

## MAKING SENSE OF SUCCESSOR LIABILITY

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### I. INTRODUCTION

A firm that buys assets from another firm ordinarily does not acquire liability to the seller's creditors simply by buying its assets.<sup>1</sup>

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1. See 15 WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 7122 at 218 (perm. ed., rev. vol. 1999); cf. *Fogg v. Blair*, 133 U.S. 534, 538 (1890) (noting that the principle that a subsequent purchaser of property at foreclosure will not

This ordinary rule is subject to important exceptions. The buyer's consent triggers an exception. If a buyer agrees to assume the seller's liability to third parties, it is for that reason liable.<sup>2</sup> This Article considers a more controversial exception—successor liability. When a court decides that an asset acquirer should be treated as a “successor” to the transferor, it is liable for the transferor's debts as though it were the transferor.

The circumstances under which a court will impose successor liability on an asset acquirer without its consent typically appear as a list of three. A transferee succeeds to its transferor's debts only when the transaction between them: (1) “amounts to a consolidation or merger” (the *de facto* merger basis); (2) the transferee is “merely a continuation” of the transferor (the mere continuation basis); or (3) the transfer is “entered into fraudulently in order to escape liability for such debts” (the fraudulent transfer basis).<sup>3</sup>

On the surface, imposition of successor liability seems to be an application of a court's equitable power to elevate substance over form.<sup>4</sup> A court will treat an asset transferee that is, in a technical legal sense, distinct from the transferor as though it is not distinct for purposes of liability whenever it is not *in substance* independent from the transferor.<sup>5</sup> For example, under the fraudulent transfer basis, if the transferee is in cahoots with the transferor and the transfer is a sham so that the transfer is a fraud on creditors, the transferee's separate legal existence should be disregarded. By disregarding its status as a distinct entity, the transferee

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acquire any liability for judicial liens that postdate the mortgage is “so familiar that it is surprising that any other can be supposed to exist”). The rule of non-liability is said to promote alienability of property, which in turn encourages its productive use. *See, e.g.,* Gallenberg Equip., Inc. v. Agromac Int'l, Inc., 10 F. Supp. 2d 1050, 1053 (E.D. Wis. 1998), *aff'd*, 191 F.3d 456 (7th Cir. 1999).

2. *See, e.g., In re Air Passenger Computer Reservations Sys. Antitrust Litig.*, 724 F. Supp. 744, 753 (C.D. Cal. 1989) (holding transferee liable for transferor's debt to attorney by agreement).

3. 15 FLETCHER ET AL., *supra* note 1, § 7122; 19 AM. JUR. 2D, *Corporations* § 2705 (1986); *see also* Golden State Bottling Co. v. NLRB, 414 U.S. 168, 182 n.5 (1973); *Sherlock v. Quality Control Equip. Co.*, 79 F.3d 731, 733 (8th Cir. 1996); *Leannais v. Cincinnati, Inc.*, 565 F.2d 437, 439 (7th Cir. 1977); RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 12 (1998) [hereinafter RESTATEMENT]; DAVID G. OWEN ET AL., 2 MADDEN & OWEN ON PRODUCTS LIABILITY § 19:6, 388-89 (3d ed. 2000); Richard L. Cupp, Jr., *Redesigning Successor Liability*, 1999 U. ILL. L. REV. 845, 847; Dorit F. Kressel, *Successor Liability in Products Liability Litigation: Modern Judicial Response to Traditional Corporate Rules*, 4 PRODUCTS LIABILITY L.J. 211, 213 (1993); Michael D. Green, *Successor Liability: The Superiority of Statutory Reform to Protect Products Liability Claimants*, 72 CORNELL L. REV. 17, 22 (1986).

4. *See, e.g.,* *Pepper v. Litton*, 308 U.S. 295, 312 (1939) (“No matter how technically legal each step in that scheme may have been, once its basic nature was uncovered it was the duty of the bankruptcy court in the exercise of its equity jurisdiction to undo it.”).

5. *See, e.g.,* *Estey & Assocs. v. McCulloch Corp.*, 663 F. Supp. 167, 171 (D. Or. 1986).

is subject to its transferor's creditor's claims as though it were the transferor.<sup>6</sup>

The other two bases for successor liability reflect the same equitable intuition. When the transferee, although technically distinct, is sufficiently similar to the transferor, the court declares the transferee is the result of a *de facto* merger between the transferor and the transferee, or declares the transferee to be "mere continuation" of the transferor.<sup>7</sup> Under the *de facto* merger basis, a court re-characterizes an asset transfer as though it were a statutory merger of the transferor with the transferee because the transferee is, in substance, indistinguishable from the transferor.<sup>8</sup> If the parties had complied with the requisites for statutory merger, the merger statute would have treated the surviving entity as having acquired the transferor's assets *and* liability.<sup>9</sup> As one court noted, "[w]hen the form of the transfer does not accurately portray substance, the courts will not refrain from deciding that the new organization is simply the older one in another guise."<sup>10</sup> To the same end, the court can

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6. See *infra* notes 149-56 and accompanying text.

7. The *de facto* merger and "mere continuation" bases do not differ significantly in their scope from each other. See, e.g., Jerry J. Phillips, *Product Line Continuity and Successor Corporation Liability*, 58 N.Y.U. L. REV. 906, 909 (1983) (noting that the *de facto* merger and "mere continuation" bases "tend to overlap, and no criteria can be identified that distinguish them in any useful manner"). But see RONALD J. GILSON & BERNARD S. BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 1507-08 & n.7 (2d ed. 1995) (asserting that the "mere continuation" basis restates fraudulent transfer law but that the *de facto* merger basis potentially embraces certain nonfraudulent transfers). At least one court has tried to differentiate between the bases. See *Nat'l Gypsum Co. v. Cont'l Brands Corp.*, 895 F. Supp. 328, 336 (D. Mass. 1995) (noting that *de facto* merger applies to situations where the ownership, control, and assets of one entity are combined with a preexisting entity; "mere continuation" applies when the selling corporation sets up a purchaser with the specific purpose of continuing the same business but with a new form).

8. A transferee is subject to successor liability if "circumstances . . . warrant a finding that there was a de facto consolidation or merger of the [transferor and transferee]." 15 FLETCHER ET AL., *supra* note 1, § 7122, at 233; see also RESTATEMENT, *supra* note 3, § 12(c) (imposing successor liability whenever the transferee "constitutes a consolidation or merger with the predecessor."); 15 FLETCHER ET AL., *supra* note 1, § 7124.20, at 301 ("A de facto merger occurs when one corporation is absorbed but without compliance with the statutory requirements for a merger."); *Id.* § 7041, at 10-11 ("The term 'merger' in connection with corporations . . . is permissibly used to denote various arrangements by which two or more corporations become united in interest . . . [A] merger means the absorption of one corporation by another; the latter retains its name and corporate identity with the added capital, franchises and powers of the merged corporation." (citations omitted)).

9. See generally 13A B. FOX & E. FOX, *BUSINESS ORGANIZATIONS*, §§ 23.01-04 (1986). Commentators have identified the origin of the *de facto* merger basis for successor liability as an analogical extension of equitable protection for minority corporate shareholders whose interests majority shareholders could otherwise squeeze out in an acquisition. See GILSON & BLACK, *supra* note 7, at 673-722.

10. *Polius v. Clark Equip. Co.*, 802 F.2d 75, 78 (3d Cir. 1986).

find the transferee is a “mere continuation” of the transferor and is therefore liable for the transferor’s debts.<sup>11</sup>

Beneath the surface of this equitable approach to successor liability is the problem of ascertaining when a transferee’s legal independence from the transferor is entitled to respect and when it is not. The fraudulent transfer basis for successor liability rests on proof of fraud between the transferor and transferee.<sup>12</sup> The other two bases rest on evidence of “continuity” between them.<sup>13</sup> Fraudulent transfer law defines fraud in connection with an asset transfer and thus provides guidance on the question of when to disregard a transfer for the benefit of creditors. There is no comparable guidance for courts who must draw a line between benign and culpable continuity to justify disregard of the existence of a transferee.

The *de facto* merger and mere continuation bases for successor liability have captured the attention of litigants and commentators, leaving the role of fraudulent transfer law in successor liability doctrine largely unexplored.<sup>14</sup> The principal treatise on corporate successor liability feebly notes that the fraud basis “is merely an application of the law of fraudulent conveyances.”<sup>15</sup> This cannot be so because imposition

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11. See 15 FLETCHER ET AL., *supra* note 1, § 7124.10, at 301 (“The ‘mere continuation’ of business exception reinforces the policy of protecting the rights of a creditor by allowing it to recover from the successor corporation whenever the successor is substantially the same as the predecessor.”). *But see* Baltimore Luggage v. Holtzman, 562 A.2d 1286, 1293-94 (Md. Ct. Spec. App. 1989) (holding that transferor’s retention of a minority interest in transferee was insufficient grounds to invoke “mere continuation” exception absent other indicia of fraud).

12. See *infra* notes 47-52 and accompanying text.

13. See *infra* notes 96-100 and accompanying text.

14. In the last thirty years, commentators have paid scant attention to the relationship between fraudulent transfer law and successor liability doctrine. See Green, *supra* note 3, at 24 n.33 (noting that fraud had not played a “significant role” in successor product liability); Phillips, *supra* note 7, at 908 (speculating that the fraud is not an important basis for successor liability “because corporate directors do not favor illegal conduct; furthermore, illegal conduct is bad business and is often detectable”); see also RESTATEMENT, *supra* note 3, § 12, reporter’s note to cmt. e (noting that the fraudulent transaction exception “has rarely been used to impose successor liability for products liability claims”); Timothy J. Murphy, Comment, *A Policy Analysis of a Successor Corporation’s Liability for Its Predecessor’s Defective Products When the Successor Has Acquired the Predecessor’s Assets for Cash*, 71 MARQ. L. REV. 815, 819 (1988) (“[The] fraudulent transaction exception is usually not successfully invoked by products liability plaintiffs.”).

15. 15 FLETCHER ET AL., *supra* note 1, § 7125, at 305 (“[I]f the transfer constitutes, either in fact or as a matter of law, a fraud upon the creditors of the other corporation, the creditors defrauded by the transfer may, in equity, follow the property into the hands of the new corporation, and subject it to the satisfaction of their claims, or hold the new corporation liable to the extent of its value.”). A few courts have enunciated what they consider to be a fraud-related yet distinct basis for imposition of successor liability—for transfers made in bad faith or with inadequate consideration. See *Man v. Raymark Indus.*, 728 F. Supp. 1461, 1469 (D. Haw. 1989); *Everest v. Am. Transp. Corp.*, 685 F. Supp. 203, 206 n.8 (D. Minn. 1988); *Ostrowski v. Hydra-Tool Corp.*, 479 A.2d 126, 127 (Vt. 1984);

of successor liability on a fraudulent transferee is not the same as fraudulent transfer avoidance.<sup>16</sup> The difference in remedy between successor liability and fraudulent transfer avoidance raises an obvious question. If a transfer is fraudulent, why should a creditor be limited to transfer avoidance in some circumstances, yet entitled to impose the broader remedy of successor liability in others? Part IV.A offers an answer to this question.

A second question arises from the form of the often-cited list of three bases for imposition of successor liability, of which fraudulent transfer is but one.<sup>17</sup> If deterring fraudulent transfers explains the fraudulent transfer basis of successor liability, what theory explains the so-called *de facto* merger and mere continuation bases? The listing of the three bases, like alternate selections on a menu, gives the impression that the latter two bases justify successor liability upon evidence of similarities between the transferor and transferee, *without* evidence that the asset transfer was a fraud on the transferor's creditors.

This impression is erroneous. All three bases of successor liability serve the same purpose as fraudulent transfer law—protecting the transferor's creditors from the effect of a transfer that defrauds them. To provide a context for understanding the role of fraud in successor liability doctrine, Part II explains how a debtor and a transferee can manipulate a transfer of assets to defraud the debtor's creditors. Part III explains how fraudulent transfer law defines transfer fraud. Part IV explains that the *de facto* merger and mere continuation bases focus on continuity as evidence of fraud, not as an independent justification for imposition of successor liability. The Article considers in Part V the most difficult successor liability case—where the transferee could not possibly have participated in a fraud on creditors because the transferor's liability to creditors (and the opportunity to defraud them by transfer) first came to light long after the transfer occurred.

