable acts commonly associated with fraud to findings of actual fraudulent intent. Called "badges of fraud,"[27] these indicia of transactions imbued with fraud developed into a sort of common law shopping list for those seeking to levy on property thought to be properly part of a debtor's estate.[28] The list's length is testimony to the ingenuity of a debtor who perceives that it is trapped by its creditors.[29]

Several items merited special attention. Transfers for little or no consideration—termed "voluntary conveyances"—were especially suspect,[30] since they drained the pool of assets available for creditors without replenishing the source.[31] Yet, if carried to its logical conclusion, setting aside all gratuitous transfers would void most gifts and other transfers otherwise deemed socially acceptable.[32]

As a consequence, British common law arrived at the view that creditors could not attack voluntary transfers so long as the transferor

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[27]A "badge of fraud" has been defined to be a fact which is calculated to throw suspicion upon a transaction, and calling for an explanation. Peebles v. Horton, 64 N.C. 374, 377 (1870); M. BIGELOW, THE LAW OF FRAUDULENT CONVEYANCES Ch. XVII, at 515 n.2 (Knowlton, ed. 1911). *See also* Boston Trading Group, Inc. v. Burnazos, 835 F.2d 1504, 1509 (1st Cir. 1987) (badges of fraud described as "a set of objective criteria . . . use[d] as a basis for inferring fraudulent intent.").

[28]The basic list is published together with Lord Coke's reporting of Tywne's Case. *See* Twyne's Case, 3 Coke 80b, 76 Eng. Rep. 809 (Star Ch. 1601).

[29]The UFTA lists eleven such badges of fraud, from the status of the transferee as an insider to the transfer of essential assets to a lienor who then transfers them to an insider of the debtor. UFTA, *supra* note 1, § 4(b)(1)-(11).

At least one authority existing at the time the UFCA was promulgated divided badges of fraud into major and minor categories. M. BIGELOW, *supra* note 27, at Ch. XVII.

[30]Originally, English common law invalidated all gratuitous transfers. Tywne's Case, 76 Eng. Rep. at 810, note b. *See also* W. ROBERTS, A TREATISE ON THE CONSTRUCTION OF THE STATUTES 13 ELIZ. C. 5, AND 27 ELIZ. C. 4 RELATING TO VOLUNTARY AND FRAUDULENT CONVEYANCES § IV (3d Am. ed. 1845). That view no longer prevails. *See infra* note 33.

[31]As Professor McCoid has noted, there is a difference between "voluntary" conveyances, which were the aim of most early cases, and transfers for inadequate consideration, which are the subject of most modern fraudulent transfer cases. McCoid, *supra* note 4. *See also* M. BIGELOW, *supra* note 27, at 519; O. BUMP, A TREATISE UPON CONVEYANCES MADE BY DEBTORS TO DEFRAUD CREDITORS §§ 57, 247 (J. Gray rev. 4th ed. 1896). Nevertheless, modern fraudulent transfer law makes no substantive distinction between the two which, as Professor McCoid notes, probably accounts for confusions such as *Durrett* has caused. McCoid, *supra* note 4.

[32]Early case law in America adopted this strict position. The most famous of these cases was Reade v. Livingston, 3 Johns. Ch. 481 (N.Y. 1818). Although *Reade* was not universally followed, see Howard v. Williams, 1 Bail. 575, 583 (S.C. 1830) (limiting *Reade* to its particular facts), its holding was sufficiently widespread to be a major cause of concern to the drafters of the UFCA. Prefatory Note to UFCA, 7A U.L.A. 427, 428 (1985).

was solvent after the transfer.[33] Solvency, in turn, was defined as the financial state of possessing more assets than liabilities.[34] From the common law lawyer's point of view, this made sense: as long as there were sufficient assets to satisfy all creditors claims, the gift should be valid.[35]

1. Two Problems: Subsequent Creditors and Marginal Solvency.— Stating the principle, however, proved easier than its application. At least two separate questions arose regarding the application and the scope of "insolvency." The first was a question of standing: if a transferor was still solvent after the transfer, were there conditions under which subsequent creditors could use this badge of fraud to attack the transfer? The second question was closely related: if a debtor intentionally transferred just enough property to sympathetic third parties to remain marginally solvent, what recourse did its present creditors have under the fraudulent conveyance laws?

The ultimate[36] answer to the first question was short and predictable: courts tested such transfers as if they were varieties of transfers made with the actual "intent to hinder, delay or defraud."[37] Phrased in this manner, subsequent creditors could attack the transfer only if they bore the burden of proof of the original fraudulent intent.[38] In short, creditors

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[33]*See, e.g.*, Shears v. Rodgers, 110 Eng. Rep. 137, 139 (K.B. 1832); Jackson v. Bowley, 174 Eng. Rep. 426, 429 (Nisi Prius 1841).

[34]*See, e.g.*, H. MAY, THE LAW OF FRAUDULENT AND VOLUNTARY CONVEYANCES 30 (W. Edwards 3d ed. 1908) (insolvency exists "if the property left after the conveyance is not enough to pay [the transferor's] debts"); Jackson v. Bowley, 174 Eng. Rep. 426, 429 (Nisi Prius 1841) ("if the property left after the conveyance is not enough to pay [the transferor's] debts, that is insolvency sufficient for the purposes of the plaintiff in this action.").

[35]As Professor McCoid has noted, however, most early courts dealt with cases with *no* consideration—so called "voluntary conveyances"—as opposed to conveyances for *inadequate* consideration. McCoid, *supra* note 4. Indeed, some early commentators treated transfers for no consideration and transfers for little consideration quite differently. *See* M. BIGELOW, *supra* note 27, Ch. XVII, at 519; O. BUMP, *supra* note 31, §§ 57, 247.

[36]The initial answer was neither clear nor uniform. As stated by Chief Justice Marshall: "With respect to subsequent creditors, the application of [the Statute of Elizabeth] appears to have admitted of some doubt." Sexton v. Wheaton, 21 U.S. (8 Wheat.) 229, 243 (1823). *See also* Williams v. Banks, 11 Md. 198 (1857) (split decision over issue).

[37]Williams v. Banks, 11 Md. 198, 250 (1857); *See also* Stratton v. Edwards, 174 Mass. 374, 378, 54 N.E. 886, 887 (1899) (proof must be of an actual intent to harm a particular creditor; general purpose of securing against hazard of future business permissible); Monroe v. Smith, 79 Pa. 459, 461 (1876); *Ex Parte* Russell, 19 Ch. D. 588, 591, 46 L.T.R. (n.s.) 113, 115 (C.A. 1882).

[38]Elwell v. Walker, 52 Iowa 256, 263, 3 N.W. 64, 70 (1879); Claflin v. Mess, 30 N.J. Eq. 211, 212 (1878). Even if transfer was a matter of public record, however, proof of actual misrepresentation as to ownership of transferred assets could shift the burden of proving a lack of fraudulent intent back to the transferor. Fisher v. Lewis, 69 Mo. 629, 632-33 (1879).

had to show that the transfer was "for the purpose" of hindering, delaying or defrauding future creditors.[39]

This required creditors to connect the transfer's consequences with the transferor's actual intent.[40] Factual circumstances often helped. In *Case v. Phelps*,[41] for example, Phelps had transferred all his assets in trust for his own and his family's benefit; he then immediately started, with no personal capital, a "traveling Indian show."[42] The New York Court of Appeals had little problem in finding that this situation evinced an "intent to defraud creditors whom he [Phelps] expected to owe, and whom possible losses might render him unable to pay . . . . This is fraud in fact . . . ."[43]

Lumping subsequent creditors with all other victims of transfers designed to defraud had other effects. One was that subsequent creditors sought to use badges of fraud from other strands of fraudulent conveyance law in addition to insolvency to fit their situation. One badge of fraud that seemed to attract creditors consisted of a transfer in which the transferor engaged in business knowingly left himself just marginally solvent, and still continued in business.

The rise of this new badge of fraud grew from the perceived underinclusiveness of simple insolvency. When testing insolvency, all that was required was the valuation of assets and liabilities; the result flowed from the numerical difference between the two. But debtors as well as creditors can add and subtract, and debtors often made voluntary transfers which left themselves solvent, but just barely so.[44] Courts found such fact

[39]*E.g.*, Mowry v. Reed, 187 Mass. 174, 177, 72 N.E. 936, 937 (1905); Stratton v. Edwards, 174 Mass. 374, 378, 54 N.E. 886, 887 (1899); Winchester v. Charter, 94 Mass. (12 Allen) 606, 610-11 (1866); Case v. Phelps, 39 N.Y. 164, 169 (1868).

[40]To make matters more difficult, at least one commentator believed that such proof had to be by "clear, full and satisfactory" evidence. O. BUMP, *supra* note 31, § 256, at 296.

[41]39 N.Y. 164 (1868).

[42]*Id.* at 165.

[43]*Id.* at 170.

[44]Bohn v. Weeks, 50 Ill. App. 236, 240 (1893) (invalidating gift of $6500, when assets were $7200 to $7300, and when transferor had outstanding and overdue a $400 note); Williams v. Huges, 136 N.C. 58, 59, 48 S.E. 518, 519 (1904) (finding, as a matter of law, that assets of $11,625 were "not fully sufficient and available for the satisfaction of the [transferor's] creditors" when liabilities equaled $11,500); Black v. Sanders, 46 N.C. (1 Jones) 67, 69 (1854) (finding that retention of $7250 in assets to cover $6848 of liabilities was insufficient, basing holding on poor quality of the assets; "[n]o man would lend money upon such security"); Crumbaugh v. Kugler, 2 Ohio St. 374, 379 (1854) (retention of $48,000 of property insufficient when outstanding debts approximated $42,000; insufficiency "owing to expenses incident to sale, and the sacrifice almost universally affecting forced sales . . . "); Monroe v. Smith, 79 Pa. 459, 461 (1875); Hunters v. Waite, 44 Va. (3 Gratt.) 25, 47 (1846); *Ex Parte* Russell, 19 Ch. D. 588, 591, 46 L.T.R. (n.s.) 113, 115 (C.A. 1882) (finding that solvency cannot be based upon the value of "some odds and ends which can possibly be sold, and on which he puts his fancy value.").

patterns to be badges of fraud—and hence permissible bridges to actual intent to defraud—if such transfers unfairly shifted the risk of liquidating assets into cash onto creditors.[45] In addition, some courts found similar unfairness if solvency after the transfer depended upon volatile or transitory factors, such as the "stability of the market."[46]

This risk shifting was seen as a species of fraud; the transferor's ability to convert his assets into cash was diminished, yet trade continued without notice of this change, usually to the detriment of a creditor who had relied on a prior course of dealing.[47] This was seen as wrong; as noted by Orlando Bump, an early commentator, creditors "have the right to expect satisfaction of their debts out of [the transferor's] property, and [the transferor] has no right, in law or morals, to throw upon them the loss which must necessarily occur in converting it into money."[48]

As a result of this reasoning, several rationales for this badge of fraud developed. It was, for example, a badge of fraud to be barely solvent after making a transfer: if one was left with assets unsuitable for lending;[49] if the resulting solvency depended to a great degree on the stability of the market;[50] or if one did not provide for reasonably anticipated[51] or overdue debts.[52] As with the problem of standing for subsequent creditors, these responses had an *ad hoc* flavor. Each case

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[45]*See, e.g.*, Schreyer v. Scott, 134 U.S. 405, 410 (1890) (stating that it was improper to knowingly "throw the hazards of business in which [the transferor] is about to engage upon others, instead of honestly holding his means subject to the chance of those adverse results to which all business enterprises are liable . . . ."); Mackay v. Douglas, 14 L.R.-Eq. 106, 121, 26 L.T.R. (n.s.) 721, 723 (Ch. 1872) (in which the thought process of someone who transfers assets in trust prior to going into a new business was characterized as follows: " 'I am going into trade; I believe I may make a great deal of money by it, but nobody knows what may happen, therefore I will make myself safe. I will make this large fortune safe by settling it on my wife and children absolutely.' "); O. BUMP, *supra* note 31, § 258, at 297.

[46]Carpenter v. Roe, 10 N.Y. 227, 231 (1851) (solvency cannot depend "on the intelligence to be brought by the next steamer"); Brown v. Case, 41 Ore. 221, 229, 69 Pac. 43, 46 (1902) (solvency cannot be "contingent on stability of the market."). *See also* Izard v. Izard, 1 Bail. Eq. 228, 236-37 (S.C. 1831) ("The fluctuations in the value of property, occasioned by the mercantile condition of the country, cannot however be ranked among [those] casualties [for which the transferor need not provide].").

[47]*See* 1 D. MOORE, A TREATISE ON FRAUDULENT CONVEYANCES AND CREDITORS' REMEDIES AT LAW AND EQUITY § 8, at 277 (1908).

[48]O. BUMP, *supra* note 31, § 258, at 297.

[49]*E.g.*, Black v. Sanders, 46 N.C. (1 Jones) 67, 69 (1854); *see also supra* note 46. *Cf.* Babcock v. Eckler, 24 N.Y. 623 (1862) (when property retained approximated $10,000, and debts then equalled $900, transfer upheld).

[50]*See* note 46 *supra*. *See also* D. MOORE, *supra* note 47.

[51]*See* D. MOORE, *supra* note 47.