## II. HOW AN ASSET TRANSFER CAN DEFRAUD CREDITORS

This article asserts that the purpose of imposing successor liability on an asset transferee is to protect creditors from transfers that defraud them. The threshold task is thus to identify the conduct that constitutes fraud on creditors. This is a daunting task in some respects because

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Orlando Light Bulb Serv., Inc. v. Laser Lighting & Elec. Supply, Inc., 523 So. 2d 740 (Fla. Dist. Ct. App. 1988); 15 FLETCHER ET AL., *supra* note 1, § 7122, at 247-48.

16. See *infra* notes 96-100 and accompanying text.

17. See *supra* note 3 and accompanying text.

“fraud,” like “justice,” is not absolutely defined or universally understood.

Fraud has a relatively stable meaning in the social context relevant to this discussion—the relationship between a debtor and its creditors. The simplest way to conceptualize debtor fraud is as deceit. A debtor defrauds its creditors when he misrepresents his wealth to creditors. He may lie to make himself look wealthier than he is to induce creditors to loan him capital in the first place. Or, he may lie to make himself look insolvent when he is not in order to skip out on his obligations to creditors and reserve his assets for himself. Suppose that a debtor has defaulted on his obligation to pay his creditor. When the creditor attempts to foreclose on the debtor’s assets, the debtor lies and says that he has none, having hidden them in a cave. By this lie, the debtor effectively steals the assets for himself at his creditor’s expense.

Fraud *by transfer* of assets is identical in effect to deceit by concealment of assets. The artifice is different because the debtor does not act alone. Instead of unilaterally concealing assets from his creditors, the debtor transfers them to a cooperative transferee, who holds them for their mutual benefit. Unless creditors can reach the assets in the hands of the transferee or otherwise make the transferee liable to them, the debtor and transferee can together deceive creditors as effectively as if the debtor had hidden the assets in a cave.<sup>18</sup>

The law of fraud protects creditors from loss from the debtor’s misrepresentation or other concealment of his assets.<sup>19</sup> Fraud *by transfer* has spawned its own legal response distinct from that of unilateral debtor fraud because the rights of a third party, the asset transferee, are implicated.<sup>20</sup> From creditors’ perspective, the transferee holds the assets the debtor once had. Left with no effective remedy against the debtor, creditors want to make the transferee pay their claims. The conflict is not between the creditor and the debtor but rather between the rights of the creditor in the transferred assets and those of the transferee.

The possibility of a corporate debtor adds an additional level of complexity. A corporate debtor is the amalgam of a variety of

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18. Garrard Glenn described the effect of transfer fraud on a creditor: “[B]ecause of a change made by the debtor in the title to assets formerly available, his creditor . . . finds no comfort in ordinary methods of realization.” 1 GARRARD GLENN, *FRAUDULENT CONVEYANCES AND PREFERENCES* 75 (rev. ed. 1940).

19. See generally PETER A. ALCES, *THE LAW OF FRAUDULENT TRANSACTIONS* ¶¶ 2.01-.02 (1989 & Supp. 2000).

20. See William T. Vukowich, *Civil Remedies in Bankruptcy for Corporate Fraud*, 6 AM. BANKR. INST. L. REV. 439, 441 (1998).

relationships among individuals who hold conflicting objectives.<sup>21</sup> When the debtor is a corporation, the debtor/creditor relationship really encompasses the relationship between creditors on the one hand and other corporate constituents who hold a different claim against or interest in the debtor, such as shareholders, on the other.<sup>22</sup> Like a human debtor who controls assets subject to the claims of his creditors, corporate insiders—such as shareholders, managers, or other claimants who can control corporate assets—have an incentive to swipe assets for themselves at creditors' expense whenever they can get away with it.<sup>23</sup> Corporate insiders can perpetrate fraud on corporate creditors like puppet masters behind the scene. Insiders cause the debtor to move assets out of creditors' reach to a place where they can capture the value of those assets for themselves free of creditors' claims.<sup>24</sup>

The propensity of insiders to divert assets to their benefit and at creditors' expense is a product of agency.<sup>25</sup> Any agent can use the

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21. See generally FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991) (explaining corporate law as a response to the problem of agency costs).

22. Michael Jensen and William Meckling described the corporate form as a collection of contractual relationships: "The private corporation or firm is simply one form of legal fiction which serves as a nexus for contracting relationships and which is also characterized by the existence of divisible residual claims on the assets and cash flows of the organization which can generally be sold without permission of the other contracting individuals." Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 311 (1976) (emphasis omitted); see also Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829, 835 (1985) ("[T]he debtor-creditor relationship is essentially contractual."). See generally EASTERBROOK & FISCHEL, *supra* note 21.

23. "Armed with private knowledge and able to keep investors in the dark, the managers can divert income to themselves, stealing and mismanaging at the same time. Diversion and sloth may not be obvious, but they exist. Even when they do not, the potential for misconduct remains." EASTERBROOK & FISCHEL, *supra* note 21, at 1.

24. See Andrew J. Nussbaum, *Insider Preferences and the Problem of Self-Dealing Under the Bankruptcy Code*, 57 U. CHI. L. REV. 603, 604-05 (1990).

25. For a discussion on the relationship between corporate stockholders and managers, see generally Lucian Arye Bebchuk, et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002); Lucian Arye Bebchuk & Christine Jolls, *Managerial Value Diversion and Shareholder Wealth*, 15 J. L. ECON. & ORG. 487 (1999); Frank H. Easterbrook, *Managers' Discretion and Investor's Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540 (1984); Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259 (1982). For a discussion on the relationship between priority secured creditors and unsecured creditors, see Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Credit in Bankruptcy*, 105 YALE L.J. 857 (1996) (discussing secured creditors' ability to shift risk of loss to nonconsensual unsecured creditors and criticizing laws governing priority of creditors' claims as inefficient). But see generally Steven L. Schwarcz, *The Easy Case for the Priority of Secured Claims in Bankruptcy*, 47 DUKE L.J. 425 (1997) (refuting Bebchuk & Fried's efficiency argument); Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured*

techniques discussed here to snatch assets for themselves at the expense of their principals. Collectively, insiders are agents for creditors to the extent that creditors cede to them control of assets held for their mutual benefit.<sup>26</sup> When insiders manipulate assets in a way that makes them better off but increases creditors' risk of loss without creditors' assent, they "externalize" loss to creditors.<sup>27</sup>

Financial economists Clifford W. Smith, Jr., and Jerold B. Warner called the tension between creditors and insiders the "bondholder-stockholder conflict."<sup>28</sup> Once creditors' claims are fixed, by contract or otherwise, insiders have incentive "to design the firm's operating characteristics and financial structure in ways which benefit [insiders] to the detriment of [creditors]."<sup>29</sup> For example, shareholders have an incentive to undertake investments that are riskier than the (typically fixed) level of risk reflected as interest on creditors' loans. By subjecting the loaned capital to a greater level of risk than that reflected by interest rates in the credit agreements, shareholders increase the residual value of their claims without compensating creditors for bearing increased risk of loss.<sup>30</sup>

When insiders transfer corporate assets outright to a cooperating third party, they may be engaging in a less subtle technique to the same end. Of course, from insiders' perspective, a transfer of assets is a worthwhile opportunistic strategy only if they can both divert assets from the reach of creditors *and* keep some (preferably all) of the value of the assets for themselves. They need a "safe" place to stow the assets away from creditors yet keep them within their own reach. The safe

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*Claims in Bankruptcy: Further Thoughts and a Reply to Critics*, 82 CORNELL L. REV. 1279 (1997). The problem appears in disputes among groups of unsecured creditors as well. For example, asbestos injury claimants who are sick, try to grab the defendant's assets, leaving claimants who have been exposed to asbestos but are not sick yet with nothing to satisfy their "future" claims. See, e.g., *Asbestos Defendants, Plaintiffs Look for Legislative, Legal Solutions as Companies Fall*, 39 BANKR. CT. DEC., WEEKLY NEWS & COMMENTS, June 25, 2002, at A1.

26. See Jensen & Meckling, *supra* note 22, at 308. See generally RICHARD A. POSNER, *THE ECONOMIC ANALYSIS OF LAW* 428 (5th ed. 1998) (stating that the economic term for the problem of controlling an agent with divergent incentive is the "problem of agency costs").

27. See, e.g., EASTERBROOK & FISCHER, *supra* note 21, at 49-50; David Morris Phillips, *Products Liability of Successor Corporations: A Corporate and Commercial Law Perspective*, 11 HOFSTRA L. REV. 249, 259-60 (1982). If all parties affected by the conduct have not consented to it, we cannot be sure that the conduct maximizes social wealth. See POSNER, *supra* note 26, at 15.

28. Clifford W. Smith, Jr. & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117, 118 (1979); see also Jensen & Meckling, *supra* note 22, at 308-10 (considering the conflict between managers (i.e., agents) and outside equity and debt holders (i.e., principals)).

29. Smith & Warner, *supra* note 28, at 118.

30. See *id.* at 118-19; POSNER, *supra* note 26, at 433-34.

place can be a transferee entity in which insiders hold a controlling equity interest. Or, it can be an unrelated third party who cooperates with the insiders in exchange for a piece of the value snatched from creditors.

Corporate creditors know in advance that insiders can manipulate assets in ways that externalize loss to them, and they do not like it. They bargain for the right to take the debtor's assets by foreclosure to enforce the debtor's agreement not to use the assets in ways that exceed fixed risk levels.<sup>31</sup> For example, a loan may describe as events of default conditions under which the debtor's enterprise exceeds a certain level of risk of loss to a creditor.<sup>32</sup> A creditor's right to foreclose on specific assets in the event of default turns the insiders' interest in the debtor (equity holders' interest in the residual value of the firm) into a hostage which the creditor can "kill" if the insiders misbehave.<sup>33</sup> Foreclosure liquidates the firm and deprives shareholders of whatever increase in the expected value of their claim their conduct might have yielded.<sup>34</sup> A creditor's right to foreclose thus controls insiders' incentive to engage in the loss externalizing behavior in the first place.

But creditors' ability to control insiders' incentive to enrich themselves at creditors' expense is incomplete. First, contractual controls are costly and costs vary among creditors.<sup>35</sup>

Second, no creditor can completely prevent opportunistic conduct as long as insiders can manipulate the debtor's assets to make the debtor insolvent.<sup>36</sup> Recall that the key to effective creditor control over opportunistic conduct is recourse to insiders' residual interest in the

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31. See Smith & Warner, *supra* note 28, at 118-19 (describing aspects of the bondholder-stockholder conflict that the parties can reconcile with bond covenants: manipulation of dividend policy, claim dilution, asset substitution and under-investment).

32. See POSNER, *supra* note 26, at 434.

33. See Smith & Warner, *supra* note 28, at 127-28 (discussing the advantages of using secured debt and how it can control the shareholders' incentive to take actions that reduce the value of the firm).

34. See POSNER, *supra* note 26, at 436 (noting that creditors' claim to the liquidation value of the firm is entitled to priority over equity claimants).

35. See *id.* at 435 (noting that contract is useless as a control on shareholder opportunism in the case of involuntary extensions of credit because such involuntary creditors have no opportunity to contract with the debtor before incurring their claims); see also Phillips, *supra* note 27, at 259 (noting that even if a tort claimant had an opportunity to assess risk prior to incurring his claim, tort claimants typically do not have the experience to do so effectively). Although they cannot customize their relationship with the debtor, involuntary claimants rely on judicial process to assert their rights against the debtor's assets. See generally ALCES, *supra* note 19, ¶ 1.01[2][a] (describing options for creditors who suspect their debtor is about to hide assets or otherwise increase their risk of loss).

36. See Marie T. Reilly, *The Latent Efficiency of Fraudulent Transfer Law*, 57 LA. L. REV. 1213, 1232-33 (1997).

debtor.<sup>37</sup> Insiders can deliberately blunt this creditors' weapon by transferring assets away from the debtor (against whom creditors have a right of recourse) to themselves or a cohort (against whom creditors have no right of recourse).<sup>38</sup> Said another way, insiders can steal the hostage out from under creditors. And, once the hostage is gone, creditors' rights against the debtor are ineffective to stop insiders from enriching themselves at creditors' expense.<sup>39</sup>

Of course, not all loss-yielding transfers of corporate assets are "frauds" on creditors. Creditors accept some risk of loss from asset transfers as a consequence of investment.<sup>40</sup> They charge interest for bearing risk. But, creditors cannot effectively price for the risk that corporate insiders will line their pockets at creditors' expense. Conversely, the debtor cannot make a valuable promise to creditors not to loot the corporate assets. Such a promise is worthless upon the debtor's insolvency when creditors need it. Once the debtor's assets are gone, creditor remedies against the debtor like foreclosure are fruitless. Without some other protection, the problem of controlling the divergent incentives of insiders will eclipse the potential gains from specialization between creditor/lenders and insider/managers.

The protection comes in the form of law that affords creditors rights *against transferees*. To provide the protection that creditors need and debtors cannot provide, the law recognizes that in certain cases a transferee does not acquire assets free of the claims of the transferor's creditors.<sup>41</sup> These cases constitute the set of asset transfers that deplete the wealth of the debtor and impose loss on creditors which they cannot effectively prevent by foreclosure, or price out through interest charges. One obvious way to describe this set is all transfers undertaken for the

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37. A more complete response to critics of limited liability on efficiency grounds is that limited liability of shareholders is the wrong scapegoat. The capacity of shareholders to hide wealth from creditors is to blame for inefficient externalization of loss. This capacity exists because of the agency of shareholders, and would exist even if shareholders could not limit their liability for the debts of the corporation to the amount of their investment.

38. See POSNER, *supra* note 26, at 434 (stating that by hiding assets from creditors, "shareholders can raise their expected return without compensating the lender for the added risk").

39. See generally Reilly, *supra* note 36, at 1231-32 (describing the effect of moral hazard on creditors' ability to control equity holders' conduct as the debtor approaches insolvency).

40. See *id.* at 1228.

41. See, e.g., *Autin v. Piske*, 24 F.2d 626, 627 (5th Cir. 1928) (holding that "[t]he bankruptcy court has jurisdiction of a suit by the trustee to recover the property of the bankrupt in the hands of third persons, transferred . . . with the intent to hinder, delay, or defraud the creditors, in violation of . . . the Bankruptcy Act").

purpose of enriching insiders at creditors' expense. A more refined description of this set is the province of fraudulent transfer law.<sup>42</sup>

### III. HOW FRAUDULENT TRANSFER LAW DEFINES TRANSFER FRAUD

#### A. Actual Fraud

A creditor can avoid a transfer<sup>43</sup> and recover the value of the transferred property from a transferee by proving that the transfer was *actually* or *constructively* fraudulent.<sup>44</sup> The first ground, actual fraud, focuses on evidence of the debtor's purpose in effecting the transfer. A creditor must show that the debtor intended that the transfer "hinder, delay, or defraud" its creditors.<sup>45</sup> Because creditors usually cannot prove the transferor's subjective intention to defraud its creditors directly,<sup>46</sup> courts have discerned the transferor's state of mind by inference from the facts of the transfer, the so-called "badges of fraud."<sup>47</sup> These badges,

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42. Fraudulent transfer law appears in common law or statutory adaptations of the English Statute of Elizabeth, 13 Eliz., c. 5 (1571), reprinted in GLENN, *supra* note 18, at 1069-70. Most states have adopted one of two uniform fraudulent transfer acts: the UNIF. FRAUDULENT CONVEYANCE ACT ("UFCA"), 7A pt. II U.L.A. 2 (1999), or the more recently promulgated UNIF. FRAUDULENT TRANSFER ACT ("UFTA"), 7A pt. II U.L.A. 266 (1984). The Bankruptcy Code contains a federal fraudulent transfer provision, 11 U.S.C. § 548 (2000), and a provision that preserves for the bankruptcy trustee the rights of creditors to avoid fraudulent transfers under non-bankruptcy law, 11 U.S.C. § 544(b). On the sources of fraudulent transfer law, see generally ALCES, *supra* note 19, ¶ 5.01[2].

43. Upon avoidance, the transferee must relinquish the transferred assets or their value to the challenging creditor. See generally CHARLES JORDAN TABB, *THE LAW OF BANKRUPTCY* 331 (1997).

44. See UFCA §§ 7 (actual fraud), 4-6 (constructive fraud); UFTA §§ 4(a)(1) (actual fraud), 2 (constructive fraud); 11 U.S.C. §§ 548(a)(1)(A) (actual fraud), 548(a)(1)(B) (constructive fraud). See generally *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 536 (1994); ALCES, *supra* note 19, ¶ 5.02.

45. The Statute of Elizabeth, 13 Eliz., c. 5 (1571), described avoidable fraudulent transfers as those which the debtor/transferor intended to "delay, hinder or defraud" creditors. This phrase appears in modern codifications of "actual fraud." See 11 U.S.C. § 548(a)(1)(A); UFCA § 7; UFTA § 4(a)(1).

46. See, e.g., *Wright v. Hart*, 75 N.E. 404, 410 (N.Y. 1905) (Vann, J., dissenting) (stating that the evidence necessary to establish the "furtive scheme must, as a rule, be drawn from hostile witnesses, usually relatives or intimate friends of the seller, who took part in the fraud and shared in the plunder"). Under the Federal Rules of Civil Procedure, a party alleging the fraud of another must plead "the circumstances constituting fraud . . . with particularity." FED. R. CIV. P. 9(b). Courts require more than a general averment that the defendant "knew" of a false representation. See, e.g., *Wexner v. First Manhattan Co.*, 902 F.2d 169, 172 (2d Cir. 1990) ("[P]laintiffs are still required to plead the factual basis which gives rise to a 'strong inference' of fraudulent intent.").

47. See, e.g., *Twyne's Case*, 76 Eng. Rep. 809, 812-14 (Star Chamber 1601) (announcing six badges of fraud); UFTA § 4(b) (listing eleven badges of fraud to be considered in determining actual fraud under section 4(a)(1)).

in various combinations, support an inference that the debtor and the transferee joined forces to use a transfer to enrich themselves at creditors' expense.<sup>48</sup>

"Actual fraud" focuses on the debtor/transferor's subjective intention to defraud its creditors.<sup>49</sup> But, it is not insensitive to the role of the transferee. Because the effect of fraudulent transfer avoidance is *on the transferee*, it does not make sense to avoid a transfer and deprive the transferee of its benefit simply because the *transferor* subjectively and privately hoped that the transfer would harm his creditors.<sup>50</sup> Indeed, the Statute of Elizabeth expressly protects from avoidance a transferee who purchases assets "upon good consideration and bona fide, . . . not having at the time any manner of notice or knowledge."<sup>51</sup> The transferee's vulnerability to avoidance on actual fraud grounds is based on an assessment of the badges of fraud. The badges, in turn, support an inference that the transferee was a participant in a collusive relationship with the transferor.<sup>52</sup>

Actual fraud as grounds for avoidance is most useful when the transfer occurred under circumstances that preclude any inference other than that the debtor and transferee colluded to enrich themselves at creditors' expense.<sup>53</sup> When there is no explanation for the transfer other than to use it as a tool to strip creditors of assets and line the pockets of the debtor and the transferee, the debtor surely intended that effect. Because no other explanation for the transfer is plausible, it is easy to infer that the transferee knowingly participated in the debtor's plan.

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48. The badges can be divided into four groups: (1) the presence of an agency, familial or other collusive relationship between the transferor and transferee; (2) concealment of the transfer from creditors or other deceit; (3) the gratuitous nature of the transfer, or the inequivalence of value given by the transferee for the assets; and (4) the transferor's insolvency or imminent financial failure at the time of the transfer. *See, e.g.*, UFTA § 4(b).

49. *See, e.g.*, Barry L. Zaretsky, *Fraudulent Transfer Law as the Arbiter of Unreasonable Risk*, 46 S.C. L. REV. 1165, 1177 (1995).

50. *See* Frank R. Kennedy, *Involuntary Fraudulent Transfers*, 9 CARDOZO L. REV. 531, 535 (1987) (noting that from creditors' perspective the debtor's subjective mental state is irrelevant).

51. 13 Eliz., c. 5 (1571). *See, e.g.*, *Stratton v. Equitable Bank*, 104 B.R. 713, 726 (D. Md. 1989), *aff'd*, 912 F.2d 464 (4th Cir. 1990) (holding that the creditor cannot avoid transfer on actual fraud grounds if transferee was without knowledge of fraud and paid fair consideration for the transfer); *In re Mesa*, 48 B.R. 208, 210 (Bankr. S.D. Fla. 1985) (stating that the transferee is immune from avoidance if it can show it did not intend to participate in a scheme to defraud the transferor's creditors). *But see In re Rubin Bros. Footwear, Inc.*, 119 B.R. 416, 423 (S.D.N.Y. 1990) (holding that the creditor must show only transferor's fraudulent intention, not transferee's).

52. *See, e.g.*, *Twyne's Case*, 76 Eng. Rep. at 814 ("[F]or no gift shall be deemed to be *bona fide* within the said proviso which is accompanied with any trust . . . that the donee shall deal [] favorably with him in regard of his poor estate . . . this shall not be called *bona fide* within the said proviso.").

53. *See* Reilly, *supra* note 36, at 1245.

### B. Constructive Fraud

Transfers that can be explained *only* as vehicles for hiding assets from creditors occur relatively infrequently.<sup>54</sup> Most transfers are ambiguous, in the sense that there is a plausible, benign explanation for them. Fraudulent transfer law addresses these ambiguous transfers through a second ground for avoidance known as “constructive fraud.”<sup>55</sup>

Simplifying the law for purposes of this discussion, a transfer is constructively fraudulent when the transferor transfers an asset to someone who pays less than it is worth at a time when the transferor meets certain financial distress criteria.<sup>56</sup> A finding of constructive fraud thus rests on proof of two facts: (1) disparity in values exchanged on the transfer which yields a depletion of the wealth of the transferor; and (2) the insolvent or perilous financial condition of the transferor at the time of the transfer or thereafter.

Depending on the applicable law, creditors must show that the transfer was not for “fair consideration”<sup>57</sup> in return, or that the transferor received “less than reasonably equivalent value”<sup>58</sup> for the assets. Under either formulation, the court compares the value of the assets transferred

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54. For rare examples, see, for example, *In re Claxton*, 30 B.R. 199, 213 (Bankr. E.D. Va. 1983) (holding that the debtor colluded with relatives and friends to keep assets out of his bankruptcy estate); *In re Jones*, 68 B.R. 483, 485 (Bankr. W.D. Mo. 1984) (holding that the debtor transferred interest in property to a relative shortly before filing his bankruptcy case but retained possession and use of property).

55. See, e.g., *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 535 (1994).

56. See UFTA § 4, 7A pt. II U.L.A. 2 (1999) (“Every conveyance made and every obligation incurred by a person who is or will be thereby rendered insolvent is fraudulent as to creditors without regard to his actual intent if the conveyance is made or the obligation is incurred without a fair consideration.”). A bankruptcy trustee can avoid a transfer made or incurred on or within one year before the date of the filing of the petition if the debtor “received less than reasonably equivalent value for the transfer,” 11 U.S.C. § 548(a)(2)(A) (1994), and the debtor was: insolvent at the time of the transfer or became insolvent as a result of it, 11 U.S.C. § 548(a)(2)(B)(i); insufficiently capitalized, 11 U.S.C. § 548(a)(2)(B)(ii); or should have known it was incurring debts beyond its ability to pay, 11 U.S.C. § 548(a)(2)(B)(iii). The UFTA similarly provides constructive fraud grounds for avoidance but differentiates between the rights of “present” and “future” creditors. A present creditor is one whose claim “arose before the transfer was made or the obligation was incurred.” UFTA § 5(a), 7A pt. II U.L.A. 266 (1984).

57. UFTA § 3 states:

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

*Id.* Note that the definition of “fair consideration” expressly incorporates the transferee’s good faith.

58. 11 U.S.C. § 548(a)(2)(A); see also UFTA §§ 4(a)(2), 5(a).

with the value, if any, the transferor receives for them.<sup>59</sup> If the transfer is not for fair or equivalent value in return, the wealth of the debtor is depleted and creditors are worse off after the transfer than they were before because the total assets remaining available to satisfy their claims are less valuable. In contrast, a transfer for equivalent value has no immediate wealth-depleting effect on the transferor's creditors.

In addition to the wealth-depleting effect, creditors must also prove that the transferor was insolvent or in perilous financial condition at the time of the transfer or immediately thereafter. This requirement is consistent with the idea that creditors should expect to bear some risk of loss from the debtor's conduct and that fraudulent transfer avoidance should be limited to those transfers that impose risk of loss that creditors cannot control by action against the debtor.<sup>60</sup> The requirement that the wealth-depleting transfer occur while the debtor is insolvent, or on the precipice of financial distress, isolates those transfers that externalize loss to creditors and that creditors cannot rectify by action against the debtor.