[52]*E.g.*, Bohn v. Weeks, 50 Ill. App. 236, 240 (1893).

stood on its own facts, with easily stated, but loose and amorphous rules as general guides for decision.

2. A Synthesis: The New Business Doctrine Augments Insolvency.— Decisions such as *Case v. Phelps*[53] galvanized early American judicial thinking, and helped to form a synthesis between the standing and marginal solvency cases. The transfer of all of a person's assets in trust for the benefit of his family, in order to begin a "traveling Indian show"[54] did not sit well. Courts saw such opportunism as an impediment to business generally, and a species of fraud perpetrated upon reasonably anticipated future creditors.[55] But at some point such opportunism melds with the prudence of financial planning; courts grappled with conditions under which they would find the requisite impermissible intent. In this struggle, subsequent creditor cases which used strict standing rules were compared with the marginal solvency cases, which seemed to provide an analytical basis for the relaxation of the standing limitations. Given the similarity of the set of injured creditors under both rules, cases began to conflate standing rules, and drop the requirement of actual intent.[56]

This blending of rationales initially produced inconsistent results. In both *Hagerman v. Buchanan*[57] and *Mackay v. Douglas*,[58] for example, transferors had conveyed their property in trust prior to entering into a trading partnership. In both cases, the partnership failed, and creditors whose debts arose after the conveyance sought to set it aside. *Hagerman* allowed the transfer to stand; *Mackay* invalidated it.

Hagerman considered "[t]he character of the business, the degree of pecuniary hazard incurred, the amount of property remaining in the grantor, the value of the property conveyed, [and] the acts and words occurring coincidentally with the transaction."[59] The court gave great weight to the transferor's belief that the partnership, although risky, was "entirely safe."[60] It thus allowed the transferor's testimony to overcome the "strong evidence of fraudulent intent" which arises when "a person has entered into a hazardous business, or engaged in a speculative enterprise, at or soon after the execution of a voluntary conveyance."[61]

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[53]39 N.Y. 164 (1868).

[54]*Id.* at 165.

[55]*Id.*

[56]*E.g.*, Edwards v. Entwisle, 13 D.C. (2 Mackay) 43, 55-56 (1882) (insolvent debtor's intent to defraud *existing* creditors is prima facie evidence of intent to defraud *subsequent* creditors); *see* cases cited *infra* note 74; O. BUMP, *supra* note 31, § 295.

[57]45 N.J. Eq. 292, 17 A. 946 (1889).

[58]14 L.R.-Eq. 106, 26 L.T.R. (n.s.) 721 (Ch. 1872).

[59]45 N.J. Eq. at 302, 17 A. at 948.

[60]*Id.*

[61]*Id.*

In *Mackay*, a managing clerk had been admitted to a jute trading partnership.[62] Immediately prior to his admission, however, he had transferred a valuable leasehold in trust for his wife.[63] Seven months after his admission, the partnership became "embarrassed," and declared bankruptcy four months thereafter.[64] The vice chancellor agreed that the circumstances justified suspicion; he ruled, however, that the transferor bore "the burden of proving . . . that [he was] in a position to make the voluntary settlement."[65]

The transferor attempted to meet this burden with evidence of his good faith and reasonable belief in the success of the venture,[66] which presumably would have sufficed under *Hagerman*. The English court parted ways with *Hagerman's* rationale, however, and held that a justified belief in success was insufficient to sustain the transfer.[67] The court stated that "the motive therefore in executing this settlement was to protect this property against his creditors, if creditors he should have; in other words, to take the bulk of his property out of the reach of his creditors if any disaster should befall him."[68] The court then found that "a man who contemplates going into trade, cannot, on the eve of doing so, take the bulk of his property out of the reach of those who may become his creditors in his trading operations."[69] As a consequence, the court invalidated the transfer.[70]

Cases such as *Hagerman* and *Mackay* highlighted the uncertain fate of subsequent creditors. Different results could be, and were, obtained depending on the deference given by the deciding tribunal to one's obligations to pay contemplated debts. Courts following *Mackay* required full provision; courts following *Hagerman* and its progeny seemed to allow more leeway for the well meaning, but improvident, transferor.

The confusion caused by the lack of clear guidelines further obscured the main goal of such cases: augmentation of the under-inclusiveness of the concept of solvency as an independent badge of fraud. The evil to be avoided was not the preservation, at any one point in time, of sufficient assets to pay existing creditors; rather, the goal was to prevent the unjust failure of the normal commercial expectation that business

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[62]14 L.R.-Eq. 106, 108, 26 L.T.R. (n.s.) 721, 721.
[63]*Id.*
[64]*Id.* at 109, 26 L.T.R. (n.s.) at 721.
[65]*Id.* at 119, 26 L.T.R. (n.s.) at 722.
[66]*Id.* at 114, 26 L.T.R. (n.s.) at 721.
[67]*Id.* at 121, 26 L.T.R. (n.s.) at 723.
[68]*Id.* at 122, 26 L.T.R. (n.s.) at 723.
[69]*Id.* at 122, 26 L.T.R. (n.s.) at 724.
[70]*Id.*

debt will be paid in a timely manner.[71] Indeed, fraudulent or questionable actions can be taken long before claims ripen or mature,[72] and the solvency concept does not address these at all.

As noted above,[73] the failure of the insolvency badge of fraud to address fully these legitimate questions caused tension. Courts observed that the risk allocation present in transfers leaving the transferor barely solvent was similar to the risk allocation involved in insulating assets from the claims of subsequent creditors.[74] Both types of transfers "rob" the pool of assets—both present and future—from which trade creditors customarily expect their claims to be satisfied.

Cases involving transfers of assets prior to the start of a new business formed the crucible for a new rule, or, in the argot of nineteenth century fraudulent conveyance law, a new badge of fraud. These new business cases, exemplified by *Hagerman* and *Mackay*, contained examples of both types of problems with insolvency as a sufficient badge of fraud. Subsequent creditors were a certainty, and often transferors explicitly sought to insulate their assets from the risks associated with new business.[75] As a consequence of the similarity of rationale, cases tended to drop

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[71]*Id.* at 286 ("The true rule by which the fraudulency or fairness of a voluntary conveyance is to be ascertained . . . is . . . the pecuniary ability of the donor at the time to withdraw the amount of the donation from his estate without the least hazard to his creditors, or in any material degree lessening their then prospects of payment."). *See also* Clark, *supra* note 1, at 544 (the "flexible concept of unreasonably small capital, which relates to insolvency in its pragmatic meaning . . . guaranties that mechanical balance sheet tests of insolvency, which can be arbitrary and misleading, do not vitiate the ideal."); Coquillette, *Guaranty of and Security for the Debt of a Parent Corporation by a Subsidiary Corporation*, 30 CASE W. RES. L. REV. 433, 454 (1980) (noting that "determinations [of unreasonably small capital and inability to pay debts as they become due] merely complement the central concept of insolvency by assuring that creditors do not lose their protection by reason of the momentary solvency of [a party] at the time of the transaction.")

[72]*See, e.g.*, NATIONAL BANKRUPTCY CONFERENCE, ANALYSIS OF H.R. 12889, 74th Cong., 2d Sess. 215 (Comm. Print 1936) ("[E]xperience has demonstrated that a dishonest debtor usually begins his fraudulent activities at a time long prior to four months before his bankruptcy . . . .").

[73]*See supra* text accompanying notes 57-70.

[74]*Cf.* Bohn v. Weeks, 50 Ill. App. 236, 239-40 (1893) (combining discussion of transfers made by insolvents with gifts made under reasonable circumstances when stating rationale for rule); Brown v. Case, 41 Ore. 221, 229, 69 Pac. 43, 46 (1902) (discussing approximations of financial ability to pay creditors after transfer for both insolvents and those on the brink of insolvency).

Indeed, if the identity of trade creditors, and the relative amounts of their respective debts, are the same both before and after the questioned transfer, the risk allocation is virtually identical.

[75]*E.g.* Case v. Phelps, 39 N.Y. 164 (1868); Hagerman v. Buchanan, 45 N.J. Eq. 292, 17 A. 896 (1889); Mackay v. Douglas, 14 L.R.-Eq. 106, 26 L.T.R. (n.s.) 721 (Ch. 1872).

the strict rule that the creditor/plaintiff had to prove actual intent to defraud, and allowed subsequent creditors standing to attack such transfers.[76]

These cases categorized the rule differently. Some stated that the transferor was impermissibly "throw[ing] the hazards of business in which he is about to engage upon others."[77] Others phrased the transferor's act as "cast[ing] upon his creditors the hazard of his speculation."[78] However stated, when courts relaxed standing rules and permitted certain acts to imply fraud, a frustrated creditor only had to show a voluntary transfer, the nature of the transferor's business and a lack of a reasonable reserve against foreseeable risks[79] of that new business.[80] Once the creditor made this showing, it became the debtor's burden of dispelling the presumption of fraud that such facts tended to establish.[81]

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[76]*E.g.*, Edwards v. Entwisle, 13 D.C. (2 Mackay) 43, 55-56 (1882) (insolvent debtor's intent to defraud *existing* creditors is prima facie evidence of intent to defraud *subsequent* creditors); *see* cases cited *supra* note 74; O. BUMP, *supra* note 31, § 295.

[77]Schreyer v. Scott, 134 U.S. 405, 410 (1890).

[78]Carpenter v. Roe, 10 N.Y. 227, 232 (1851).

[79]The concept of risk was often expressed as a "hazard" to be avoided. *See supra* notes 77-78. This concept was sometimes applied not to the general risks of businesses, but to the nature of the business itself. Indeed, the first draft of the UFCA applied only to a transferor in a "hazardous" business; this was deleted from the second draft. *See infra* text accompanying notes 87-93. Collier indicates that the omission of the qualifying adjective "hazardous" in the final draft "can be construed only as conscious and deliberate." 4 COLLIER ON BANKRUPTCY ¶ 548.04, at 548-55 to 548-56 n.10 (15th ed. 1988), and thus strongly indicative of a broad application of section 5.

Notwithstanding this change, some early section 5 cases continued to base their holdings on findings that the transferor was involved in a hazardous or speculative business. *See, e.g.*, State v. Nashville Trust Co., 28 Tenn. App. 388, 190 S.W.2d 785 (1944), *cert. denied*, 181 Tenn. 74 (1945); Fidelity Trust Co. v. Union Nat'l Bank of Pittsburgh, 313 Pa. 467, 169 A. 209 (1933), *cert. denied*, 290 U.S. 680 (1934); People Sav. & Dime Bank & Trust Co. v. Scott, 303 Pa. 294, 154 A. 489 (1931). The current view, however, is that even traditional businesses can run afoul of this section. *Compare* Fidelity Trust Co. v. Union Nat'l Bank of Pittsburgh, 313 Pa. 467, 169 A. 209 (1933), *cert. denied*, 290 U.S. 680 (1934) (speculative nature of trading stocks considered) *with* Teitelbaum v. Voss (*In re* Tuller's, Inc.), 480 F.2d 49 (2d Cir. 1973) (business involved was simple drugstore) *and* Zuk v. Hale, 114 N.H. 813, 330 A.2d 448 (1974) (business was that of independent general contractor). *See also* M. BIGELOW, *supra* note 27, Ch. VIII, § 3, at 237.

[80]*E.g.*, Gable v. Columbus Cigar Co., 140 Ind. 563, 567, 38 N.E. 474, 475 (1894); Fisher v. Lewis, 69 Mo. 629, 632 (1879). *See also* M. BIGELOW, *supra* note 27, Ch. VII, § 3, at 230-31; O. BUMP, *supra* note 31, § 258; 1 G. GLENN, *supra* note 1, § 335.

[81]*See* Elwell v. Walker, 52 Iowa 256, 263, 3 N.W. 64, 70 (1879); State v. Nashville Trust Co., 28 Tenn. App. 388, 419, 190 S.W.2d 785, 796-97 (1944), *cert. denied*, 181 Tenn. 74 (1945); Mackay v. Douglas, 14 L.R.-Eq. 106, 113, 26 L.T.R. (n.s.) 721, 722 (Ch. 1872); H. MAY, *supra* note 34, at 30-31.

Such views, however, were hardly uniform, and the dissonance in these decisions led to a movement to unify and harmonize these disparate themes.[82]

B. The Uniform Fraudulent Conveyance Act

Differences over standing rules and the interpretation of insolvency were by no means the only non-uniform interpretations of the Statute of Elizabeth. Because the prevailing analysis used various factors and badges of fraud, each having a different weight—both among themselves and in different cases—non-uniform results were the norm.[83] Consequently, one of the first uniform acts suggested by the National Conference was the Uniform Fraudulent Conveyance Act (UFCA),[84] proposed in 1916, but not adopted until 1918.

This act, ultimately adopted in 25 states,[85] preserved the traditional ability to set aside transactions entered into with actual intent to "hinder, delay or defraud" creditors. But it went beyond the original language of the Statute of Elizabeth, codifying and distilling the cases in an attempt to produce objective tests for classifying a transfer as sufficiently "fraudulent" to allow creditors to ignore the suspect transaction and levy upon the items transferred.