Evidence that the transfer was for less than reasonably equivalent value serves a function other than proof that the transfer hurt creditors. It is a visible symptom of collusion.<sup>61</sup> That the transferee paid a price for the assets "unreasonably" less than their true value tends to support an inference of cooperative price manipulation between the transferor and the transferee. Put another way, when a transfer of assets occurs for less than equivalent value in exchange, but evidence of collusion is inconclusive, it is reasonable to infer that the transferee should have known that the transfer depleted the wealth of the transferor, and that the transfer increased risk of loss to its creditors. When a transferee has notice of this fact, it is reasonable to infer further that the transferee should have known the transfer externalized that loss to creditors, not only to the transferee's benefit, but also to the benefit of the transferor's shareholders or other insiders.<sup>62</sup>

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59. See, e.g., *BFP*, 511 U.S. at 536; see Jack F. Williams, *Revisiting the Proper Limits of Fraudulent Transfer Law*, 8 *Bankr. Dev. J.* 55, 79-82 (1991) (discussing judicial interpretation of "reasonably equivalent value" and concluding that the case law is "hopelessly confused"). For a discussion of the economic purpose of the requirement of value inequivalence, see Reilly, *supra* note 36, at 1235-40.

60. See Zaretsky, *supra* note 49, at 1176 (stating that a transfer "is unreasonably risky" to creditors when "there is a high probability that the transaction will inhibit the debtor's ability to pay its creditors").

61. See Reilly, *supra* note 36, at 1235.

62. Glenn noted: "[W]hen the argument is that the consideration for a transfer was insufficient, one is not only bound to consider the fraudulent intent of the debtor, but he must use the same evidence to test the good faith of the [transferee]." GLENN, *supra* note 18, at 511. Glenn

Colloquially, a transferee who gets the deal of the century probably has an inside connection to the transferor, such as common principals who can control the terms of the transfer for their mutual benefit and at the expense of “outsiders” like creditors. Deals that are overwhelmingly one-sided are usually reserved for “family.” And if a transferee is “family,” it is probably in a good position to know precisely what the transferor’s insiders are doing.<sup>63</sup>

There is a formidable obstacle to the use of value inequivalence to support an inference of collusion between the transferor and transferee. It is not always possible to ascertain the “true” value of assets as a standard of comparison for the value actually exchanged in the transfer. When a transfer is to the highest bidder among numerous fully informed bidders, it follows that the transferee paid equivalent value for the assets. Under such conditions we say that it paid “fair market value” for the assets.<sup>64</sup> If, however, the transfer occurs under other than vigorously competitive market conditions, it does *not* follow that the value the transferee pays for the property is the equivalent of its *hypothetical* “true” value.<sup>65</sup> Absent benchmark evidence such as the price at which comparable assets recently sold under analogous market conditions, there is no evidence of the assets’ “true” value apart from the transfer price itself.<sup>66</sup> Consequently, there is no way to compare the transfer price with the value of the assets for purposes of assessing value inequivalence.<sup>67</sup>

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explained that in this context, whether the transferee acted “in good faith” turns on “whether the [transferee] *knew, or should have known*, that he was not trading normally, but that on the contrary, the purpose of the trade, so far as the debtor was concerned, was the defrauding of his creditors.” *Id.* at 512. (emphasis added).

63. See GLENN, *supra* note 18, at 511 (explaining that inadequacy of consideration will tend to show the transferee’s bad faith as “a buyer knows what he is getting”).

64. When the transferor and transferee are participants in a competitive market, we describe the deal they reach as “at arm’s length” or “for fair market value.” Other than the increased risk of loss from an increase in liquidity, such a transfer does not negatively affect creditors.

65. Conditions common among sales of going concern assets that complicate the question of value include forced sale or other circumstances that limit the number of interested bidders. See Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738, 763 (1988) (observing that “[i]f an informational asymmetry prevents third parties from accurately assessing the value of the firm, the secured creditor may be the high bidder at the foreclosure sale even when the firm is in fact worth more than its claim”).

66. See, e.g., *In re Morris Communications NC, Inc.*, 914 F.2d 458, 475 (4th Cir. 1990) (noting that in the absence of a sale of comparable assets, *post-hoc* testimony regarding valuation at the time of sale “does not provide credible evidence to sustain a finding of fraudulent conveyance”).

67. See, e.g., *McGill v. Commercial Credit Co.*, 243 F. 637, 647 (D. Md. 1917) (describing the problem of hypothetical valuation:

Recall that one reason we care about value inequivalence is that it supports an inference of collusion between the transferor and transferee. When assessment of value inequivalence is an exercise in speculation, *post hoc* hypothetical assessments of the “true” value of the assets without more, do not support an inference that the transferee colluded with the transferor or otherwise was on notice of a potential fraud on creditors. The parties could have colluded, but no inference can be drawn based solely on a comparison between the transfer price, and a contrived, hypothetical market value.<sup>68</sup> The perspective from which value equivalence is to be judged in cases like this is the subject of controversy.

The disagreement is over whether a transfer that in retrospect appears to have depleted the wealth of the debtor should be avoidable by creditors without evidence of collusion between the transferor and transferee.<sup>69</sup> The controversy plays out in fraudulent transfer cases through confusing layers of abstraction. Recall that for a transfer to be avoidable on constructive fraud grounds, it must have occurred for less than fair, or reasonably equivalent, value in exchange.<sup>70</sup> The Uniform Fraudulent Conveyance Act (“UFCA”) expressed this concept with the term “fair consideration,” which by definition requires proof of the transferee’s “good faith.”<sup>71</sup> In a note to the section defining “fair consideration,” the drafters observed that cases considering the fairness of consideration given for the transferred assets turned on whether the

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The effort is to find out not what a real buyer and a real seller, under the conditions actually surrounding them, do, but what a purely imaginary buyer will pay a make-believe seller, under circumstances which do not exist . . . . It is not easy to guess what will take place in Wonderland, as other people than Lewis Carroll’s heroine have found out.

*Id.* On valuation problems in the context of successor liability, see Mark J. Roe, *Mergers, Acquisitions, and Tort: A Comment on the Problem of Successor Corporation Liability*, 70 VA. L. REV. 1559, 1569-77 (1984). On valuation of assets under conditions of uncertainty generally, see GILSON & BLACK, *supra* note 7, at 81-98.

68. See, e.g., *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 545 (1994).

69. See, e.g., Robert M. Zinman, *Noncollusive, Regularly Conducted Foreclosure Sales: Involuntary, Nonfraudulent Transfers*, 9 CARDOZO L. REV. 581, 584 (1987) (rejecting the proposition that the debtor’s scheme to defraud its creditors is irrelevant under the constructive fraud grounds for avoidance). “[T]he purpose of the badges, presumptions, and finally the constructive fraud provisions was to develop methods of ferreting out those transactions that are inequitable to creditors by the debtor’s deliberate design or indifference.” *Id.*

70. See *supra* notes 56-59 and accompanying text.

71. UFCA § 3, 7A pt. II U.L.A. 2, 32 (1999).

value disparity indicated fraudulent intent on the part of the transferor or collusion on the part of the transferee.<sup>72</sup>

The subsequently promulgated fraudulent transfer provisions in the Bankruptcy Code and in the Uniform Fraudulent Transfer Act (“UFTA”) do not use the term “fair consideration” but instead use “reasonably equivalent value.”<sup>73</sup> Neither defines “reasonably equivalent value.” So, unlike under the UFCA, evidence of the transferee’s “faith,” good or bad, is not *expressly* required to establish value inequivalence.<sup>74</sup> This new language arguably unlinked value equivalence from its role as evidence of collusion between the transferor and transferee, leading some commentators to argue for a new, broader role for fraudulent transfer avoidance as a means of addressing not only collusive transfers, but all wealth depleting transfers made while the debtor is, or thereby, becomes insolvent.<sup>75</sup>

Commentators who read the Bankruptcy Code and the UFTA as rendering the transferor’s or transferee’s “good faith” irrelevant on the question of reasonably equivalent value, take the position that if after the transfer, appraisers will testify that the price the transferee paid for the assets was significantly less than their “fair market value,” then the transfer price was not a “reasonable equivalent” of the assets.<sup>76</sup> Under

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72. See NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, PROCEEDINGS OF THE TWENTY-EIGHTH ANNUAL MEETING 352 (1918); see also Note, *Good Faith and Fraudulent Conveyances*, 97 HARV. L. REV. 495, 498 (1984) (“Despite the Commissioners’ efforts to reduce or eliminate subjective inquiries, [they] are still necessary under the good-faith requirements of the sections of the Act that concern constructive fraud and remedies.”) (citations omitted). In the Commissioner’s Prefatory Note to the UFCA, the drafters note three “confusions and uncertainties” of the existing law that they intended the UFCA to correct. See UFCA Prefatory Note, 7A pt. II U.L.A. 2, 2-3 (1999). One of these three confusions was the attempt by courts to “make the Statute of Elizabeth cover all conveyances which wrong creditors, even though the actual intent to defraud does not exist.” *Id.*

73. UFTA §§ 4(a)(2), 5, 7A pt. II U.L.A. 266, 301, 330 (1984); 11 U.S.C. § 548(a)(1)(B)(i) (1994).

74. See, e.g., ALCES, *supra* note 19, ¶5.01[2][c] (noting that after the language change, “comparisons of the value received by a debtor with the value given up by a debtor are not complicated with subjective determinations regarding the good faith of the transferee”). Alces is right if “good faith” is understood as meaning subjective honesty in fact. But, he is not correct in assuming that the transferee’s objectively derived state of mind, what it should have known, is similarly irrelevant.

75. See, e.g., Kennedy, *supra* note 50, at 576 (“The injury to creditors resulting from a forfeiture of an asset having significant value is equally palpable and ought to be equally remediable in any rational system without regard to the debtor’s mental state, whether or not that condition is accurately assessed.”); ALCES, *supra* note 19, ¶5.01 (noting the “increasing ‘objectification’ of fraud law”).

76. See, e.g., BFP v. Resolution Trust Corp., 511 U.S. 531, 552 (1994) (Souter, J., dissenting); Kennedy, *supra* note 50, at 535 (explaining the use of hypothetically derived fair market value to evaluate the reasonable equivalence of value exchanged at a foreclosure sale is “wholly consonant

this view, the test for reasonable equivalence turns exclusively on *post hoc* appraisal testimony, without regard to collusion between the parties to the transfer, or the effect of transferee's legal right to exploit forced sale market conditions on the "true" value of the property.<sup>77</sup>

In a case interpreting the Bankruptcy Code fraudulent transfer section, the United States Supreme Court held that "reasonably equivalent value" must be understood to take into account non-bankruptcy law that authorizes real property foreclosure sales under other than fair market conditions. In *BFP v. Resolution Trust Corp.*,<sup>78</sup> the Court held that a real property foreclosure sale price (although significantly less than a hypothetically derived "fair market value") is the "reasonably equivalent value" of the property whenever the sale was non-collusive and properly conducted under state law.<sup>79</sup> If, however, the foreclosure sale was collusive, or otherwise invalid under state law, then the foreclosure sale price would not enjoy "conclusive force" as the reasonably equivalent value.<sup>80</sup>

In a footnote, the Court limited its holding to mortgage foreclosures of real estate, cryptically noting that "considerations bearing upon other foreclosures and forced sales (to satisfy tax liens, for example) may be different."<sup>81</sup> The Court did not explain why some non-collusive forced sale conditions must be taken into account in ascertaining the "true" value of assets, whereas others might not matter.

Since *BFP*, courts have taken a variety of positions about the kind of evidence relevant to assess the reasonable equivalence of transfer

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with the course of development of creditors' remedies against injurious transfers of their debtors' assets").

77. The significance of the transferee's state of mind as an indicator of the "fairness" of the value exchanged for the transferred assets has become muddled in scholarly analysis. For example, Peter Alces notes that "fair consideration" under UFCA "does not require absolute equivalence . . . ; there is room for some inequality, hence, the 'fair' equivalence standard." ALCES, *supra* note 19, ¶ 5.02[2][b][i]. He reasons that "[t]he purpose for the flexibility in the definition is to assure that fraudulent disposition law will not have too great a chilling effect on commercial transactions." *Id.* "Fairness," in his view "provides an accommodation of the interests implicated, a balance between the need to permit transactors to make deals . . . and the need to fix a point beyond which courts will not permit [transferors] to enter into transactions that will too profoundly impair their ability to discharge obligations to creditors." *Id.* Alces observes merely that "fairness" means "fairness."

78. 511 U.S. 531 (1994) (interpreting 11 U.S.C. § 548).

79. *See id.* at 545. In 1984, Congress considered, but did not adopt, a provision which would have confined fraudulent transfer avoidance in bankruptcy for foreclosure sales to those involving collusion or other procedural irregularities. S. 445, 98th Cong., § 360 (1983).

80. *See BFP*, 511 U.S. at 545-46.

81. *Id.* at 537 n.3.

prices at forced sales.<sup>82</sup> For example, some courts have held that a tax sale conducted according to state law does not per se yield reasonably equivalent value for purposes of a fraudulent transfer action by a trustee in the debtor's bankruptcy case.<sup>83</sup> Other courts have held that a non-collusive tax sale does yield per se reasonably equivalent value if the state law provided for due process and an opportunity for competitive bidding akin to the judicial foreclosure sale of real property at issue in *BFP*.<sup>84</sup>

*BFP* resolved one aspect of the controversy about "reasonably equivalent value." "True" value does not equal value hypothetically derived without regard to the market conditions under which the transfer actually occurs, at least in circumstances analogous to the forced sale at issue in that case. The Court did not resolve the larger controversy about what purpose value comparison is to achieve in constructive fraud analysis.<sup>85</sup> Specifically, *BFP* neither adopted nor rejected the view that the reason to assess value inequivalence is as an indirect way of assessing the likelihood of collusion between the transferor and transferee in fraud of creditors.<sup>86</sup> Although *BFP* does not resolve this controversy, it does support the view that the assessment of "reasonably equivalent value" must render benign factors that affect the price received for the assets on the transfer, but do not support an inference of collusion, such as mortgage foreclosure procedures that authorize and regulate forced sales.<sup>87</sup>

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82. Compare *Vermillion v. Scarbrough*, 176 B.R. 563, 568 (Bankr. D. Or. 1994) (land sale contract forfeiture sale price yields reasonably equivalent value) and *McCanna v. Burke*, 197 B.R. 333, 341 (D.N.M. 1996) (same) with *In re Grady*, 202 B.R. 120, 125 (Bankr. N.D. Iowa 1996) (land sale contract forfeiture sale price not per se reasonably equivalent value).

83. See, e.g., *In re Sherman*, 223 B.R. 555, 559 (B.A.P. 10th Cir. 1998) (tax sale under Wyoming law to person selected in random lottery for amount of outstanding taxes and without regard to value of property, however measured); *In re Wentworth*, 221 B.R. 316, 319-20 (Bankr. D. Conn. 1998) (tax forfeiture sale occurred under Maine law without judicial oversight, public notice or competitive bidding).

84. See, e.g., *In re Russell-Polk*, 200 B.R. 218, 221 (Bankr. E.D. Mo. 1996); *In re Golden*, 190 B.R. 52, 58 (Bankr. W.D. Pa. 1995); *In re Hollar*, 184 B.R. 243, 252 (Bankr. M.D.N.C. 1995); *In re Lord*, 179 B.R. 429, 434 (Bankr. E.D. Pa. 1995).

85. The case addressed the meaning of the term "reasonably equivalent value" in 11 U.S.C. § 548(a)(1)(B)(i) (1994). The same term appears in the same context in the UFTA § 4(a)(2), 7A pt. II U.L.A. 266 (1999). Although courts interpreting the UFTA (including bankruptcy courts applying UFTA via 11 U.S.C. § 544(b)) may consider *BFP* as persuasive, they are not bound by the holding even in cases involving real property foreclosure sales.

86. See generally *BFP*, 511 U.S. 531.

87. See *id.* at 540.

#### IV. THE IMPORTANCE OF FRAUD IN SUCCESSOR LIABILITY CASES

##### A. *Successor Liability for Actual Fraud: The Traditional Requisites for De Facto Merger and Mere Continuation*

We have considered how an asset transferee can be a fraudulent transferee and subject to transfer avoidance.<sup>88</sup> When should a fraudulent transferee be treated *as a successor* subject to successor liability? The question is worth asking because the remedy of transfer avoidance is different than imposition of successor liability. Transfer avoidance permits a creditor to proceed against the transferred property or its value, even though it has passed into the hands of a transferee.<sup>89</sup> Under federal bankruptcy law on fraudulent transfer avoidance, “the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property.”<sup>90</sup> The challenging creditor enjoys any post-transfer appreciation in the property’s value, and the fraudulent transferee absorbs any depreciation.<sup>91</sup>

In contrast, successor liability is not an asset-specific remedy. It renders the transferee derivatively liable *in personam* and subject to all claims valid against the transferor as though it were the transferor, without limitation to the value of the specific property transferred.<sup>92</sup> Where inconclusive market data, passage of time or other factors make proof of the assets’ value difficult, or where the creditor’s claim exceeds the current value of the transferred assets, successor liability is clearly the creditors’ remedy of choice.

The question is the domain of successor liability apart from fraudulent transfer avoidance. The answer becomes clear by examining the traditional requisites for imposition of successor liability on grounds

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88. See generally *supra* Parts II and III.

89. See 11 U.S.C. § 548(a)-(b); UFTA § 7(a)(1); UFCA §§ 9(1)(a), 10(c), 7A pt. II U.L.A. 2 (1999); TABB, *supra* note 43, at 451-54.

90. 11 U.S.C. § 550(a) (1994); see also UFTA § 8(b).

91. See TABB, *supra* note 43, at 453. Tabb describes this outcome as “heads-I-win-tails-you-lose” from the perspective of the avoiding creditor. See *id.* If the property appreciates in value following the transfer, the creditor will choose to recover the property itself. See 11 U.S.C. § 550(a). Both the Bankruptcy Code and UFTA subject this value to equitable adjustments in favor of a “good faith” transferee to take into account post-transfer improvements in the property made by such a transferee. See 11 U.S.C. § 550(e); UFTA § 8(c). If the property declines in value post-transfer, the creditor will ask the court to order the transferee to pay the value of the property transferred fixed as of the date of the transfer. See generally Reilly, *supra* note 36, at 1240-41 (describing the relatively more favorable treatment afforded a “good faith” fraudulent transferee whose connection to the fraud is by negligence).

92. See FLETCHER ET AL., *supra* note 1, § 7122.

of *de facto* merger or “mere continuation.” The factors traditionally required to establish that a transfer of assets constituted a *de facto* merger, or the transferee is a “mere continuation” of the transferor are:

(1) a continuation of the enterprise of the seller corporation so that there is a continuity of management, personnel, physical location, assets, and general business operations; (2) a continuity of shareholders which results from the purchasing corporation paying for the acquired assets with shares of its own stock, this stock ultimately coming to be held by the shareholders of the seller corporation so that they become a constituent part of the purchasing corporation; (3) the seller corporation ceases its ordinary business operation, liquidates and dissolves as soon as legally and practically possible; and (4) the purchasing corporation assumes those obligations of the seller ordinarily necessary for the uninterrupted continuation of normal business operations of the seller corporation.<sup>93</sup>

This list of four factors for a finding of *de facto* merger is an ingredient list for a particular kind of fraudulent transfer. Suppose that a debtor borrows \$100,000 from a creditor and uses the money to purchase assets for a widget-making business. The debtor’s shareholders decide they would like to exploit the business for themselves without repaying to the creditor the \$100,000 that the debtor borrowed. In other words, they form classic fraudulent intent. One obvious strategy is to load the widget-making assets on a truck and drive for the hills. The success of this strategy depends on whether the shareholders can hide in the hills and still exploit the widget-making assets. Suppose that successful hiding requires moth-balling the assets, defeating the purpose of absconding with them in the first place.

An alternate strategy is to sell the assets to a third party for their market value (\$100,000) then pocket the cash and head for the hills. The shareholders would extract for themselves the liquidation value of the assets and leave the debtor unable to satisfy the claims of its creditors. Leaving aside for the moment the shareholders’ vulnerability as fraudulent transferees upon receipt of a \$100,000 dividend from the debtor corporation, by selling the widget-making assets to a third party, they forfeit any going concern value intrinsic in use of the assets for widget-making under their management. Liquidating the business in

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93. FLETCHER ET AL., *supra* note 1, § 7124.20. The litany of elements in Fletcher has been influential. It appears regularly in cases that consider successor liability on grounds of *de facto* merger. *See, e.g.*, *Keller v. Clark Equip. Co.*, 715 F.2d 1280, 1291 (8th Cir. 1983); *Arnold Graphics Indus. v. Indep. Agent Ctr., Inc.*, 775 F.2d 38, 42 (2d Cir. 1985); *Philadelphia Elec. Co. v. Hercules, Inc.*, 762 F.2d 303, 310 (3d Cir. 1985).

order to steal the cash is relatively unattractive whenever the shareholders value their interest in the business as a going concern more highly than the market does.

The shareholders want to have their cake and eat it too. They want to reap the benefits of a fraud on creditors, without losing their idiosyncratic interest in the going concern value of the firm. So they create or acquire a transferee that is a technically distinct entity but which they control. They arrange for the debtor to transfer its assets to this transferee. The transferee “pays” for the assets by issuing its equity directly to the shareholders (paying nothing to the debtor), or to the debtor who distributes the cash to its shareholders.<sup>94</sup> After the transfer, the shareholders control the transferee and thereby the transferred assets. The transferee continues the widget-making business operation exactly as the shareholders had run it before the transfer. If the creditor cannot assert its claim against the transferee, the shareholders will have worked a perfect fraud.<sup>95</sup>

The factors requisite for a finding of *de facto* merger or mere continuation describe this hypothetical transaction—a particular kind of actual fraud on creditors.<sup>96</sup> The shareholders continue their interest in the widget-making business now technically in the hands of the transferee and free of creditors’ claims. The transfer does not affect the widget-making business other than to separate creditors from recourse to it.<sup>97</sup> Only one conclusion about this type of transfer is possible. It is a vehicle by which the debtor’s shareholders divert assets to themselves through the artifice of a transferee at the expense of creditors.

Recall that the question is why creditors should be able to impose *successor liability* on the transferee in these circumstances rather than the asset specific remedy of fraudulent transfer avoidance. The answer is that in this case, there is no difference between the remedies of transfer

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94. See, e.g., *Pepper v. Dixie Splint Coal Co.*, 181 S.E. 406, 407 (Va. 1935) (involving a transferee, organized under the same name as the transferor and owned by the transferor’s shareholders, acquiring the assets of the transferor but paying nothing for them).

95. See, e.g., *Estey & Assoc. v. McCulloch Corp.*, 663 F. Supp. 167, 171 (D. Or. 1986) (finding that the theory of the “mere continuation” basis is to prevent fraud on creditors when a corporation goes through a change in form but not substance); *In re Acushnet River & New Bedford Harbor*, 712 F. Supp. 1010, 1014 (D. Mass. 1989) (recognizing application of successor liability doctrine to CERCLA claims prevents polluters and their acquirers from escaping liability “through formalistic corporate slight of hand”).

96. See *supra* note 93 and accompanying text.

97. Courts have adopted a millinery metaphor to describe this scheme. “[T]he purchasing corporation maintains the same or similar management and ownership but wears a ‘new hat.’” *Baltimore Luggage Co. v. Holtzman*, 562 A.2d 1286, 1293 (Md. Ct. Spec. App. 1988); *Bud Antle, Inc. v. Eastern Foods, Inc.*, 758 F.2d 1451, 1458 (11th Cir. 1985).

avoidance and successor liability, assuming that nothing has changed between the time of the sham transfer and that of the creditor's challenge. Whenever the transferee acquired *all* the assets of the transferor as a going concern, and perfectly replicates the debtor's operations at all times, the value of the debtor's assets at the time of the transfer necessarily equals the value of the transferee's assets at the time of the challenge.<sup>98</sup> If we relax the assumption to assume that the *value* of the assets has changed with the passage of time, subjecting all of the assets of the transferee to the creditors' claims still achieves the same result as fraudulent transfer avoidance. The creditors enjoy any appreciation in the value of the assets post-transfer, and the transferee absorbs any depreciation.<sup>99</sup>

Now further relax the assumption of perfect and permanent identity between the debtor and the transferee. When a fraudulent transferee deploys the acquired assets after the transfer in a different, noncontinuous, way with different shareholders, directors and managers, we see a difference between the remedies of transfer avoidance and successor liability. Suppose that between the time of the transfer and the creditor's challenge, the transferee has acquired other assets. Or suppose that at the time of the transfer, the transferee already had a profitable business operation which the transferred assets complemented. In either case, the transferee's value exceeds the value of the transferred assets. By imposition of successor liability on such a transferee, the creditor receives the full value of its claim, without limitation to the value of the transferred assets.<sup>100</sup> In this situation, successor liability exceeds the property-specific avoidance remedy. What creditors of the transferor gain, investors in the transferee lose. The amount at issue is the value the transferee's investors created by their pre- and post-transfer skill. Successor liability doctrine that transfers *this* value to the transferor's creditors creates an inefficient disincentive to value-maximizing investment.<sup>101</sup>

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98. Both fraudulent transfer law and successor liability allocate to the creditor any post-transfer appreciation in the value of the assets to the extent of his claim. *See supra* notes 19 and 94 and accompanying text; *Roe, supra* note 67, at 1575.