The UFCA was revised three times prior to its adoption. Each draft sought to validate certain gifts against creditor attack.[86] The initial classification chosen upheld such transfers if the transferor was not left in one of three discrete descriptions of financial conditions. These con-

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[82]One attempt was made in Gately v. Kappler, 209 Mass. 426, 95 N.E. 859 (1911), in which the court held that it was appropriate for a transferor to provide against unknown risks, but not to make transfers that unreasonably protected against known debts. *Id.* at 427-28, 95 N.E. at 859.

[83]*Compare* O. BUMP, *supra* note 31, § 255, at 295 (debts guaranteed or which are co-endorsed not counted for purposes of insolvency) *with* M. BIGELOW, *supra* note 27, Ch. VIII, § 3, at 234-35 (opposite).

Indeed, one of the main purposes of the Uniform Fraudulent Conveyance Act was to resolve the split among the states over the validity of gifts as against future creditors. *See* Prefatory Note to UFCA, 7A U.L.A. 427, 428 (1985); *Report of the Committee on Uniform State Laws*, 5 A.B.A.J. 481, 492 n.2 (1919).

[84]*See supra* note 1.

[85]7A U.L.A. 73 (Supp. 1988). Nebraska was the last to adopt it, and did so in 1980. *Id.* It also has been adopted in the Virgin Islands. *Id.*

The UFCA's influence, however, extends beyond those states which have adopted it by statute. Some states which have not enacted the UFCA have accepted its provisions as accurate restatements of the received learning of the Statute of Elizabeth. Molitor v. Molitor, 184 Conn. 530, 535, 440 A.2d 215, 218 (1981) (finding that the UFCA "is largely an adoption and clarification of the standards of the common law.").

[86]*See supra* note 83.

ditions, however, were further distinguished on the basis of what type of creditors could use them.

One sticking point in this classification scheme was the appropriate circumstances under which future creditors could attack a constructively fraudulent transfer. The first draft of the UFCA, delivered to the Conference in 1916,[87] contained the forerunner of section 5 of the current UFCA, which attempted to answer this question.[88] As promulgated, this section provided that a voluntary conveyance for less than fair consideration could be set aside if "the person making it is engaged or is about to engage in a hazardous business or transaction involving risks exceeding his remaining assets."[89] Standing to challenge such transfers was extended to "persons who become creditors . . . as the result of obligations entered into or acts done during the continuation of such business or transaction."[90]

The Conference recommitted the draft to committee.[91] The second draft, promulgated in 1917,[92] significantly changed the text of proposed section 5. It dropped the "hazardous business" concept, and inserted in its place the current language regarding unreasonably small capital.[93] No explanation for the change was made; indeed, the reporter used the same explanatory notes to elaborate the origins of the section.[94]

The text was again returned to committee.[95] The third and final draft of the UFCA was presented in 1918 at the Conference's annual meeting in Cleveland.[96] Although the text of section 5 had not changed,[97] controversy apparently surrounded it. Immediately prior to adoption of the motion recommending the UFCA to all the states, a motion was made to exclude section 5 from the Conference's recommendation.[98] No

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[87]UFCA (First Tentative Draft), *reprinted in* NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, PROCEEDINGS OF THE TWENTY-SIXTH ANNUAL MEETING OF THE NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS 254 (1916) [hereinafter 1916 PROCEEDINGS].

[88]UFCA § 5 (First Tentative Draft), *reprinted in id.*, at 258.

[89]*Id.*

[90]*Id.*

[91]*See* NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, PROCEEDINGS OF THE TWENTY-SEVENTH ANNUAL MEETING OF THE NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS 249 (1917) [hereinafter 1917 PROCEEDINGS].

[92]UFCA (Second Tentative Draft), *reprinted in id.*, at 250.

[93]UFCA § 5 (Second Tentative Draft), *reprinted in id.*, at 254.

[94]*Id.* at 255.

[95]*Id.* at 65-66.

[96]UFCA (Third Tentative Draft), *reprinted in* NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, PROCEEDINGS OF THE TWENTY-EIGHT ANNUAL MEETING OF THE NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS 348 (1918).

[97]*Id.* at 353.

[98]*Id.* at 52.

other section was singled out for this exclusion. While this motion to exclude ultimately was defeated, the vote was close; of the twenty-nine states present, only sixteen voted to keep section 5 of the Act.[99] Of the remaining thirteen states, twelve voted to exclude section 5, and one state was divided.[100] Thus born in controversy, section 5 was presented to the states.

C. *The Bankruptcy Act, the Bankruptcy Code and the Uniform Fraudulent Transfer Act*

Many states soon adopted the UFCA.[101] Following this lead, Congress in 1938 adopted, almost verbatim, the text of the UFCA as the federal fraudulent transfer standard in the Bankruptcy Act of 1898 (Act).[102] The legislative history lauded the UFCA as incorporating the better reasoned cases under the Statute of Elizabeth.[103] Although not adopted, language stating that the federal statute should be interpreted consistently with the UFCA was suggested.[104]

The enactment of the present Bankruptcy Code (Code)[105] in 1978 was the first major revision to the statutory text of fraudulent transfer law. The Code revised the treatment of the characterization of exchange; "reasonably equivalent value" rather than "fair consideration" became the test.[106] The financial stringency test of "unreasonably small capital,"

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[99]*Id.*

[100]*Id.*

[101]It was ultimately adopted by twenty-five states and the Virgin Islands. *See* 7A U.L.A. 427 (1985).

[102]The text was added by amendments to the 1898 Act, known generally as the Chandler Act. Act of June 22, 1938, c. 575, § 1, 52 Stat. 840, 875 (repealed 1979).

[103]"We have condensed the provisions of the Uniform Fraudulent Conveyance Act, retaining its substance, and, as far as possible, its language." NATIONAL BANKRUPTCY CONFERENCE, ANALYSIS OF H.R. 12889, 74th Cong., 2d Sess. 214 (Comm. Print 1936).

[104]*Id.* at 217. Notwithstanding the omission from the final text, one leading commentator states that powerful considerations should be shown to justify a federal court in departing from well reasoned interpretations of the Uniform Act. 4 COLLIER ON BANKRUPTCY, *supra* note 79, ¶ 548.01, at 548-18 n.25.

[105]*See supra* note 1.

[106]The two terms were intended to be equivalent with respect to the measurement of the amount of consideration. COMMISSION REPORT, *supra* note 10, Part I, at 211; Comment, *Guaranties and Section 548(a)(2) of the Bankruptcy Code*, 52 U. CHI. L. REV. 194, 198 n.18 (1985) (citing other relevant legislative history). Under the UFCA, however, "fair consideration" also includes the concept of good faith. UFCA, *supra* note 1, § 3. *See generally* Comment, *Good Faith and Fraudulent Conveyances*, 97 HARV. L. REV. 495 (1983). The Code and UFTA break out the concept of good faith from the concept of consideration, and make it an affirmative defense, validating the transfer or the obligation to the extent the transferee gave with good faith. 11 U.S.C. §§ 548(c) (1982) (initial transferee); 550(b) (mediate and intermediate transferees); UFTA, *supra* note 1, §§ 8(a), (d) (same).

however, remained the same, and the reach of the section was expanded from conveyances to "obligations incurred."[107]

Although the substantive requirements for other types of fraudulent transfers were little changed, the Code significantly altered (although it purported not to) the section condemning transfers by insolvents. In adopting the insolvency test previously used to test "acts of bankruptcy"[108] and other matters[109]—that of liabilities exceeding assets "at a fair valuation"[110]—the Code rejected the Act's and the UFCA's reliance on asset valuation at a "present fair salable value."[111] The difference between the two tests was known,[112] and is significant.[113] The Code thus makes proof of insolvency a much more difficult task.

The Uniform Fraudulent Transfer Act (UFTA),[114] when promulgated in 1984, adopted most of the Code's changes. Indeed, one of the UFTA's

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[107]11 U.S.C. § 548(b)(2)(B)(ii) (1982). *See also supra* note 8 for a discussion of the differences between the text of the Code and the UFCA.

[108]*See, e.g.*, Act, *supra* note 1, §§ 3(a)(3), 11 U.S.C. § 21(a)(3) (repealed 1979) (suffering imposition of a lien while insolvent); 3(a)(5), 11 U.S.C. § 21(a)(5) (repealed 1979) (appointment of a receiver or trustee while insolvent).

[109]The Act used the "fair valuation" formula in determining whether a person was insolvent for purposes of assessing preferences. Act, *supra* note 1, § 60, 11 U.S.C. § 96 (repealed 1979). In addition, under Chapter X of the Act, 11 U.S.C. §§ 501-676 (repealed 1979), a finding of insolvency permitted a court to appoint a receiver. *Id.* at § 115, 11 U.S.C. § 515 (repealed 1979), and triggered certain protections for dissenting shareholders. *Id.* § 216(8), 11 U.S.C. § 616(8) (repealed 1979).

[110]"A person shall be deemed insolvent . . . whenever the aggregate of his property, . . . shall not at a fair valuation be sufficient in amount to pay his debts." Act, *supra* note 1, § 1(19), 11 U.S.C. § 1(19) (repealed 1979). *Cf.* 11 U.S.C. § 101(31) (1982) (" 'insolvent' means . . . financial condition such that the sum of the entity's debts is greater than all of such entity's property, *at a fair valuation* . . . .") (emphasis added).

[111]*See* Act, *supra* note 1, § 67(1)(d), 11 U.S.C. § 107d(1)(d) (repealed 1979).

[112]*See e.g.*, Holahan v. Lewis, 182 F. Supp. 473 (N.D. Fla. 1960). In that case the court stated:

> The Court construes the definition of insolvency as defined in Section 107 as the controlling one in the application of Section 107 sub. d(2)(a) et. seq. The definition of insolvency as enunciated in Section 1, Subdivision 19, carries a far broader sweep than does Section 107. It is apparent that Congress intended less stringent proof of insolvency in Section 107 than in other phases of bankruptcy proceedings.

Id. at 476-77. *See also* 1 G. GLENN, *supra* note 1, at § 272.

[113]Early courts noted this difference and specifically found that the "fair valuation" test produced a more liberal and higher total asset value than did the present fair valuation standard. *In re* Crystal Ice & Fuel Co., 283 F. 1007, 1009-10 (D. Mont. 1922); Stern v. Paper, 183 F. 228, 231 (D.N.D. 1910) (court noted that the fair valuation standard is "liberal" and "ought not to be enlarged."). *See also* Tri-Continental Leasing Corp., Inc. v. Zimmerman, 485 F. Supp. 495, 498 (N.D. Cal. 1980); Meyer v. General American Corp., 569 P.2d 1094, 1096 (Utah 1977). Professor Glenn argued early and strenuously for the abolition of the fair valuation test in favor of one such as was adopted in the UFCA. 1 G. GLENN, *supra* note 1, at § 272.

[114]*See supra* note 1.

implied purposes was to conform the uniform state law with the Code.[115] The UFTA, for example, adopts the reasonably equivalent value test,[116] and the Code's extension of the action to obligations.[117] It also adopts the Code's revised formulation of insolvency.[118]

The UFTA, however, broke some new ground. It changes the formulation of section 5's financial stringency condition to "unreasonably small *assets*."[119] The UFTA defines "assets" as non-exempt property which is not subject to a valid lien.[120] This change was made to avoid confusing working capital concepts—which are the heart of the section—with corporate law concepts of paid in capital[121]—which are irrelevant to fraudulent transfer law.[122] The focus has thus been shifted from adequacy at inception to adequacy at all reasonably foreseeable times.

The UFTA has been rapidly adopted by at least seventeen states,[123] with some inevitable variations, mostly in the UFTA's resurrection of badges of fraud.[124] What remains fairly constant, however, is the thrust

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[115]*See* Prefatory Note to UFTA, *reprinted in* 7A U.L.A. 639 (1985).

[116]UFTA, *supra* note 1, §§ 4(a)(2); 5(a).

[117]UFTA, *supra* note 1, § 4(a)(2)(i). *See also supra* note 8.

[118]UFTA, *supra* note 1, § 2. The UFTA expands upon the Code's definition, however, by creating a rebuttable presumption of insolvency if a transferor is not "generally paying its debts as they become due." *Id.* § 2(b). *See* Cook & Mendales, *The Uniform Fraudulent Transfer Act: An Introductory Critique*, 62 AM. BANKR. L.J. 87, 91-92 (1988).

In the context of passing the UFTA, at least one state has tackled head on the issue of the valuation of assets, adopting views which would have eliminated much of the recent furor fraudulent transfer law has caused. *See, e.g.*, Comments (6) and (7) to proposed CAL. CIV. CODE § 3439.02, CAL. ASSEMBLY J., *supra* note 7, at 8574-75 (valuation of contingent debts).

[119]UFTA, *supra* note 1, § 4(a)(2)(i).

[120]UFTA, *supra* note 1, § 1(2).

[121]For cases apparently using corporate capital concepts, *see, e.g.*, Diller v. Irving Trust Co. (*In re* College Chemists, Inc.), 62 F.2d 1058 (2d Cir. 1933); Wells Fargo Bank v. Desert View Bldg. Supplies, 475 F. Supp. 693 (D. Nev. 1978), *aff'd mem.*, 633 F.2d 225 (9th Cir. 1980).