99. *See supra* notes 39-40 and accompanying text.

100. *See supra* note 93 and accompanying text.

101. *See Roe, supra* note 67, at 1576. *Roe* notes the need to isolate and protect the contribution of third parties to the value of the transferee is "critical to the goal of asset mobility." *Id. See also* RESTATEMENT, *supra* note 3, § 12 cmt. b (expressing concern that imposition of successor liability may unfairly permit a products liability claimant to recover more than they could have had the transferor/manufacture remained in business). *But see* David Gray Carlson, *Is Fraudulent Conveyance Law Efficient?*, 9 CARDOZO L. REV. 643 (1987) (arguing that fraudulent transfer law is

Imposition of successor liability in a case like this instead of transfer avoidance may nonetheless be appropriate as a second best solution. Fraudulent transfer avoidance depends on assessment of the value of the property as of the time of the transfer relative to the transfer price. As we have seen, when the transfer occurs other than under vigorously competitive conditions, the “true” value of the assets, as of the time of the transfer, may be impossible to discern.<sup>102</sup> When the assets transferred are a collection of operating assets sold as a going concern—the typical successor liability scenario—this condition is especially likely to exist. Further, the asset-specific remedy of transfer avoidance depends on the practical ability to value the transferred assets some time after they have been physically and economically incorporated into a “different” firm. The passage of time may make impractical a retrospective assessment of the value of the transferred assets exclusive of the value of the business into which they have been incorporated.

Imposition of successor liability may be the only workable measure of the extent of the transferee’s liability.<sup>103</sup> In these cases, courts should consider the extent to which imposition of successor liability, rather than an asset specific avoidance, affects the rights of non-insider investors in the transferee who could not have participated in the fraud. On this point, the relevance of continuity of insiders between the transferor and transferee becomes clear. The greater the identity between the insiders in the transferor and transferee, the less the reason to be concerned about the rights of uninvolved third parties. The converse is also true.

### *B. Successor Liability for Constructive Fraud*

The previous section explained how continuity between the transferor and transferee coupled with problems of valuation justifies imposition of the remedy of successor liability as opposed to the asset specific remedy of transfer avoidance. Evidence of continuity has another function common to both successor liability and fraudulent

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not efficient to the extent that the transferee is not subject to liability beyond the current value of the property transferred).

102. See *supra* notes 67-102 and accompanying text.

103. See, e.g., *Wesco Supply Co. v. El Dorado Light & Water Co.*, 155 S.W. 518, 519 (Ark. 1913) (holding that fraudulent transferee failed to carry its burden of proof as to the value of the assets transferred and was liable to the creditor to the full extent of the creditor’s claim). See *Roe*, *supra* note 67, at 1572 n.32 (explaining that transfer value is a theoretically superior measure of the transferee’s liability, but “a lid [on the transferee’s liability] based on the current value is practical and provides a rough surrogate for transfer value”).

transfer analysis. Evidence of continuity in some circumstances supports an inference of collusion and fraud.

As discussed above, the list of traditional factors for a finding of *de facto* merger or mere continuation describes a transfer and a transferee that have no purpose but to defraud creditors.<sup>104</sup> Not surprisingly, fraudulent transfer law, together with this often repeated articulation of the bases of successor liability, have greatly reduced the potential for success of such blatantly fraudulent transfers.<sup>105</sup> Insiders set on fraud must undertake a more subtle strategy. Courts asked to apply successor liability doctrine typically face an ambiguous transfer to an entity that is not a perfect replica of the transferor, and which has a plausible purpose other than merely to separate creditors from recourse to assets.<sup>106</sup> In cases like these, litigants have asked courts to interpret the requisites for *de facto* merger and mere continuation to expand the scope of successor liability to include more than the obvious sham transfer.<sup>107</sup>

Whether a transferee should be liable as a successor in cases which present some, but not all, the factors on the list has become a matter “of some ferment.”<sup>108</sup> Some courts interpreting the scope of the *de facto* merger basis hold that the key factor is continuity of ownership.<sup>109</sup> Others emphasize continuity of shareholders together with the absence

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104. See FLETCHER ET AL, *supra* note 1, § 7124.20.

105. See Roe, *supra* note 67, at 1568.

106. See *id.* at 1566.

107. See Keller v. Clark Equip. Co., 715 F.2d 1280, 1284-85 (8th Cir. 1983).

108. See, e.g., Knapp v. N. Am. Rockwell Corp., 506 F.2d 361, 369 (3d Cir. 1974) (preferring to decide successor liability case by reference to public policy “rather than by a mere procrustean application of formalities”); *In re Acushnet River & New Bedford Harbor*, 712 F. Supp. 1010, 1015 (D. Mass. 1989) (stating that the doctrine of *de facto* merger “rests on general equitable principles”). See generally Phillips, *supra* note 7, at 906-07 (noting a controversy among courts concerning “what kind and degree of continuity must exist between a corporation and its successor in order to hold the successor liable”).

109. See, e.g., Gallenberg Equip., Inc. v. Agromac Int’l, Inc., 10 F. Supp. 2d 1050, 1054 (E.D. Wis. 1998), *aff’d*, 191 F.3d 456 (7th Cir. 1999) (“[C]ourts will not generally find a case within either the mere continuation or *de facto* merger exceptions unless there is continuity of ownership between the selling and purchasing corporation.”); *United States v. Distler*, 741 F. Supp. 637, 641 (W.D. Ky. 1990) (noting that majority of jurisdictions require continuity of shareholders); *Crawford Harbor Assocs. v. Blake Constr. Co.*, 661 F. Supp. 880, 884 (E.D. Va. 1987) ([T]he “most critical element, however, is continuity of ownership”); *Dayton v. Peck, Stow & Wilcox Co.*, 739 F.2d 690, 693 (1st Cir. 1984) (same); *Bud Antle, Inc. v. Eastern Foods, Inc.* 758 F.2d 1451, 1458-59 (11th Cir. 1985) (holding same); *Sylvester Bros. Dev. Co. v. Burlington N. R.R.*, 772 F. Supp. 443, 448 (D. Minn. 1990) (same, applying federal common law in CERCLA case); *Manh Hung Nguyen v. Johnson Machine & Press Corp.*, N.E.2d 1104, 1110 (Ill. App. Ct. 1982) (“Continuity of shareholders is the ultimate justification for allowing liabilities to carry over to the successor.”). See generally Phillips, *supra* note 7, at 912-13 (noting that courts have been “most persistent” in requiring stockholder continuity as an essential element of *de facto* merger).

or inadequacy of value paid for the transferred assets.<sup>110</sup> At least one court has held that plaintiff must show both commonality of shareholders and corporate leadership.<sup>111</sup>

Clearly, courts are uncertain about why continuity of shareholders, or corporate leadership are important, and what they might be important to show. One court explained the significance of continuity of shareholders in vague relational terms. When a transfer of assets is for cash such that the transferor's shareholders do not acquire an equity interest in the transferee, the transferor and transferee "were strangers before the sale and continue to remain strangers after the sale."<sup>112</sup> The choice of language seems to suggest that if the transferee's shareholders keep in contact with the transferor after a transfer, they may acquire successor liability in addition to a new friend.

Once fraud is the basis for successor liability, however, the importance of continuity of shareholders becomes clear. Continuity can support an inference of the transferee's complicity with insiders of the transferor. Continuity of shareholders shows that the parties had an opportunity to rig the transfer to benefit themselves at the expense of the transferor's creditors. It is not critical that the transferor's *shareholders*, as such, continue their interest in the transferee. The fact that any person who can influence the disposition of the transferor's assets shows up as a principal on both sides of a transfer supports an inference that the transfer was rigged.

Suppose a group of the debtor's managers (insiders) decide to snatch the debtor's assets for their own benefit, stiffing its non-insider equity claimants and creditors. The insiders locate a transferee and acquire it. Then they arrange for the debtor (whom they effectively control) to convey all its assets to the transferee for cash less than the value of the transferor's assets, an amount of the transferee continues the business operation formerly conducted by the debtor. The insiders manipulated both the debtor and the transferee to depress the price of the

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110. *See, e.g.*, T.H.S. Northstar Assocs. v. W.R. Grace & Co., 840 F. Supp. 676, 678 (D. Minn. 1993) (holding that the key factors are continuity of management, personnel, assets and operations, plus transferee's provision of stock for acquired assets); *Crawford Harbor Assocs.*, 661 F. Supp. at 885 (stating that identity of ownership and management and the absence of consideration are key factors); *G.P. Publications, Inc. v. Quebecor Printing-St. Paul, Inc.* 481 S.E.2d 674, 680 (N.C. Ct. App. 1997) (holding that continuity of ownership, adequacy of consideration, and bona fides of transferee are key factors).

111. *See* *Timmerman v. Am. Trencher, Inc.*, 368 N.W.2d 502 (Neb. 1985).

112. *McKee v. Harris-Seybold Co.*, 264 A.2d 98, 104, (1970), *aff'd*, 288 A.2d 585 (N.J. Sup. Ct. 1972). But, where the sale of assets is for stock in the transferee, such that the transferor's shareholders continue their equity interest in the assets, the parties are not strangers post-transfer. *See* *Shannon v. Samuel Langston Co.*, 379 F. Supp. 797, 801-02 (W.D. Mich. 1974).

transferred assets, thereby diverting wealth to themselves (through the artifice of the transferee) that should have been available to non-insiders.

Although this transfer is a constructive fraud if it leaves the debtor insolvent, these facts do not fit squarely with the factors for a finding of *de facto* merger or mere continuation. For example, all the debtor's shareholders do not become shareholders of the transferee.<sup>113</sup> Moreover, the transfer was for cash, and not shares of the transferee.<sup>114</sup> Continuity of insiders between the transferor and transferee together with evidence of value inequivalence on the transfer support the inference that the transferee colluded with the transferor's insiders to defraud creditors. As discussed above, imposition of successor liability on the transferee may be appropriate as a second best remedy in this case as a surrogate measure of the value of the transferred assets.<sup>115</sup>

Now suppose that a transferee acquires the debtor's business for cash equal to the fair market value of the assets and continues the business of the transferor. None of the debtor's shareholders acquire an interest in the transferee, and no insider of the transferor has an interest in the transferee. These facts do not support an inference of fraud. Although the transferee continues to *use* the transferred assets in the same way, perhaps at the same location with the same managers, there are no insiders on both sides of the transfer who might have rigged it to enrich themselves at creditors' expense.

The debtor's insiders do not control the transferee, and the transferee got no bargain on the transfer. Under these facts, there is no reason to suspect that the transferor and transferee colluded to enrich themselves at creditors' expense, and thus no basis to characterize the transfer of assets to the transferee as fraudulent. Neither fraudulent transfer avoidance or successor liability are appropriate even though the transferee continued to use the assets in the same way at the same location and under the same (non-insider) management.

In *A.R. Teeters & Associates v. Eastman Kodak Co.*,<sup>116</sup> the court correctly identified the relationship between evidence of continuity and fraud. The presence of one controlling shareholder on both sides of the transfer, coupled with continuous use of assets, did not support an inference of collusion or justify successor liability.<sup>117</sup> The transfer was made with the knowledge and direction of the challenging creditor who

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113. See *supra* note 93 and accompanying text.

114. See *id.*

115. See *infra* Part IV.A.

116. 836 P.2d 1034 (Ariz. Ct. App. 1992).

117. See *id.* at 1040.

wanted to retain the transferor's patronage as a customer, but did not want to do business with one of the transferor's two equity holders.<sup>118</sup> The remaining acceptable equity holder set up the transferee with himself as sole shareholder.<sup>119</sup> There was no evidence that the price the transferee paid the transferor for the assets was inadequate.<sup>120</sup>

The court held that for imposition of successor liability, the ownership and control of the two corporations must be "substantially identical."<sup>121</sup> Second, "there [must] be insufficient consideration running from the new company to the old."<sup>122</sup> Because the transferee paid fair value for the assets, the transfer was not fraudulent, and the creditor was not entitled to relief against the transferee.<sup>123</sup>

The court in *Glynwed, Inc. v. Plastimatic, Inc.*<sup>124</sup> misunderstood the relationship between continuity and fraud. It held that an asset transferee who continued some of the attributes of the transferor could be liable as a successor even without evidence of collusion.<sup>125</sup> To address their financial problems, Plastimatic and another company, Danco, agreed to relinquish their assets to secured creditors for foreclosure.<sup>126</sup> Insiders of Danco and Plastimatic organized a third company, Danco/Plastock, to bid on the assets at the sale.<sup>127</sup> Two bidders appeared at the sale, but Danco/Plastock was the only bidder and its bid exceeded the appraised value of the assets.<sup>128</sup>

Glynwed was a creditor of Plastimatic under a lease.<sup>129</sup> It sought summary judgment against the transferee as a successor to the liability of Plastimatic, and alternatively, that the transfer of assets by sale was avoidable.<sup>130</sup> The transferee argued unsuccessfully that Uniform

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118. *See id.*

119. *See id.*

120. *See id.* at 1041.

121. *See id.* at 1039-40.

122. *Id.* (citing *Maloney v. American Pharm. Co.*, 207 Cal. App. 3d 282, 287 (Cal. Ct. App. 1989)); *see also* *Enos v. Picacho Gold Mining Co.*, 133 P.2d 663, 671 (Cal. Dist. Ct. App. 1943) (stating that "the lack of consideration running from the new company to the old is "an essential foundation" of the mere continuation basis). *But see* *Ray v. Alad Corp.*, 560 P.2d 3 (Cal. 1977).

123. *See Eastman Kodak*, 836 P.2d at 1040-41.

124. 869 F. Supp. 265 (D.N.J. 1994).

125. *See id.* at 278.

126. *See id.* at 268.

127. *See id.* The sale was conducted by a third party, Thomas Industries, who appraised the assets at \$1,850,000 and widely advertised the sale by direct mail and in industry trade journals. Danco and Plastimatic also notified their creditors, including Glynwed, of the sale.

128. *See id.*

129. Plastimatic was an assignee of Glynwed's rights as lessee under a lease. Plastimatic had defaulted under the lease, exposing Glynwed to liability to the lessor. *See id.* at 266-67.

130. *See id.* at 269.

Commercial Code (“UCC”) § 9-504 precluded a finding of successor liability against it,<sup>131</sup> and that successor liability doctrine was not available to a contractual creditor but only holders of tort and environmental claims.<sup>132</sup>

Glynwed argued that the transferee was a mere continuation of its debtor, or the result of a *de facto* merger.<sup>133</sup> The creditor could establish continuity of management, personnel, physical location and general business operations between the debtor and Danco/Plastock.<sup>134</sup> The creditor also met the second criteria for a finding of *de facto* merger—post-transfer dissolution of the debtor—although Plastimatic’s dissolution appeared to be triggered by a consolidation with Danco, over a year before the foreclosure sale.<sup>135</sup> The court found that individual shareholders, who collectively owned a significant minority of Plastimatic and Danco, also held the equity of the transferee, Danco/Plastock.<sup>136</sup>

The court imposed successor liability on the transferee because it found mutual intent “to effectuate a merger or consolidation rather than a sale of assets.”<sup>137</sup> The continuous interest of insiders and of the going concern was enough to justify successor liability, notwithstanding that the foreclosure sale was widely advertised and the transferee’s cash bid

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131. *See id.* Section 9-504 (pre-revised), as enacted in New Jersey, provided that:

A secured party after default may sell, lease or otherwise dispose of any or all of the collateral . . . . When collateral is disposed of by a secured party after default, the disposition transfers to a purchaser for value all of the debtor’s rights therein, discharges the security interest under which it is made and any security interest or lien subordinate thereto. The purchaser takes free of all such rights and interests even though the secured party fails to comply with the requirements of this Part or of any judicial proceedings.

U.C.C. § 9-504(1) (1972). Section 9-504 does not expressly address the rights under successor liability law of a creditor like Glynwed who was an unsecured creditor of the original debtor against a transferee from a secured party. Section 9-504 states that a transfer from a secured creditor to a transferee “discharges the security interest under which it is made and any security interest or lien subordinate thereto.” *Id.* § 9-504(c)(4). Glynwed did not assert a security interest or lien in the assets of the debtor, but rather an unsecured claim against the debtor. The court found this distinction significant. *See Glynwed*, 869 F. Supp. at 273-74. The fact that the transferee acquired the assets via a section 9-504(3) foreclosure sale did not provide an absolute bar to imposition of successor liability on the transferee for an unsecured claim against the debtor.

132. *See Glynwed*, 869 F. Supp. at 271. The court rejected this argument, recognizing that “the *de facto* merger doctrine is supported by ‘social policy considerations’ independent of any particular cause of action.” *Id.* (quoting *Philadelphia Elec. Co. v. Hercules, Inc.*, 762 F.2d 303, 311-12 (3d Cir. 1985)).

133. *See Glynwed*, 869 F. Supp. at 275.

134. *See id.* at 275-76.

135. *See id.* at 276.

136. *See id.* at 277.

137. *See id.* It also appeared to be relevant to the court that “Danco/Plastock held itself out to the world” as the continuation of Plastimatic and Danco. *Id.*

exceeded the appraised value of the assets.<sup>138</sup> In other words, evidence of continuity was sufficient to support successor liability, even though the insiders did not rig the transfer price to their advantage.<sup>139</sup> In fact, the court denied Glynwed's alternative motion for summary judgment against Danco/Plastock on fraudulent transfer grounds, finding that Glynwed had failed to carry its burden of establishing that the foreclosure sale was commercially unreasonable or in bad faith.<sup>140</sup>

### C. *Evaluating the Transferee's Role in a Post-Transfer Fraud on Creditors*

#### 1. The Transferee Who Knows

So far we have considered transfers in which the transferee participates in a fraud on creditors in the sense that by colluding with the transferor, it receives at least part of the booty wrested from creditors by the transfer. A transferee may be a participant in a fraud on creditors even without proof that the transferee benefited from it. Under fraudulent transfer law, even if a transferee gives reasonably equivalent value for the assets, the transfer still may be subject to avoidance if the transfer was an actual fraud on creditors.<sup>141</sup> In the absence of conclusive evidence of value inequivalence, under what circumstances should a transfer be treated as fraudulent and the transferee subject to successor liability?

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138. *Contra* G.P. Publications, Inc. v. Quebecor Printing—St. Paul, Inc., 481 S.E.2d 674, 683 (N.C. Ct. App. 1997) (holding purchaser of assets at secured creditor's foreclosure sale not liable to transferor's unsecured creditor as a successor absent evidence that it colluded with the transferee in connection with the sale). *Cf.* Voest-Alpine Trading USA Corp. v. Vantage Steel Corp., 919 F.2d 206, 215 (3d Cir. 1990) (holding transfer avoidable when it was part of a scheme accomplished with the use of a "friendly and collusive lienor"). U.C.C. § 9-615(f) provides for an adjustment of the deficiency in the debtor's favor following a sale of collateral where the transferee is the secured party, a person related to the secured party (§ 9-102), or a secondary obligor. The drafters note that when the sale is to the foreclosing secured party or a related party, the secured party may "lack[] the incentive to maximize the proceeds of disposition." *Id.*, official cmt. 6. It requires calculation of the debtor's deficiency in a case where the sale proceeds are "significantly below the range of proceeds" based on the amount of proceeds that "would have been realized in a disposition complying with this part to a [non-insider transferee]." *Id.* § 9-615(f). The section appears to address collusion that succeeds notwithstanding the procedural safeguard of "commercial reasonableness." The drafters provide no guidance as to how the hypothetical sale price to a non-insider should be derived, particularly whether the hypothetical disposition should be a foreclosure sale or a voluntary, non-forced sale.

139. *See Glynwed*, 869 F. Supp. at 277-78.

140. *See id.* at 278.

141. *See supra* notes 49-53 and accompanying text.

Suppose that a debtor transfers its entire business operation to a transferee for cash. After the transfer, the debtor distributes the cash to its shareholders and dissolves without paying the claim of its creditor. The creditor seeks to impose successor liability on the transferee. Suppose further (as is likely the case in the transfer of all the assets of a going concern firm) that there is no objective evidence of the assets' value other than the transfer itself and that the creditor cannot prove that the transferee paid the debtor less reasonably equivalent value for the assets.

The transfer of assets did not deplete the wealth of the transferor, nor did it enrich the transferee. At least the available evidence on relative value at the time of the transfer is inconclusive.<sup>142</sup> It is clear, however, that a wealth-depleting transfer occurred. The wealth-depleting transfer was to shareholders, and it occurred after the first transfer to the transferee.

Imposition of liability *on the transferee* in a case like this is appropriate only to the extent that it creates an incentive for transferees to prevent or insure creditors against a subsequent fraudulent transfer of assets from the transferor to its shareholders. A transferee has an opportunity to do so if it *knows* that the debtor plans a two-stage transfer fraud, and that a liquidating transfer to it is the first part of the debtor's plan.

If the transferee knows of the debtor's plans for after the transfer, it has an opportunity to prevent loss to creditors that creditors lacked. So informed, the transferee has an opportunity to be a conduit for imposing creditors' risk of post-transfer loss on the debtor.<sup>143</sup> As part of its contract of transfer with the debtor, the transferee could have imposed onto the debtor (its shareholders really) the cost of bearing the debtor's expected liability to its creditors, thwarting shareholders' plan of extracting the liability-free value of assets for themselves.<sup>144</sup> By

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142. In many cases involving sale of an ongoing business, *post-hoc*, hypothetical valuation of the assets is inconclusive. See discussion *supra* notes 62-69 and accompanying text.

143. See, e.g., Green, *supra* note 3, at 21, 39-40 (arguing that the conduit theory is the only valid justification for holding transferees derivatively liable as successors); GILSON & BLACK, *supra* note 7, at 1532 ("[T]he point of successor liability is not to cause the *successor* to bear the costs of the predecessor's defective products, but as a tool to insure that the *predecessor* bears the cost."); Alan Schwartz, *Products Liability, Corporate Structure, and Bankruptcy: Toxic Substances and the Remote Risk Relationship*, 14 J. LEGAL STUD. 689 (1985).

144. See GILSON & BLACK, *supra* note 7, at 1532.

Imposing liability on any future purchaser of the manufacturer's business means that the manufacturer must take the cost of future products liability claims into account currently because it will always bear them. If it continues to operate the business, it will bear the costs directly through products liability litigation; if it sells the business it will bear the

exposing a transferee to liability in these circumstances, we create an efficient incentive for it to use the information it has to protect creditors against a future loss at a cost lower than creditors' cost of protecting themselves.<sup>145</sup> In moral terms, a transferee who knows what shareholders are about to do but does nothing to stop them is as reprehensible as the deceitful shareholders.

Of course, just as it is difficult to prove "actual fraud," it is difficult, but not impossible, to show that a transferee *knew* of the shareholder's post-transfer plans.<sup>146</sup> Evidence of continuity of insiders is key. The fact that the transferee and the transferor shared common insiders tends to show that they also shared knowledge about the effect of the first transfer on creditors' risk of loss from a subsequent distribution from the debtor to its insiders. Indeed, when the evidence on relative value is inconclusive, the presence of common insiders suggests, perhaps as powerfully as evidence of value inequivalence, that the transferee stood to gain something from the transfer.<sup>147</sup> In such a case, where the transferee continues the business of the transferor, successor liability is an appropriate second best sanction for an actually fraudulent transferee. If, however, the evidence is clear that the transfer was for reasonably equivalent value, then the presence of common insiders should not support an inference of fraud.<sup>148</sup>

## 2. The Transferee Who Should Have Known

For creditors, loss is just as painful whether the cause is a wealth-depleting transfer to a collusive transferee or a post-transfer, wealth-eliminating fraudulent dividend to shareholders of their debtor. Absent evidence of value inequivalence, or common insiders sufficient to

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costs indirectly through a reduction in the price a purchaser will be willing to pay for the business.

*Id.*

145. See, e.g., Schwartz, *supra* note 143, at 716 ("It is better for the risk to be borne by successors who can protect themselves by contract than by tort victims who cannot.")