[122]Reporter's Note to UFCA § 4, 7A U.L.A. 654 (1985). *See also* Comment (4) to Proposed Section 3439.04 of the CAL. CIV. CODE, CAL. ASSEMBLY J., *supra* note 7, at 8577.

[123]These are: Arkansas, California, Florida, Hawaii, Idaho, Maine, Minnesota, Nevada, New Hampshire, North Dakota, Oklahoma, Oregon, Rhode Island, South Dakota, Texas, Washington, and West Virginia. 7A U.L.A. 88 (Supp. 1988). Of these seventeen, only nine, California, Idaho, Minnesota, Nevada, New Hampshire, North Dakota, Oklahoma, South Dakota and Washington, had adopted the UFCA. *Id.*

[124]California, for example, did not adopt the UFTA recitation of badges of fraud as indicia of transfers made with the actual intent to hinder, delay or defraud. CAL. CIV. CODE § 3439.04 (West Supp. 1988). It did, however, list those badges of fraud in the legislative history as a "nonexclusive list of some facts which courts have considered . . ." in finding actual intent. Comment (5) to Proposed Section 3439.04 of the CAL. CIV. CODE, CAL. ASSEMBLY J., *supra* note 7, at 8577.

of the section as deterring transfers for less than reasonably equivalent value by businesses bordering on insolvency.

III. Case Law Developments

Despite the basic textual differences in the various sources of fraudulent transfer law, the cases are not so diverse. Indeed, with but a few exceptions, the cases have been true to the original limited intent of the section. It is to a brief review of these cases that this article now turns.

A. Interpretations of Section 5

After the promulgation of the UFCA, section 5 received little independent notice.[125] The case law that did develop, however, did little to illuminate the basic question: what is the scope of the unreasonably small capital section? Several false starts occurred. One view concentrated on the transferor's "working capital"—loosely defined as the excess of current assets over current liabilities.[126] Another looked to a transferor's "capitalization," taken to be the amount of assets placed at risk in the business.[127]

The main view, to the extent that one developed, focused on the transferor's ability to marshal sufficient cash, either from operations, equity infusions, new loans or some combination of these, to pay expected creditors.[128] These cases took a forward looking view, comparing anticipated cash flow against anticipated debt incurrence.[129]

Most cases, however, avoided taking sides with these definitional issues, and instead developed *per se* rules derived from other fraudulent conveyance law notions, and from corporate law generally.[130] Section 5's history, however, as well as the historical purpose of promoting

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[125]*See supra* note 15.

[126]*See, e.g.*, Steph v. Branch, 255 F. Supp. 526 (E.D. Okla. 1966), *aff'd* 389 F.2d 233 (10th Cir. 1968); Zuk v. Hale, 114 N.H. 813, 330 A.2d 448 (1974).

[127]*See, e.g.*, Wells Fargo Bank v. Desert View Bldg. Supplies, 475 F. Supp. 693 (D. Nev. 1978) ("The primary intent of this statute is to prevent an under-capitalized company from being thrust into the market place to attract unwary creditors to inevitable loss while one or more preferred creditors are provided relative safety of a security interest in the company's assets."), *aff'd mem.*, 633 F.2d 225 (9th Cir. 1980).

[128]Credit Managers Ass'n of S. Cal. v. Federal Co., 629 F. Supp. 175 (C.D. Cal. 1985); Steph v. Branch, 255 F. Supp. 526 (E.D. Okla. 1966), *aff'd*, 389 F.2d 233 (10th Cir. 1968); *In re* Atlas Foundry Co., 155 F. Supp. 615 (D.N.J. 1957); Jacobson v. First State Bank of Benson (*In re* Jacobson), 48 Bankr. 497 (Bankr. D. Minn. 1985); Jenney v. Vining, 120 N.H. 377, 415 A.2d 681 (1980).

[129]*See, e.g.*, Credit Managers Ass'n of S. Cal. v. Federal Co., 629 F. Supp. 175 (C.D. Cal. 1985).

[130]*See infra* text accompanying notes 136 to 166.

"true and plain dealing,"[131] both augur against such iron clad and inflexible rules. Section 5 was created to address perceived inadequacies in section 4[132]—dealing with transfers by insolvents—and even then its adoption was only by a narrow margin.[133] This uncritical expansion not only ignores the section's historical roots, but also ignores the current role of fraudulent transfers involving unreasonably small capital.

B. Uncritical Expansion of the Action

Since its enactment, two lines of cases have expanded the scope of the unreasonably small capital action in unjustifiable ways. The first line of these cases declared that a pledge of all or substantially all of a company's assets *ipso facto* leaves the transferor with unreasonably small capital.[134] The second line holds that a finding of insolvency is *per se* a finding of unreasonably small capital.[135] These cases, at first glance, seem to provide certainty to a confusing area of the law. In reality, however, they preserve an ossified and incorrect view of fraudulent transfer law, and an examination of their reasoning demonstrates their lack of continuing validity.

1. Encumbrance of All Assets.—A few cases have held that if a company has little or no unencumbered assets, it automatically has unreasonably small capital. The seminal case for this proposition is *Diller v. Irving Trust Co.* (In re *College Chemists, Inc.*).[136] There, Diller had sold all of the shares of her company, College Chemists, Inc., to Weiner.[137] Weiner agreed to pay the purchase price by causing his new company, College Chemists, to grant Diller a security interest in all of its assets.[138] When College Chemists was declared bankrupt, the trustee in bankruptcy sued to invalidate the security interest and succeeded. The basis of its claim was that the transfer of the security interest was a fraudulent conveyance of the unreasonably small capital variety.[139]

The Second Circuit, in a one page *per curiam* opinion, affirmed the invalidation. The court had no problem finding unreasonably small capital, because it determined that "there was no capital at all, because

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[131]*See supra* text accompanying notes 18 to 21.

[132]*See supra* note 71.

[133]*See supra* notes 99-100.

[134]*See infra* text accompanying notes 136 to 158.

[135]*See infra* text accompanying notes 159 to 166.

[136]62 F.2d 1058 (2d Cir. 1933) (per curiam).

[137]*Id.*

[138]*Id.*

[139]*Id.* The Second Circuit's opinion is silent with regard to whether the trustee had also sought to show that College Chemists had been made insolvent by the transfer.

Weiner's debt was more than its value."[140] In short, by counting the acquisition debt, College Chemists' balance sheet liabilities exceeded its balance sheet assets. To allow the pledge to stand, in the court's view, would allow "Weiner to carry on the business on an expectancy of profit."[141] The rule in *College Chemists* has been followed at least three times, in each case without detailed analysis.[142] Although the circumstances present in each of these cases may have presented a sufficient factual basis for their result, they certainly do not compel automatic relief.

As recognized by several recent cases,[143] it does not necessarily follow that the lack of unencumbered assets constitutes "unreasonably small" capital. These cases focus on several factors tending to establish the availability of cash to operate the business, rather than on a single factor such as a lack of unencumbered assets. For example, in *Credit Managers Associations of Southern California v. Federal Co.*,[144] General Electric Credit Corp. ("GECC"), a well-known asset-based lender, lent over seven million dollars in a management-lead leveraged buyout. When a labor strike and other setbacks caused financial problems, GECC increased its line by over two and one-half million dollars.[145] The court properly considered this an appropriate and anticipated source of capital.[146]

Similarly, in *Allied Products Corp. v. Arrow Freightways, Inc.*,[147] the New Mexico Supreme Court was faced with the exact situation in *College Chemists*: a sale of a business in which the buyer caused its new company to secure the deferred portion of the purchase price with

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[140]*Id.* at 1058. The court seemed to infer that the purchase price had been too high; since "Weiner's debt" equalled the purchase price, the "value" of the assets could only be less than that amount if Weiner paid too much, with the result that Diller received a debt in excess of the value of the assets sold. The Second Circuit confirmed this reading in Teitelbaum v. Voss (*In re* Tuller's, Inc.), 480 F.2d 49 (2d Cir. 1973). There, under essentially the same facts as in *College Chemists*, the court stated that the security interest in favor of the departing shareholders "left [the transferor] with all of its tangible assets mortgaged. It was [thus] effectively devoid of capital . . . ." *In re Tuller's*, 480 F.2d at 52.

[141]*College Chemists*, 62 F.2d at 1058.

[142]Teitelbaum v. Voss (*In re* Tuller's, Inc.), 480 F.2d 49, 51-52 (2d Cir. 1973); Pirrone v. Toboroff (*In re* Vaniman Int'l, Inc.), 22 Bankr. 166, 186 (Bankr. E.D.N.Y. 1982); Sharrer v. Sandlas, 103 A.D.2d 873, 477 N.Y.S.2d 897, *motion for leave to appeal denied*, 63 N.Y.2d 610, 473 N.E.2d 1190, 484 N.Y.S.2d 1024 (1984), *reargument denied*, 64 N.Y.2d 885, 476 N.E.2d 1008, 487 N.Y.S.2d 1029 (1985). *Accord In re* Atlas Foundry Co., 155 F. Supp. 615, 617 (D.N.J. 1957) (court found that encumbrance of assets to finance leveraged acquisition reduced the "free assets of the bankrupt corporation to a point too low to permit it to carry on its operations with safety.").

[143]*See infra* text accompanying notes 144 to 158.

[144]629 F. Supp. 175 (C.D. Cal. 1985).

[145]*Id.* at 186.

[146]*Id.* at 184.

[147]104 N.M. 544, 724 P.2d 752 (1986).

the company's own assets. In *Allied Products*, however, the new owner invested over $100,000, personally guaranteed over $250,000 in trade debt, and renegotiated other debt.[148] Although the court found that the "security interests made future financing difficult, if not impossible,"[149] it also found, presumably from the new owner's efforts and investments, that there was "uncontradicted testimony" as to remaining capital.[150]

The rule of *College Chemists* ignores these alternative sources of operating capital. As established in *Credit Managers* and in *Allied Products*, borrowing against or selling unencumbered assets is only one of many commercially reasonable methods of raising cash. A company may seek additional equity capital, either through capital contributions from existing owners or by the sale of equity interests to new investors.[151] It may issue unsecured debt. If there is a senior blanket security interest, a new lender may lend more on the same assets secured by a junior lien, the existing lender may itself lend more, or the existing lender may subordinate its interest to a new lender. In short, even though debt may exceed aggregate asset value, as was the case in *College Chemists*, many avenues exist to funnel cash into the company.

In addition to this failure to consider all possible sources of operating capital, *College Chemists* and its progeny disregard the true economic effect of the types of transactions involved. The transaction examined in *College Chemists* involved a pattern familiar to acquisitions generally; a portion of the consideration passing to the selling equity interests is deferred and expected to be paid from future profits of the business sold. The buyer, in turn, uses its newly acquired control to cause the company bought to secure the deferral with the assets of the company sold. Recently, these transactions have been called leveraged buyouts.[152] *College Chemists* condemns these transactions, based upon the view that such transfers allow the transferor to conduct business on "an expectancy of profit,"[153] presumably for the sole benefit of the transferor. But in

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[148]*Id.* at 545, 724 P.2d at 753.

[149]*Id.* at 548, 724 P.2d at 756.

[150]*Id.*

[151]Professor Clark has recognized that the provision of additional equity can be relevant. Clark, *supra* note 1, at 560.

[152]*See generally* Carlson, *Leveraged Buyouts in Bankruptcy*, 20 GA. L. REV. 73 (1985); Baird & Jackson, *supra* note 6; Comment, *supra* note 1. Indeed, some commentators have indicated that the new UFTA may be more lenient in allowing successful fraudulent transfer attacks on leveraged buyouts. Cook & Mendales, *supra* note 118, at 91 ("a leveraged acquisition that left a corporation with little or no unencumbered property would be even more readily subject to attack than under present law").

[153]Diller v. Irving Trust Co. (*In re* College Chemists, Inc.), 62 F.2d 1058, 1058 (2d Cir. 1933). *See also* Mackay v. Douglas, 14 L.R.-Eq. 106, 121, 26 L.T.R. (n.s.) 721, 723 (Ch. 1872) (characterizing the thought process of someone who transfers assets in trust

College Chemists the person benefitting from the transfer—the seller—was *not* the transferor. In short, in a leveraged buyout, the "culprit," if any, is the departing equity owners. It is decidedly not the third party financing the transaction.

Two observations flow from this review of the position of the parties. If a third party finances the leveraged buyout, setting aside its lien or obligation may automatically give rise to an action by the financing party for return of the loan funds or other consideration on equitable theories such as unjust enrichment.[154] Accordingly, in the bankruptcy context the remedy of invalidation is not without its detractions.[155] Second, since the real flow of funds is from the operating company to its departing shareholders, a question exists whether fraudulent transfer law even applies.[156] State laws on dividend restrictions exist for the protection of creditors against shareholders' ability to divert corporate funds.[157] Not only are these statutes crafted to deal directly with this type of transfer, but the original drafters of the UFCA declined to include such a section in the UFCA, even though it had been proposed

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prior to going into a new business as follows: "'I am going into trade; I believe I may make a great deal of money by it, but nobody knows what may happen, therefore I will make myself safe. I will make this large fortune safe by settling it on my wife and children absolutely.'").

[154]*See* RESTATEMENT OF RESTITUTION § 17 (1937) (person who has paid money or void or voidable agreement may receive restitution). *See also* Stratton v. Hanning, 139 Cal. App. 2d 723, 727, 294 P.2d 66, 68 (1956).

[155]In a state court setting, the issue is typically one of priorities between two creditors, the plaintiff and the transferee/defendant. In a bankruptcy context, however, the plaintiff represents *all* creditors, and the benefits of the avoided transfer are preserved for the benefit of the bankruptcy estate. 11 U.S.C. § 551 (1978). Invalidating a transfer and reducing the status of that lien creditor to one of an unsecured creditor may or may not help other unsecured creditors. *See, e.g.*, H. Rep. 595, 97th Cong., 1st Sess. 376 (1977); S. Rep. 989, 95th Cong., 2d Sess. 91 (1982). For example, if significant unencumbered assets existed prior to invalidation, and the claim sought to be invalidated was undersecured, the result of a successful action might be detrimental to unsecured creditors, *i.e.*, it would result in a lesser dividend. Accordingly, the rights inuring to the benefit of a defeated lien creditor are important, and must be considered by the debtor or trustee. Further subordination, to that of equity interests, would require additional and more egregious acts. *See generally* Bank of New Richmond v. Production Credit Ass'n of River Falls (*In re* Osborne), 42 Bankr. 988, 996-97 (W.D. Wisc. 1984); DeNatale & Abram, *The Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors*, 40 BUS. LAW. 417 (1985).

[156]Although cases exist which permit a fraudulent conveyance attack on dividend payments, these cases do not critically consider the policy reasons, examined *infra* at note 158, as to why fraudulent transfer law ought not to be so extended. Consove v. Cohen (*In re* Roco Corp.), 701 F.2d 978, 982 (1st Cir. 1983); Fox v. MGM Grand Hotels, 137 Cal. App. 3d 524, 187 Cal. Rptr. 141 (1983).

[157]*See* Prefatory Note to UFTA, 7A U.L.A. 639 (1985).

in the first draft.[158] Against this background, it makes little sense to bring fraudulent transfer law to bear upon the problem, let alone erect a *per se* rule against such transactions.

2. From Insolvency Directly to Unreasonably Small Capital.—A second line of cases has developed another unwarranted *per se* rule: that a finding of insolvency is automatically a finding of unreasonably small capital.[159] This rule does violence to the carefully structured standing rules applicable to fraudulent transfers and achieves results inconsistent with the UFCA's original intent. As such, it should be repudiated.

The vice of this rule is demonstrated by recalling the standing rules for fraudulent transfers: a transfer which renders a transferor insolvent may be attacked by any of the transferor's then-existing creditors, but not by creditors whose debts arise after the transfer. The rationale for this distinction is that future creditors at least have the opportunity to inquire as to the transferor's financial condition and decline to trade if the information obtained was negative.[160] Those who were creditors at the time of the transaction had no such opportunity.

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[158]Section 8 of the First Tentative Draft of the UFCA was entitled "Payment of Dividend by Corporation." 1916 PROCEEDINGS, *supra* note 87, at 259-60. The Second Tentative Draft omitted this section "as belonging to a Corporation [Act] rather than a Fraudulent Conveyance Act." 1917 PROCEEDINGS, *supra* note 91, at 258. Professor Glenn also believed that restrictions on corporate dividends were not the province of fraudulent conveyance laws. 1 G. GLENN, *supra* note 1, § 604, at 1043-47. *See also* Coquillette, *supra* note 71, at 446-48.

Professor Clark argues strenuously for coverage of corporate dividends by fraudulent transfer laws, based in part on his view that dividend restriction statutes are "virtually meaningless" because they are rigid, bright line tests, focusing on "formalistic accounting conventions" rather than on the UFCA's "purposive concept of capital." Clark, *supra* note 1, at 556, 558-59 n.154. Professor Clark seems to discount the UFCA's historical origins, and also gives too little deference to state legislatures in the control of the corporate creatures they create. Instead, he exalts the flexibility of the common law over the perceived restricting influence of legislation. It makes little sense, however, to enact statutes specifically designed to regulate the shareholder/corporation relationship if common law concepts will always, or nearly always, usurp their function. Given the set of balances a legislative body strikes in creating corporations with their limited liability to exist, Professor Clark's position seems to pass wide of the mark.

[159]United States v. Gleneagles Investment Co., Inc., 565 F. Supp. 556, 580 (M.D. Pa. 1983), *aff'd sub nom.* United States v. Tabor Court Realty Corp., 803 F.2d 1288 (3d Cir. 1986); New York Credit Men's Adjustment Bureau, Inc. v. Adler, 2 Bankr. 752, 756 (S.D.N.Y. 1980); White v. Coon (*In re* Purco, Inc.), 76 Bankr. 523, 529 (Bankr. W.D. Pa. 1987); Louisiana Indust. Coatings, Inc. v. Pertuit (*In re* Louisiana Indust. Coatings, Inc.), 31 Bankr. 688, 698 (Bankr. E.D. La. 1983) ("A negative capital position represents *ipso facto* an unreasonably small capital with which to do *any* business") (emphasis in original).

[160]Crumbaugh v. Kugler, 2 Ohio St. 374, 379 (1854) (subsequent creditors "give credit to their debtor as he is—for what he has, not for what he once had"); Monroe v. Smith,

In contrast, a transfer which leaves a transferor with unreasonably small capital may be attacked not only by present creditors, but future creditors as well. This standing rule derives from the historical antecedents of the section that equated "securing against the hazards of business" with fraud on future creditors, since they were the target of the malign intent.[161]

Regardless of the origin of the distinction in standing, however, the distinction exists. At bottom, it implies strongly that a transferor may be insolvent, and yet still retain an adequate amount of capital or cash flow. This proposition is not as wild as it may first seem: insolvency under the UFCA developed into an incredibly creditor-protective calculation. Assets which could not be quickly sold were given no value, regardless of their cost;[162] contingent assets could be disregarded;[163] and guaranties and other contingent obligations were valued at face,[164] with little consideration of offsetting rights.[165] As a consequence, companies which held relatively liquid assets such as land could quite easily be insolvent, but could still operate effectively and could generate sufficient

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79 Pa. 459, 462 (1876) ("It is difficult to perceive how one who had knowledge of such a conveyance before he dealt with the grantor, and hence must have acted in view of it, could, by any possibility, be defrauded thereby"). *See also* Todd v. Nelson, 109 N.Y. 794, 797, 16 N.E. 360, 364-65 (1888).

[161]Schreyer v. Scott, 134 U.S. 405, 409-10 (1890); Winchester v. Charter, 94 Mass. (12 Allen) 606, 610-11 (1866); D. MOORE, *supra* note 47, § 8, at 277.

[162]Corbin v. Franklin Nat'l Bank (*In re* Franklin Nat'l Bank Securities Litigation), 2 Bankr. 687, 711-12 (E.D.N.Y. 1979), *aff'd mem.*, 633 F.2d 203 (2d. Cir. 1980) (book value of stock of subsidiary had no present fair salable value; court reasoned that since "there were no purchasers or bidders for [the stock] in May and June of 1974, [the] stock, realistically speaking, had no value."); Chase Nat'l Bank v. United States Trust Co., 236 App. Div. 500, 503, 260 N.Y.S. 40, 44 (1932) ("Not every asset, but only such as are salable, enter the equation."); Fidelity Trust Co. v. Union Nat'l Bank of Pittsburgh, 313 Pa. 467, 169 A. 209 (1933), *cert. denied*, 291 U.S. 680 (1934) (reversing trial court's refusal to give "present" controlling meaning).

[163]*See, e.g.*, Kepler v. Atkinson (*In re* Atkinson), 63 Bankr. 266, 269 (Bankr. W.D. Wisc. 1986) (unmatured claim against insolvent person has no value under Wisconsin version of UFCA). *Cf.* Wight v. Rohlffs, 48 Cal. App. 2d 696, 121 P.2d 76 (1942) (under precursor of UFCA; court only considered assets subject to court process in California and excluded consideration of transferor's interest in Massachusetts probate estate).

[164]Chase Manhattan Bank (N.A.) v. Oppenheim, 109 Misc. 2d 649, 652, 440 N.Y.S.2d 829, 831 (N.Y. Sup. Ct. 1981); Marine Midland Bank v. Stein, 105 Misc. 2d 768, 770, 433 N.Y.S.2d 325, 327 (Sup. Ct. 1980). *But cf.* Cate v. Nicely (*In re* Knox Kreations, Inc.), 474 F. Supp. 567, 571-72 (E.D. Tenn. 1979), *aff'd in part, rev'd in part on other grounds*, 656 F.2d 230 (6th Cir. 1981) (corporate guaranty which was not likely to be enforced not counted as liability under Tennessee version of UFCA); *In re* Xonics Photochemical, Inc., 841 F.2d 198, 200 (7th Cir. 1988) (contingent liabilities must be discounted to reflect probability that contingency will materialize).

[165]Tri-Continental Leasing Corp., Inc. v. Zimmerman, 485 F. Supp. 495, 499 (N.D. Cal. 1980); Bergquist v. First Nat'l Bank of St. Paul (*In re* American Lumber Co.), 5 Bankr. 470, 475-76 (D. Minn. 1980); 1 COLLIER ON BANKRUPTCY, *supra* note 79, ¶ 101.31[5], at 101-66.

capital to augment the existing capital base.[166] Therefore, the application of a *per se* rule subsuming unreasonably small capital within insolvency would appear unwarranted. Its blind application produces an antinomy; the automatic extension of standing to future creditors upon proof of insolvency—which is a result consciously not included in the statute.

These two *per se* rules combine with the intensely fact-bound nature of the analysis in all other cases to create a featureless framework for critical analysis of unreasonably small capital cases. Given the action's history, and the general trend of current case law, a synthesis is possible which contains a principled and logical analytical framework for future cases. It is to that task that this article now turns.

IV. Toward True and Plain Dealing: A Proposed Synthesis

With the Code's and the UFTA's softening of creditor-protective definitions of insolvency,[167] lawyers seeking to set aside questionable transfers will inevitably come to rely more heavily upon the unreasonably small capital section.[168] It does not require proof of insolvency and neatly avoids the issue of standing. In addition, the case law interpreting the section is scarce and, at best, cryptic, allowing for good faith arguments for expansion.

Against this background, it is inevitable that arguments will arise pressing for new or expansive interpretations of this action.[169] Fast application of the new UFTA or the new provisions of the Code may, however, outpace the original intent behind the action; that is, curing specific perceived deficiencies with the concept of insolvency.[170] The received learning and the jurisprudence of section 5 argue against such easy applications.

In addition, the frailties of the two lines of cases set forth above can point to a better understanding of the unreasonably small capital action. First, the deficiencies of *College Chemists* and its progeny un-

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[166]*Cf.* American Insulator Co. v. Marsh Plastics, Inc. (*In re* American Insulator Co.), 60 Bankr. 752, 755 (Bankr. E.D. Pa. 1986) (valuation of land acquired in 1920 at cost, as indicated by applicable rule, would unduly skew insolvency calculation in favor of insolvency; recent appraisals used instead).

[167]*See supra* text accompanying notes 108 to 113.

[168]*See, e.g.*, Alces & Dorr, *A Critical Analysis of the New Uniform Fraudulent Transfer Act*, 1985 U. Ill. L. Forum 527, 560 (categorizing application of unreasonably small assets test of UFTA as "easy, even tautological" in the case of failed businesses); Cook & Mendales, *supra* note 118, at 91 ("a leveraged acquisition that left a corporation with little or no unencumbered property would be even more readily subject to attack than under present law").

[169]*Id.*

[170]*See supra* text accompanying notes 70 to 72.

derscore the importance of a broad definition of capital.[171] Next, the inherent contradiction of cases making the unwarranted leap from insolvency to unreasonably small capital shows that inadequacy of capital must stand on its own ground to preserve the structure created by the standing rules of both the UFCA and the UFTA.[172] Each of these concerns is addressed below.

A. Defining "Capital"

Initially, in order to determine what is "unreasonably small" capital, the definition of "capital" or "assets"[173] must be made clear. One recent case surmised that it was "the unadjusted value of all assets, however encumbered."[174] The UFTA definition of "assets," however, rejects this view by explicitly excluding "assets" to the extent they are subject to valid encumbrances.[175] Also rejected is any notion that "capital" includes only invested or "risk" capital,[176] and the notion that "capital" consists only of free or unencumbered assets.[177]

So much for what "capital" is not. Some hint of what it is can be gleaned from the text of the statute. Both the Code and the UFTA require that the "capital" or "assets" be adequate "in relation to the [transferor's] business or transaction."[178] This formulation forces a forward looking view; it requires a transferor to retain adequate wherewithal for future businesses or transactions.

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[171]*See supra* text accompanying notes 150 to 152.

[172]*See supra* text accompanying notes 159 to 166.

[173]The remainder of this article will refer to "capital" rather than assets. This use comports with the intent of the UFTA to clarify, rather than change, the scope of the section. *See* Reporter's Note to UFTA § 4(b)(1), 7A U.L.A. 654 (1985).

[174]Jacobson v. First State Bank of Benson (*In re* Jacobson), 48 Bankr. 497, 501 (Bankr. D. Minn. 1985).

[175]Section 1(2) defines "asset" to mean "property of a debtor, but the term does *not* include: (i) property to the extent it is encumbered by a valid lien . . ." (emphasis supplied). *Cf.* Comment (3) to Proposed Section 3439.04 of the CAL. CIV. CODE, CAL. ASSEMBLY J., *supra* note 7, at 8576-77 ("The premise of this Act is that when a transfer is for security only, the equity or value of the asset that exceeds the amount of the debt secured remains available to unsecured creditors and thus cannot be regarded as the subject of a fraudulent transfer merely because of the encumbrance resulting from an otherwise valid security transfer.").

[176]"The reference to 'capital' in the [UFCA] is ambiguous in that it may refer to net worth or to the par value of stock or to the consideration received for the stock issued. The special meanings of 'capital' in corporation law have no relevance in the law of fraudulent transfers." Comment (4) to Proposed Section 3439.04 of the CAL. CIV. CODE, CAL. ASSEMBLY J. 8569, *supra* note 7, at 8577. *See also* Reporter's Note to UFTA § 4, 7A U.L.A. 654 (1985).

[177]*See supra* text accompanying notes 136 to 158; Clark, *supra* note 1, at 555 n.140 (equating "net worth" with "capital").

[178]11 U.S.C. § 548(b)(2)(B)(ii) (1982); UFTA, *supra* note 1, § 4(a)(2)(i).

Courts have recognized this perspective; "capital" has been extended to reasonably foreseeable future cash flow, be it from operations,[179] equity capital infusions,[180] residual equity in equipment obtained through the use of purchase money financing[181] or new and commercially reasonable loans.[182] As a consequence, the test for unreasonably small "capital" should include these concepts; the aggregate amount of "capital," in short, would include all reasonably anticipated sources of operating funds, which may include new equity infusions, cash from operations or cash from secured or unsecured loans over the relevant period.[183]

B. Determining "Unreasonably Small" Amounts of Capital

If capital comprises all available cash resources over the relevant period, what constitutes "unreasonably small" amounts of it? An outline of the answer can be given by examining existing unreasonably small capital cases for the elements of a successful case.[184] This examination

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[179]Credit Managers Ass'n of S. Cal. v. Federal Co., 629 F. Supp. 175, 184 (C.D. Cal. 1985) (consideration of future cash flow from operations in determining whether remaining capital was sufficient).

[180]Allied Products Corp. v. Arrow Freightways, Inc., 104 N.M. 544, 724 P.2d 752 (1986); Kupetz v. Continental Ill. Nat'l Bank and Trust Co. of Chicago, 77 Bankr. 754, 762 (C.D. Cal. 1987) (failure of witness to consider effect of principal shareholder's secured guaranty a factor in not believing testimony regarding unreasonably small capital), *aff'd sub nom.* Kupetz v. Wolf, 845 F.2d 842 (9th Cir. 1988).

[181]Lackawanna Pants Mfg. Co. v. Wiseman, 133 F.2d 482, 485 (6th Cir. 1943).

[182]*Id.* (court considered commercial reasonableness of purchase money chattel mortgage); Credit Managers Ass'n of S. Cal. v. Federal Co., 629 F. Supp. 175 (C.D. Cal. 1985) (court considered, after increase had occurred, likelihood at time of transfer that primary lender would increase credit line). *See also* Kupetz v. Continental Ill. Nat'l Bank and Trust Co. of Chicago, 77 Bankr. 754, 762 (C.D. Cal. 1987) (failure of witness to consider possible refinancing or new loans a factor in not accepting witness' conclusion of unreasonably small capital), *aff'd sub nom.* Kupetz v. Wolf, 845 F.2d 842 (9th Cir. 1988).

[183]As used in this context, "relevant period" means that time span from the date of the transfer to the date of non-payment, limited only by the applicable statute of limitations. By way of example, if the statute of limitations is four years, the non-payment occurs one year after the transfer, but the transferor's expected capital, when judged from the vantage point of transfer, would have been adequate for three years, no action will lie. *See infra* text accompanying notes 235-54. Similarly, under this hypothetical, no action will lie for any failures to pay which occur after four years due to the bar of the statute of limitations. Finally, again under this hypothetical, a non-payment which occurs three and one-half years after the transfer—within the four year statute of limitations but beyond the period of adequacy of capital—would be actionable.

[184]In this outline, pre-UFCA cases and authorities are used. This use is not only appropriate given the paucity of section 5 cases, *see supra* note 15, but also due to the uncertain origins of section 5 itself. As noted above, section 5 was hotly contested in the original convention which adopted the UFCA. *See supra* text accompanying notes 98-100. This disagreement indicates that the final text was less than a perfect fit for the concept as developed by the common law. The use of pre-UFCA cases to tailor the unreasonably small capital action as an accessory and adjunct to the insolvency branch of constructively fraudulent transfers should thus be permissible.

demonstrates that, by definition, the challenger must first establish that the transfer was for less than a reasonably equivalent value. Once shown, the creditor must then show the following: the transfer was made by a person in business or for a business transaction; that non-payment of the plaintiff's claim was a reasonably foreseeable effect given the amount of the transferor's remaining and reasonably foreseeable cash resources; and that, in at least a "but for" sense, the lack of adequate resources caused the non-payment.

1. The First Requirement: A Business or Business Transaction.— The first requirement is textual: a transfer must be made by one who is "engaged or is about to engage in a *business*."[185] Additionally, the business must be one that requires working capital, or liquid funds, in the business' daily activities.[186] The historical antecedent for this requirement lies in the notion that carrying on a business is an implicit representation of an ability to pay those debts incurred in the business; no such requirement attends to individuals in their personal affairs.[187]

The statute also extends to those "engaged or . . . about to engage in a . . . *transaction*" for which the remaining property is inadequate.[188] The statute is silent as to the distinction between a "business" and a "transaction." One case, however, has interpreted "transaction" to cover joint ventures; that is,temporary associations to achieve a limited business purpose.[189] This reading is consistent with the text of the original statute;

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[185]UFCA, *supra* note 1, § 5 (emphasis supplied). *See also* 11 U.S.C. § 548(a)(2)(B)(ii) (1982); UFTA, *supra* note 1, § 4(a)(2)(i).

[186]Iannacone v. Capital City Bank (*In re* Richards), 58 Bankr. 233 (Bankr. D. Minn. 1986) (company which merely held title to assets for purposes of securing a debt was not engaged in business which needed capital); Jacobson v. First State Bank of Benson (*In re* Jacobson), 48 Bankr. 497 (Bankr. D. Minn. 1985) (section 548(a)(2)(B)(ii) found inapplicable because, although debtor was in business, no showing that additional capital was necessary; indeed, transferee showed that business could be run more effectively with the use of less capital). *Cf.* Tarbox v. Zeman (*In re* Zeman), 60 Bankr. 764 (Bankr. N.D. Iowa 1986) (fact that involuntary transfer forced transferor to cease business established that property was necessary to business, and that its transfer left the transferor with unreasonably small capital).

[187]*See, e.g.*, Winchester v. Charter, 94 Mass. (12 Allen) 606 (1866); Todd v. Nelson, 109 N.Y. (64 Sickels) 316, 16 N.E. 360 (1888). *See also* Kepler v. Atkinson (*In re* Atkinson), 63 Bankr. 266, 269 (Bankr. W.D. Wisc. 1986) (mother's guaranty of son's debt was not a business or transaction contemplating business).

[188]11 U.S.C. § 548(a)(2)(B)(ii) (1982); UFTA, *supra* note 1, § 4(a)(2)(i); UFCA, *supra* note 1, § 5.

[189]Holcomb v. Nunes, 132 Cal. App. 2d 776, 283 P.2d 301 (1955). *See* Kepler v. Atkinson (*In re* Atkinson), 63 Bankr. 266, 269 (Bankr. W.D. Wisc. 1986), in which the court held that a mother's guaranty of her son's debts was not a "transaction" of the type contemplated in the UFCA, and stating that the section "appear[s] to be principally directed to those situations in which a party is about to engage in a business venture . . . ."

it limits the population of potential plaintiffs to those who become creditors "during the *continuance* of such . . . transaction."[190] The UFTA carries on this concept with its requirement that the "remaining assets of the debtor [be] unreasonably small *in relation to* the . . . transaction."[191] Both of these sections limit the type of transactions which may qualify; both require a showing of a need for capital or assets for the continuance of the transaction. This limitation also leads to the second requirement: that non-payment was a reasonably foreseeable effect of the lack of adequate resources.

2. The Second Requirement: A Reasonably Foreseeable Connection.—The second requirement can most easily be seen as an analogue to section 4 of the UFCA dealing with transfers by insolvents. The objective of section 4 was creditor protection by requiring the transferor to retain sufficient assets to meet all debts.[192] Yet, as the early cases showed, many debtors took advantage of vagaries surrounding asset valuation and difficulties regarding the proof of intent, and left themselves solvent, but just barely so.[193]

Section 5 of the UFCA was an attempt to close these gaps. It imposes an additional burden on transferors; they must not leave themselves with unreasonably small—or inadequate[194]—capital or reserves. This protects present creditors from valuation squabbles and future creditors from the debtor who would gamble on their extension of credit.[195] It is important to note, however, that the statute does not make the transferor the insurer of adequacy; it only condemns as fraudulent those transfers which leave the transferor with "*unreasonably* small capital."

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[190]UFCA, *supra* note 1, § 5 (emphasis supplied); *see also* 11 U.S.C. § 548(a)(2)(B)(ii).

[191]UFTA, *supra* note 1, § 4(a)(2)(i) (emphasis supplied).

[192]*See supra* text accompanying notes 53 to 82.

[193]*See supra* text accompanying notes 44 to 52; M. BIGELOW, *supra* note 27, § 3, at 230-33.

[194]The Reporter's Notes to the UFTA indicate that "unreasonably small" and "inadequate" are essentially interchangeable. Reporter's Notes to § 4 of the UFTA, 7A U.L.A. 654 (1985) ("The subparagraph focuses attention on whether the amount of all assets retained by the debtor was inadequate, *i.e.*, unreasonably small, in light of the needs of the business or transaction in which the debtor was engaged or about to engage").

[195]The classes protected against this gamble are broad. They include taxing agencies as well as regulatory authorities. United States v. Gleneagles Investment Co., 565 F. Supp. 556 (M.D. Pa. 1983) (indication that factor in finding unreasonably small capital under Pennsylvania law was that transferor failed to provide adequately for union health care contributions and for environmental "backfilling" obligations to Pennsylvania), *aff'd sub nom.* United States v. Tabor Court Realty Corp., 803 F.2d 1288 (3d Cir. 1986), *cert. denied sub nom. McClellan Realty Co. v. United States*, 107 S. Ct. 3229 (1987); United States v. Vertac Chem. Corp., 671 F. Supp. 595, 617 F. Supp. 595, 617 (E.D. Ark. 1987) (United States and state environmental agencies have standing to attack fraudulent conveyances under Tennessee version of UFCA); United States v. 58th Street Plaza Theatre Inc., 287 F. Supp. 475 (S.D.N.Y. 1968) (taxing authority).

But what is an "unreasonable" amount? As noted in many cases, the exact amount varies with the particular case.[196] This does not translate, however, into a toothless, relative, standard. Rather, the existing cases can be distilled into the following: capital remaining after a transfer is unreasonably small when the unpaid creditor/plaintiff can show its non-payment was a reasonably foreseeable effect[197] of the transferor's failure to retain, or failure to provide for, an adequate amount of resources from and after the transfer to satisfy the unpaid plaintiff/creditor's claim.[198]

An essential element of this formulation is the presence of a connection between the disputed transfer and non-payment of the creditor's claim. This requirement is historical; section 5 was distilled from cases which allowed creditors to attack a transfer only if they could somehow connect their non-payment with some universally agreed inference that the transferor, at a relevant time, knowingly left itself with too little reserves.[199]

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[196]Wells Fargo Bank v. Desert View Bldg. Supplies, 475 F. Supp. 693 (D. Nev. 1978), *aff'd mem.*, 633 F.2d 225 (9th Cir. 1980); Zuk v. Hale, 114 N.H. 813, 330 A.2d 448 (1974); 1 G. GLENN, *supra* note 1, § 335.

[197]If the claim was subject to a bona fide dispute, the showing would entail proof that the claim was genuine, and that non-payment, after the normal course of dispute resolution, was the result of inadequate capital. *Cf.* 11 U.S.C. § 303(h)(1) (1982) (only claims not subject to bona fide dispute may be counted in meeting jurisdictional minimum amount for involuntary bankruptcy). In addition, holders of subsequent claims related to expenses which are necessary, such as utilities and trade suppliers, will fare better than holders of subsequent non-essential expenses, in that holders of such "non-essential" claims will have a more difficult time showing a connection between the transfer and their non-payment.

[198]*See* Comment, *supra* note 5, at 1509 (assuming transfers that leave transferors with few unencumbered assets must be "causally linked" to inability to pay debts in order to create fraudulent transfer liability). *See also* cases cited *infra* note 199; Kepler v. Atkinson (*In re* Atkinson), 63 Bankr. 266, 269 (Bankr. W.D. Wisc. 1986) (Capital retained must be measured "relative to the nature of the venture.").

This test may be applied differently depending upon whether the plaintiff is an individual creditor, a bankruptcy trustee or debtor in possession. In the case of the private party plaintiff, the date of non-payment will set the relevant period for the review of the adequacy of capital. *See supra* note 183. With respect to trustees and debtors in possession, the plaintiff is a representative of all creditors, either under the strong arm powers of 11 U.S.C. § 544(b) or under 11 U.S.C. § 550(a). As such, the trustee or debtor in possession would be able to use an extended period of relevancy, bounded at one end by the date of the transfer and at the other end by the date fixed by the applicable statute of limitations. In addition, a trustee or debtor in possession would have a relaxed version of causation; the hierarchy of necessity would no longer be relevant given the broad representation of the trustee. *See supra* note 197. *See also* Moore v. Bay, 284 U.S. 4 (1931).

[199]In Sexton v. Wheaton, 21 U.S. (8 Wheat.) 229 (1823) for example, the Supreme Court considered the connection between the transfer and the loss claimed by the creditor. In *Sexton*, there had been a two year delay between the challenged transfer and the creation of the creditor's debt. In finding that this period of time was sufficient to cleanse

This type of requirement, although not articulated as such, has played a vital role in many section 5 cases finding fraudulent transfers. In *Fidelity Trust Co. v. Union National Bank*,[200] for example, a depression-era bank president engaged in stock speculation to support artificially the price of the bank's stock. Even though the president was found to be solvent after the transfer in question—by at least $80,000[201]—the court looked to the nature of the speculation and found that "[t]he precarious chance of successful issue of business conducted with such slender margin must be considered,"[202] and that the scale of business rendered the remaining capital inadequate.[203] In short, the wide swings inherent in such trade required large reserves; by deliberately reducing the reserves by the transfers—which went to premium payments on the life insurance policies that were the subject of the lawsuit—it was reasonably foreseeable that his resultant insufficiency of capital would result in unpaid creditors.[204]

Similarly, in *McBride v. Bertsch*,[205] a fruit juice manufacturer and seller conveyed all his personal property, worth $30,000, in trust for his

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the transfer, the Court noted that at the time of the transfer, Wheaton, the transferor, "had no view to trade. Although his failure was not very remote from the date of the deed, yet the debts and the deed can in no manner be connected with each other; they are as distinct as if they had been a century apart." *Id.* at 250. *See also* Kearny Plumbing Supply Co. v. Gland, 105 N.J. Eq. 723, 149 A. 530 (1930) (refusing, under New Jersey version of section 5, to draw "unfavorable inference" as to unreasonably small capital when non-payment occured two years after transfer); Mackay v. Douglas, 14 L.R.-Eq. 106, 122, 26 L.T.R. (n.s.) 721, 723 (Ch. 1872) ("If a person enters into no contract which would result in insolvency, and was not contemplating anything which might have that result, such a settlement would be perfectly good. . . ."); M. BIGELOW, *supra* note 27, § 3, at 231 ("There must be a connection between the gift and the subsequent credit.").

More recently, in *In re* Process-Manz Press, Inc., 236 F. Supp. 333, 346 (N.D. Ill. 1964), *rev'd on jurisdictional grounds*, 369 F.2d 513 (7th Cir. 1966), *cert. denied sub nom.* Limperis v. A.J. Armstrong Co., Inc., 386 U.S. 957 (1967), the court found evidence of unreasonably small capital from a demonstrated inability to pay debts as they matured after the transfer, and from numerous bank overdrafts. *See also* New York Credit Men's Adjustment Bureau, Inc. v. Adler, 2 Bankr. 752, 756 (S.D.N.Y. 1980).

[200]313 Pa. 467, 169 A. 209 (1933), *cert. denied*, 290 U.S. 680 (1934).

[201]*Id.* at 476, 169 A. at 212-13.

[202]*Id.* at 482, 169 A. at 215.

[203]*Id.* at 476, 169 A. at 213.

[204]That different amount of reserves would be required by different transferors was a point noted early and widely. M. BIGELOW, *supra* note 27, § 3, at 233, 237; O. BUMP, *supra* note 31, § 257, at 297. *See also* Bakst v. Presley (*In re* E.D. Presley Corp., Ltd.), 44 Bankr. 781, 783 (Bankr. S.D. Fla. 1984) (operation of Canadian securities firm requires substantial liquid assets). Indeed, in the early case of Hunters v. Waite, 44 Va. (3 Gratt.) 25 (1846), the transferor was characterized as "a man of sanguine temperament, and extremely imprudent habits." *Id.* As such, the Court scrutinized carefully his transfer, and found it lacking for failure to consider his "imprudent habits" in providing for the future. *Id.* at 47.

[205]McBride v. Bertsch, 58 F.2d 797 (W.D. Mich. 1930), *aff'd*, 58 F.2d 799 (6th Cir. 1932).

family. At the time of the transfer, he had $11,000 in debts.[206] Although "substantially" all of these debts were paid when the transferor went bankrupt three year later,[207] the court found that the seller had "practically no capital," but an intent "to continue in the business and to incur large indebtedness in and about its expansion and operation."[208] These expansion plans highlighted the inadequacy of the remaining capital. A business may exist on the cash and income it generates; it is reasonably foreseeable, however, that expansion financed concurrently from income may require some reserves. Without such reserves, the court invalidated the transfer.[209]

McBride left unanswered a crucial question—whether the transfer would have withstood scrutiny if no expansion was contemplated. Recent cases have addressed this problem by concentrating on a business' ability to generate sufficient cash from operations, or to issue debt or equity securities for cash.

One such case was *Wells Fargo Bank v. Desert View Building Supplies, Inc.*[210] There, the sole shareholder of a corporation caused the corporation to borrow funds on a secured basis.[211] He later removed these funds from the corporation to pay a personal loan to the same bank.[212] Although the corporation had equity of over $57,000 after the transaction,[213] the court noted that, prior to the transaction, the corporation had only been marginally profitable. The incurrence of the secured loan thus not only reduced the pool of unsecured assets, it imposed a further drain on the corporation's cash flow through the introduction of new and additional debt service. Accordingly, its only hope was to expand sales—with the hope of expanding profits and additional cash—but the debt service on the secured loan effectively prevented it from successfully undertaking this expansion.[214] With this connection between the reasonably anticipated effect of the transfer and

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[206]*Id.* at 797.

[207]*Id.*

[208]*Id.* at 798.

[209]*Id.*

[210]475 F. Supp. 693 (D. Nev. 1978), *aff'd mem.*, 633 F.2d 225 (9th Cir. 1980). In Sweney v. Carroll, 118 N.J. Eq. 208, 178 A. 539 (1935), decided under section 5 of the UFCA, the resources of an individual who was building a house were at issue. The plaintiffs were unsatisfied trade creditors. In deciding whether a previous transfer had left the individual with sufficient funds, the court took into account that "[t]here was no intent or expectation of building the house on credit." *Id.* at 215, 178 A. at 543. Since the court found that this intent was not unreasonable, it upheld the transfer. *Id.*

[211]475 F. Supp. 693, 695 (D. Nev. 1978), *aff'd mem.*, 633 F.2d 225 (9th Cir. 1980).

[212]*Id.*

[213]*Id.*

[214]*Id.* at 697.

the non-payment thus established, the court found the transfer invalid.[215]

A more detailed analysis of cash flow was at issue in *Credit Managers Association of Southern California v. Federal Co.*[216] There, General Electric Credit Corporation (GECC) had financed a management-lead leveraged buyout, in which management purchased their company, Crescent Foods, from The Federal Company. As in *Desert View*, management caused their new company, Cresent, to pledge its assets as security for both the loan from GECC and the deferred portion of the purchase price to Federal. Unlike *Desert View*, however the court found that the extensive cash flow projections prepared to convince GECC to make its loan reasonably showed that Cresent would have "sufficient expected cash flow to stay in business."[217] Under the circumstances, the court found the remaining capital to be adequate.[218]

Other cases have also looked to cash flow, albeit in more oblique manners. Some cases have looked to "working capital," which is sometimes defined as the difference between liquid or short term assets and short term liabilities. Thus, in *Zuk v. Hale*,[219] a special equity master found the transferor had $5,000 in "working capital" at the time of the transfer.[220] Although there was evidence that the transferor's business of being a general contractor generally required $7,000 to $13,000 in such "working capital,"[221] the transferor's retention of a lower figure was supported on testimony that it would be sufficient in that case if receivables were timely paid.[222] In other words, the amount of the contractor's expected cash receipts was adequate to cover his expected debts.

A different result was reached in *Steph v. Branch*.[223] In *Steph* a shareholder sold the stock in his business to another, who in turn secured the deferred portion of the purchase price with the assets of the business.[224] The business also agreed to pay this deferred portion over time.[225] Again, there was a finding of solvency at the time of the transfer,[226] but there was testimony from accountants that the range of "reasonable" capital

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[215] *Id.*

[216] 629 F. Supp. 175 (C.D. Cal. 1985).

[217] *Id.* at 184.

[218] *Id.* at 187-88.

[219] 114 N.H. 813, 330 A.2d 448 (1974).

[220] *Id.* at 816, 330 A.2d at 450.

[221] *Id.* at 816, 330 A.2d at 451.

[222] *Id.*

[223] 255 F. Supp. 526 (E.D. Okla. 1966), *aff'd*, 389 F.2d 233 (10th Cir. 1968).

[224] *Id.* at 528.

[225] *Id.*

[226] *Id.* at 529 (court found that insolvency occurred some three months after the transfer).

was from $10,000 to $50,000.[227] From this testimony, the court had no trouble finding that working capital of $5,000 was inadequate.[228]

In each of these cases the nature of each business and its individual operating needs set the range of reasonable capital.[229] If, as in *Steph*, the remaining capital was not in this range, the capital was unreasonably small.[230] Cases such as *Credit Managers* and *Zuk*, however, show that not all failed businesses with meager capital qualify as businesses with "unreasonably small" capital.[231] From this analysis, it can be seen that non-payment for reasons other than inadequate resources may not qualify under section 5 and its progeny. For example, under this analysis a transferor could defeat an unreasonably small capital action if it could show that it had adequate reserves but did not pay the debt due to a bona fide dispute over whether the debt was due.[232] In short, the proof required seems to be that, all other things being equal and the debt being valid, non-payment was the reasonably foreseeable effect of inadequate operating *reserves*, not other commercial defenses to payment.[233] As a result, if the transferor can show a course of trade justifying the amount of reserves retained, or can produce reasonable cash flow pro-

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[227]*Id.* at 532.

[228]Similarly, in *In re* Atlas Foundry Co., 155 F. Supp. 615 (D.N.J. 1957), the court made an explicit finding that although the questioned transfer left the transferor solvent, it left the transferor with "cash capital" of only $25,000, which was insufficient to meet its standard requirement of $200,000 to $300,000 in such cash capital. *See also* Kearny Plumbing Supply Co. v. Gland, 8 N.J. Misc. 789, 151 A. 873 (1930) (transfer made in a month in which net worth dropped from $3868 to a negative $941.19 was made at a time when transferor had unreasonably small capital).

[229]*In re* Process-Manz Press, Inc., 236 F. Supp. 333, 346 (N.D. Ill. 1964), *rev'd on jurisdictional grounds*, 369 F.2d 513 (7th Cir. 1966), *cert. denied sub nom.* Limperis v. A.J. Armstrong Co., Inc., 386 U.S. 957 (1967) (court found evidence of unreasonably small capital from a demonstrated inability to pay debts as they matured after the transfer, and from numerous bank overdrafts); *accord* New York Credit Men's Adjustment Bureau, Inc. v. Adler, 2 Bankr. 752, 756 (S.D.N.Y. 1980). *See also* Fidelity Trust Co. v. Union Nat'l Bank of Pittsburgh, 313 Pa. 467, 169 A. 209 (1933), *cert. denied*, 291 U.S. 680 (1934) (court found transferor solvent, but not sufficiently so to carry on stock speculation business).

[230]*See also* United States v. 58th St. Plaza Theatre, Inc., 287 F. Supp. 475 (S.D.N.Y. 1968) (court found that capital was inadequate if tax liability were to be assessed at full amount claimed; left unanswered whether transferor was bound to consider full amount of liability or only discounted value after probability of success was taken into account).

[231]"But the law does not require that companies be sufficiently well capitalized to withstand any and all setbacks to their business. The requirement is only that they not be left with 'unreasonably small capital' at the time of the conveyance alleged as fraudulent." Credit Managers Ass'n of S. Cal. v. Federal Co., 629 F. Supp. 175, 187 (C.D. Cal. 1985).

[232]*See supra* text accompanying notes 197-98.

[233]*Cf.* 11 U.S.C. § 303(h)(1) (1982) (order for relief on involuntary petition not allowed when debts not being generally paid are subject to a bona fide dispute).

jections from the time of the transfer, covering the time period in which the plaintiff's claim arose,[234] it will have shown that, although it had small capital, the amount was not unreasonably so.[235]

3. The Final Requirement: A Direct and Causal Link Between the Transfer and Non-Payment.—The last prerequisite to finding inadequate capital is that the transfer must directly lead to non-payment. Initially excluded by this test are cases where there is an alternate and cheaper manner in which to conduct the business; in short, the transferor's profligacy may be used as a supervening cause.[236] A case in point is *Jacobson v. First State Bank* (In re *Jacobson*).[237] In that case, the court found that alternate ways of conducting the business after the transfer—by renting the land and equipment transferred—would have been cheaper, and presumably would have avoided creditors' non-payment.[238] Accordingly, it found the remaining capital was adequate.[239]

This additional requirement is also necessary because subsequent events may make it inequitable to prefer a creditor over a transferee. Take, for example, the occurrence of an unforeseen and unforeseeable calamity after a transfer. If this calamity would have accounted for non-payment even if adequate reserves had been retained, the presence of this intervening and supervening cause should bar fraudulent transfer liability. Likewise, if a transferor leaves itself with unreasonably small capital, but later builds up capital or assets to a reasonable level,

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[234]For differences in treatment between private party plaintiffs and plaintiffs whose standing derives from the Code, see *supra* text accompanying note 198.

[235]The outside limit within which the parties to the transaction are at risk is limited by the applicable statute of limitations. *See supra* note 198. The UFTA suggests a four year limitation period for transfers involving unreasonably small assets, UFTA, *supra* note 1, § 9; the Code limits the period to one year prior to the date the bankruptcy petition was filed. 11 U.S.C. § 548(a) (1982). The rule under the UFCA is not uniform; some states have statutes of limitations as long as six years, McNellis v. Raymond, 287 F. Supp. 232, 237-38 (N.D.N.Y. 1968), *aff'd in relevant part*, 420 F.2d 51 (2d Cir. 1970), and at least one case has suggested that no statute of limitations under the UFCA may apply against the United States as sovereign. United States v. Gleneagles Investment Co., Inc., 565 F. Supp. 556, 583 (M.D. Pa. 1983), *aff'd sub nom.* United States v. Tabor Court Realty Corp., 803 F.2d 1288 (3d Cir. 1986). This may prove to be a boon to bankruptcy trustees, *see* 11 U.S.C. § 544(b) (1982) (bankruptcy trustee has standing of any creditor as of the date the petition was filed).

[236]*See* Hunters v. Waite, 44 Va. (3 Gratt.) 26 (1846) (imprudent habits of transferor considered when evaluating transfer).

[237]48 Bankr. 497 (Bankr. D. Minn. 1985).

[238]*Id.* at 501.

[239]It did this by finding that the property transferred was not "necessary to the continued operation of Plaintiff's business." *Id. Cf.* Tarbox v. Zeman (*In re* Zeman), 60 Bankr. 764, 768 (Bankr. N.D. Iowa 1986) (involuntary transfer which forced transferor to cease business established that property was necessary to business, and that its transfer left the transferor with unreasonably small capital).

subsequent creditors should have no ability to challenge the original transfer.[240]

The case law has recognized this common sense notion. Early cases recognized that "losses in trade, or by fire, or by storms" cut off liability to future creditors.[241] More recent cases have added to this list. For example, in *Jenney v. Vining*,[242] a husband and wife had transferred ownership of their house from joint ownership to sole ownership by the wife.[243] Later, one of the husband's business associates challenged this transfer in order to levy execution on the house.[244] The husband had not paid the judgment leading to the levy because, four months after the transfer, he and his business had entered into a new venture, and that venture had failed.[245]

After finding that the transfer left the husband solvent,[246] the equity master found that the new venture was not in contemplation at the time of the conveyance, and was the cause of the demise of the husband's business.[247] In short, although the master, by implication, found that non-payment was reasonably foreseeable given the low level of capital left by the transfer, he also found the new venture was *not* reasonably foreseeable. This subsequent event was thus held to override the level of capital remaining after the transfer.

Similarly, in *Credit Managers Association of Southern California v. Federal Co.*,[248] a management led leveraged buyout failed. An attack was mounted along unreasonably small capital lines. Although the court found that capital was adequate on the basis of cash flows developed at the time of the cash flows,[249] it also inquired into intervening events. In particular, the transferee pointed to two unforeseen events: the loss of a major customer,[250] and a four month labor strike by the Teamsters' union.[251] Both of these events adversely affected an admittedly marginal operation; indeed, the court characterized the strike as a "crippling blow from which [the transferor] never fully recovered."[252] As a consequence,

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[240]The historical antecedent for this proposition is set forth in M. BIGELOW, *supra* note 27, § 3, at 227 n.1; D. MOORE, *supra* note 47, § 10, at 283.

[241]O. BUMP, *supra* note 31, § 262, at 300-01. *See also* M. BIGELOW, *supra* note 27, § 3, at 229.

[242]120 N.H. 377, 415 A.2d 681 (1980).

[243]*Id.* at 378, 415 A.2d at 682.

[244]*Id.*

[245]*Id.*

[246]*Id.*

[247]*Id.* at 379, 415 A.2d at 683.

[248]629 F. Supp. 175 (C.D. Cal. 1985).

[249]*Id.* at 187. *See also supra* text accompanying notes 144 to 146.

[250]*Id.* at 184.

[251]*Id.*

[252]*Id.* at 186.

the court did not allow the ultimate failure of the business to lead, in an "almost tautological manner"[253] to a finding of unreasonably small capital. Rather it viewed these events to be in the nature of supervening causes, excusing or exonerating the transferor. This holding recognizes that businesses fail for all sorts of reasons, and that fraudulent transfer laws are not a panacea for all such failures.[254]

C. *Burdens of Proof*

Once a transfer has been isolated for the above analysis, practical questions arise: who has the burden of producing evidence on the points set forth above, and who has the burden of persuading the trier of fact of the truth of each point? Under the UFCA, the plaintiff would have each of these burdens.[255] If applied directly to the above analysis, this would require the plaintiff to present evidence and to prove the truth of each of the following: lack of fair consideration or reasonably equivalent value; that the transferor was in business or about to be engaged in business; that non-payment was reasonably foreseeable at the time of the transfer due to the transferor's lack of adequate present and future resources; and that, but for the transfer, the plaintiff's claim would have been paid.

A well-recognized exception, however, permits the court to infer a proscribed financial state once the plaintiff has shown a lack of fair consideration or reasonably equivalent value.[256] The burden then shifts to the transferor, or, more likely, the transferee,[257] to show that the transferor's financial state permitted such a cheap transfer. The underlying premise of this exception derives from the typical state court setting:

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[253]*See* Alces & Dorr, *supra* note 168 at 560.

[254]*See* M. BIGELOW, *supra* note 27, § 3, at 227 n.1.

[255]*See, e.g.*, Bodino v. Barondess (*In re* Good Time Charley's, Inc.), 54 Bankr. 157, 162 (Bankr. D.N.J. 1984) (applying New Jersey law, the court dismissed case because, after showing a lack of fair consideration, trustee "failed to present evidence to establish" unreasonably small capital); T W M Homes Inc. v. Atherwood Realty & Inv. Co., 214 Cal. App. 2d 826, 29 Cal. Rptr. 887 (1963) (California version of section 4 of the UFCA); Holcomb v. Nunes, 132 Cal. App. 2d. 776, 283 P.2d 301 (1955) (California version of section 5 of the UFCA).

[256]Kingdom Uranium Corp. v. Vance, 269 F.2d 104 (10th Cir. 1959) (applying New Mexico law); Tri-Continental Leasing Corp. v. Zimmerman, 485 F. Supp. 495, 499 (N.D. Cal. 1980) (applying California law); Neumeyer v. Crown Funding Corp., 56 Cal. App. 3d 178, 187-89, 128 Cal. Rptr. 366, 371-73 (1976) (citing similar cases from New York, Pennsylvania and Maryland).

[257]In most cases, the transferee will be the primary target, since resort to fraudulent transfer law by its nature presupposes that the transferor/debtor is unable to satisfy its obligations to the creditor/plaintiff. *See, e.g.*, Neumeyer v. Crown Funding Corp., 56 Cal. App. 3d 178, 187-89, 128 Cal. Rptr. 366, 371-73 (1976).

two creditors battling over whether one should be able to retain the benefits of a cheap transfer. Since the transferor is typically not present,[258] or without incentive to defend,[259] the shift makes sense; it forces the recipient of a cheap transfer to justify its retention.

This shift applies, however, only to cases in which the UFCA or the UFTA provide the governing law; it does not apply to cases brought under section 548 of the Code since the assumptions supporting the shift do not apply.[260] The debtor in possession or the trustee[261] is most likely to possess financial information regarding the transferor, and, presumably is in the best position to recreate the transferor's financial state. Moreover, these entities are directly attacking their predecessor's bargain, and thus may be in a better position to control or color the proof regarding it.

This division of proof and the equitable allocation of labor it entails is sound, and should be carried through to the analysis set forth above. A transferor or its favored transferee should be able to better establish whether the transferor was engaged in business. With respect to adequacy of resources and causation, liberal discovery should enable plaintiffs to at least establish a prima facie case.[262] In addition when the burden

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[258]In *Neumeyer*, for example, the transferor had long since disappeared and could not be compelled to attend the trial. 56 Cal. App. 3d at 182, 128 Cal. Rptr. at 368.

[259]*See supra* text accompanying notes 196-97.

[260]Corbin v. Franklin Nat'l Bank (*In re* Franklin Nat'l Bank Securities Litigation), 2 Bankr. 687, 710 (E.D.N.Y. 1979), *aff'd mem.*, 630 F.2d 203 (2d Cir. 1980) (under Act); Jacobson v. First State Bank of Benson (*In re* Jacobson), 48 Bankr. 497, 501 (Bankr. D. Minn. 1985) (burden of proof on debtor in possession as plaintiff); *In re* Tabala, 11 Bankr. 405, 408 (Bankr. S.D.N.Y. 1981); 4 COLLIER ON BANKRUPTCY, *supra* note 79, ¶ 548.10, at 548-123 to 548-124. *Compare* Credit Managers Ass'n of S. Cal. v. Federal Co., 629 F. Supp. 175, 183 (C.D. Cal. 1985) (assignee for benefit of creditors empowered to use presumption under state decisional law) *with* Kupetz v. Continental Ill. Nat'l Bank and Trust Co. of Chicago, 77 Bankr. 754, 762 (C.D. Cal. 1987) (bankruptcy trustee did not show he met state law conditions for presumption), *aff'd sub. nom.* Kupetz v. Wolf, 845 F.2d 842 (9th Cir. 1988).

[261]In some jurisdictions, entities other than the debtor in possession or trustee may bring a fraudulent transfer action. Hansen v. Finn (*In re* Curry and Sorensen, Inc.), 57 Bankr. 824, 828-29 & n.3 (Bankr. 9th Cir. 1986); *see generally* Karasik, *Standing to Initiate Adversary Proceedings in a Bankruptcy Case*, 92 COM. L.J. 83 (1987). Because the standing of these parties appears to be derivative to the trustee or the debtor in possession, the burden shift should not apply. *Currey and Sorensen, Inc.*, 57 Bankr. at 828. *See* Kupetz v. Continental Ill. Nat'l Bank and Trust Co. of Chicago, 77 Bankr. 754, 762 (C.D. Cal. 1987) (finding insufficient factual basis to justify state law burden shift), *aff'd sub. nom.* Kupetz v. Wolf, 845 F.2d 842 (9th Cir. 1988).

[262]In *In re* Process-Manz Press, Inc., the court found evidence of unreasonably small capital from a demonstrated inability to pay debts as they matured after the transfer, and from numerous bank overdrafts. 236 F. Supp. 333 (N.D. Ill. 1964), *rev'd on jurisdictional grounds*, 369 F.2d. 513 (7th Cir. 1965), *cert. denied sub nom.* Limperis v. A.J.

shift discussed above is available,[263] a plaintiff will also be able to state and make its case by simply showing that the transfer was for less than reasonably equivalent value. This burden shift is also supported by the fact that, under cases such as *Credit Managers*, a transferor or transferee can provide a complete defense by producing reasonable and realistic cash flow projections from the vantage point of the transfer.[264]

V. CONCLUSION

Although the unreasonably small capital section of the fraudulent transfer laws has not drawn great attention, it has developed a significant body of case law. As shown above, a general theme for future application of the section can be distilled from these precedents. An action will lie under the unreasonably small capital section if a transfer is made for less than reasonably equivalent value, and if: the transferor is engaged in business or a business transaction; non-payment of the plaintiff's claim was reasonably foreseeable at the time of the transfer due to the inadequacy of the transferor's reasonably foreseeable present and future resources; and but for the transfer and the inadequacy of the transferor's resources, the plaintiff's claim would have been paid.

This analysis views the unreasonably small capital section in its historical context; that is, as an auxiliary and adjunct to the section of the fraudulent conveyance law on transfers by insolvents. It also is a tool to distinguish and discredit at least two unwarranted *per se* rules that have developed in the unreasonably small capital jurisprudence.

Given the renewed interest in fraudulent transfers generally, and the likely increased resort to the unreasonably small capital section specifically, the analysis developed in this article can be used to restore part of fraudulent transfer law to its original place. Consistency and "true and plain dealing" could then be restored to an area of the law not necessarily known for those virtues.

Armstrong Co., Inc., 386 U.S. 957 (1967). *See also* New York Credit Men's Adjustment Bureau, Inc. v. Adler, 2 Bankr. 752, 756 (S.D.N.Y. 1980).

[263] *See supra* text accompanying notes 256-57.

[264] Credit Managers Ass'n of S. Cal. v. Federal Co., 629 F. Supp. 175, 184 (C.D. Cal. 1985).