146. In a leveraged buyout transaction, creditors of the acquired corporation can avoid the transfer of a security interest to the selling shareholders without establishing inequivalent value on the transfer. The proof required is that the transferees (selling shareholders of the target company) knew or should have known that the financing arranged to purchase their shares would deplete the assets of the target company in fraud of its creditors. See, e.g., Lippi v. City Bank, 955 F.2d 599, 612 (9th Cir. 1992); Kupetz v. Wolf, 845 F.2d 842, 847-48 (9th Cir. 1988); Weiboldt Stores, Inc. v. Schottenstein, 94 B.R. 488, 502 (N.D. Ill. 1988).

147. See, e.g., Eagle Pac. Ins. Co. v. Christensen Motor Yacht Corp., 959 P.2d 1052 (Wash. 1998); Schmoll v. Acands, Inc., 703 F. Supp. 868, 873 (D. Or. 1988), *aff'd*, 977 F.2d 499 (9th Cir. 1992).

148. See *Glynwed* discussion *supra* notes 124-40 and accompanying text.

support an inference that the transferee actually knew about the debtor's plan to defraud its creditors, should a transferee be liable to creditors on proof that it *should have known* of such a plan?

Suppose that the transferee and the debtor did not share common principals and that the transfer of assets occurred under circumstances that raise no suspicion of collusion. Suppose further that by examining the debtor's books before the transfer, the transferee might have discovered that the debtor had creditors who could not quickly and cheaply foreclose on its post-transfer assets to satisfy their claims, at least not before shareholders distributed the assets to themselves and took off to parts unknown. With this information, the transferee is arguably in a better position than the transferor's creditors to prevent (or insure against) loss from a subsequent fraudulent transfer.

It should not be enough to justify successor liability that a transferee should have known of potential claims against the transferor that may go unsatisfied after the transfer.<sup>149</sup> To justify imposition of liability, the transferee must have had notice at the time of the transfer of facts that would make it able *to affect* the risk of loss to the transferor's creditors.<sup>150</sup> Suppose that before the transfer, the debtor's total liability exceeded the value of its assets (it is insolvent). It transferred its assets for their fair market value to the transferee, and distributed the cash it received to its priority creditor.<sup>151</sup> The transferor's unsecured creditors would have received nothing if the transfer had not occurred. So, neither the transfer nor the post-transfer distribution to priority creditors made creditors worse off. The critical assumption is that this transfer occurred under market conditions that preclude collusion between the transferor's priority creditors and the transferee. If that is true, then the transferee could have done nothing to prevent or internalize to the debtor the loss to unsecured creditors, even though the transferee may have known that the debtor had claims against it that would go unsatisfied after the transfer.<sup>152</sup>

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149. The drafters of the Restatement (Third) of Torts: Products Liability wondered whether evidence that a transferee knew or should have known of the existence of contingent products claims against the transferor at the time of the transfer should be sufficient to justify imposition of successor liability. See RESTATEMENT, *supra* note 3, § 12, reporters' notes to cmt. e (suggesting that the fraud basis for successor liability may apply when the transferee knows or has reason to know that the transferor's products are defective at the time of the transfer); see also Murphy, *supra* note 14, at 830, 847-50 (1988) (proposing a "non-bona fide purchaser" exception to the ordinary rule of transferee non-liability, under which a transferee who knew or should have known of existing or potential defects in the transferor's products is liable as a successor).

150. See Murphy, *supra* note 14, at 830.

151. This was likely the case in *Glynwed* discussed *supra* notes 124-40 and accompanying text.

152. Murphy asserts that a transferee who knows of defects in its transferor's products, and that

The remaining problem is determining when a transferee *could have discovered*, at the time of the transfer, information about the transferor's creditors post-transfer risk of loss about which it could have done something. To make a judgment about what an arms' length transferee should have known about the plans of the debtor/transferor, we must ascertain the scope of its "reasonable" due diligence review of the debtor at the time of the transfer. The transferee gains nothing from a review of facts necessary to ascertain creditors' post-transfer risk of loss other than immunity from successor liability. So, ideally, the scope of a reasonable review would reflect a balance of the average cost to the transferee of such review (not insignificant) with the average benefit to creditors.

Given the seemingly infinite energy of frauds, and the multitudinous guises of fraud, any *ex ante* development of a safe harbor for due diligence is likely to be difficult and immediately obsolete. On the other hand, a *post-hoc* approach is perhaps hopelessly afflicted with hindsight bias.<sup>153</sup> It is difficult to exclude from an assessment of what a transferee "should have known" at the time of the transfer information about what actually happened after the transfer at issue.<sup>154</sup>

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the transferor plans to dissolve and distribute its assets after the transfer, "may be said to be a cause in the plaintiff's inability to recover from the predecessor." Murphy, *supra* note 14, at 849. This is an overstatement. A transfer "causes" loss to creditors only if the transfer *increases* their expected loss. This occurs only if shareholders or priority creditors use the transfer to divert assets to themselves that would otherwise be available to satisfy creditors' claims. Whether as a matter of policy, legal rules should afford secured creditors with priority claims in the debtor's assets over involuntary (and unsecured) creditors like products liability claimants is the subject of debate. *See supra* note 37.

153. *See generally* Jeffrey J. Rachlinski, *A Positive Psychological Theory of Judging in Hindsight*, 65 U. CHI. L. REV. 571 (1998). For an example of the hindsight bias problem in an analogous setting, consider the "innocent landowner" defense to liability under the Comprehensive Environmental Response, Compensation, and Liability Act ("CERCLA"), 42 U.S.C. § 9601(35)(a) (1994). A purchaser can escape liability if it can show that it did not know and had no reason to know of the contamination at the time it acquired the property. The purchaser must show it used "appropriate inquiry into the previous ownership and uses of the property consistent with good commercial and customary practice." *Id.* at § 9601(35)(B). The court must examine "any specialized knowledge or experience on the part of the defendant, the relationship of the purchase price to the value of the property if uncontaminated, commonly known or reasonably ascertainable information about the property, the obviousness of the presence or likely presence of contamination at the property, and the ability to detect such contamination by appropriate inspection." *Id.* A commentator noted that in practice this defense has been unsuccessful because courts find that if the purchaser did not discover contamination existing at the time of the transfer, it did not conduct an appropriate inquiry. *See* Larry Schnapf, *Cost-Effective Environmental Due Diligence in Corporate Mergers and Acquisitions*, 15 NAT. RESOURCES & ENV'T 80, 81 (2000).

154. As one commentator stated,

In hindsight, people consistently exaggerate what could have been anticipated in foresight. They not only tend to view what has happened as having been inevitable but

Fraudulent transfer law addresses the problem of ascertaining what the transferee should have known about the effect of the transfer on risk of loss to creditors indirectly through an assessment of the financial condition of the transferor at the time of the transfer.<sup>155</sup> Recall that to show that a transfer is constructively fraudulent, the creditor must show that the debtor was insolvent at the time of the transfer, or was rendered insolvent thereby.<sup>156</sup> Or, he must show that the debtor was engaged in business with “unreasonably small capital”<sup>157</sup> or “intended to incur debts that would be beyond his ability to pay.”<sup>158</sup>

The assessment of the debtor’s financial condition is problematic in some cases given the broad definitions of “claim” under bankruptcy law<sup>159</sup> and under the UFTA.<sup>160</sup> A court may determine that a person had a bankruptcy “claim” against a product manufacturer at a given moment in time (e.g., the filing of the manufacturer’s bankruptcy case) even if at that time, the probability that he would be injured and the magnitude of loss if he were injured was uncertain.<sup>161</sup> His products liability claim exists for purposes of bankruptcy administration, although it will not exist in a cognitive sense until later, if at all.<sup>162</sup> It is not clear whether such a “claim” should count for purposes of the retrospective assessment of the debtor’s financial condition that fraudulent transfer law requires.

The drafters of fraudulent transfer law may not have contemplated the case of the contingent future claimant or the impact of his claim on

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also to view it as having appeared ‘relatively inevitable’ before it happened. People believe that others should have been able to anticipate events much better than actually was the case.

Baruch Fischhoff, *For Those Condemned to Study the Past: Heuristics and Biases in Hindsight in JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES* 335, 341 (Daniel Kahneman et al. eds. 1982).

155. See Reilly, *supra* note 36, at 1225.

156. See UFCA, § 4, 7A pt. II U.L.A. 2 (1999); UFTA § 5, 7A pt. II U.L.A. 266 (1984) (available only to present creditors), 11 U.S.C. § 548(a)(1)(B)(ii)(I).

157. UFCA § 5; UFTA § 4(a)(2)(i); 11 U.S.C. § 548(a)(1)(B)(ii)(II).

158. UFCA § 5; UFTA § 4(a)(2)(ii); 11 U.S.C. § 548(a)(1)(B)(ii)(III).

159. See 11 U.S.C. § 101(5) (1994). See generally Frederick Tung, *Taking Future Claims Seriously: Future Claims and Successor Liability in Bankruptcy*, 49 CASE W. RES. L. REV. 435 (1999) (discussing the importance of resolving contingent claims issues in bankruptcy and other contexts).

160. See UFTA § 1(3).

161. See, e.g., Tung, *supra* note 159, at 438; *In re Amatec Corp.*, 755 F.2d 1034, 1042-43 (3d Cir. 1985) (holding that “future claimants” were “parties in interest” under the Bankruptcy Code); *In re Johns-Manville Corp.*, 36 B.R. 743, 745 (Bankr. S.D.N.Y. 1984), *aff’d*, 52 B.R. 940 (S.D.N.Y. 1985).

162. See, e.g., *Kline v. Johns-Manville*, 745 F.2d 1217, 1218 (9th Cir. 1984) (transferee acquired asbestos line in 1962); *Gee v. Tenneco, Inc.* 615 F.2d 857, 860 (9th Cir. 1980) (transferee acquired manufacturer of X-ray contrast dye in 1963 revealed decades later to be carcinogenic).

the “solvency” of the transferor as of the time of the transfer. Close reading of the statutes does not yield a satisfactory answer. The UFCA is the most explicit. Section 2 states that a person is insolvent “when the present fair salable value of his assets is less than the amount that will be required to pay his probable liability on his existing debts as they become absolute and matured.”<sup>163</sup> Courts have interpreted “probable liability on existing claims” broadly in favor of creditors.<sup>164</sup> But, it is not clear that courts would consider a claim based on injury yet to occur that nobody anticipates at the time of the transfer “probable liability on his existing debts” under the UFCA.<sup>165</sup>

Under UFTA, “a debtor is insolvent if the sum of the debtor’s debts is greater than all of the debtor’s assets at fair valuation.”<sup>166</sup> “Debt” means “liability on a claim.”<sup>167</sup> “Claim” includes rights that are contingent and unliquidated at the time of assessment, i.e., future claims.<sup>168</sup> In apparent conflict with the broad definition of “claim,” the UFTA sets different tests for transfer avoidance for creditors whose claims “arose before the transfer was made” and those whose claims “arose” later.<sup>169</sup> Under section 5, the first group of creditors can avoid a transfer for less than reasonably equivalent value on proof that the transferor was insolvent or became insolvent because of the transfer.<sup>170</sup> A creditor whose claim did *not* “arise” until after the transfer, however, may not use section 5.<sup>171</sup> He may still avoid such a transfer, but only upon proof that the transfer was for less than reasonably equivalent value, and the debtor

- (i) was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small

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163. UFCA § 2.

164. *See, e.g.*, *Cont’l Bank v. Marcus*, 363 A.2d 1318, 1320 (Pa. Super. Ct. 1976); *Baker v. Geist*, 321 A.2d 634, 636 (Pa. 1974) (involving an unliquidated personal injury claim for injury occurring pre-transfer held probable liability); *Tri-Cont’l Leasing Corp. v. Zimmerman*, 485 F. Supp. 495, 500 (N.D. Cal. 1980) (holding that “existing debts” includes pending claims “however farfetched”) (citation omitted); *United States v. St. Mary*, 334 F. Supp. 799, 803 (E.D. Pa. 1971) (stating that unassessed tax is a liability for purposes of assessing transferor’s insolvency).

165. *See* UFCA § 2.

166. UFTA § 2(a), 7A pt. II U.L.A. 266 (1984).

167. UFTA § 1(5).

168. *See* UFTA § 1(3) (“‘Claim’ means a right to payment, whether or not the right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured.”); *see also* 11 U.S.C. § 101(5) (1994) (definition of “claim”).

169. The UFTA is silent on when a claim “arises” for this purpose.

170. *See* UFTA § 5.

171. *See id.*

in relation to the business or transaction; or (ii) intended to incur, or believed or reasonably should have believed that he [or she] would incur, debts beyond his ability to pay as they became due.<sup>172</sup>

The second of the two alternative grounds is clearly subjective and would not apply if the creditors' late arising claim was unknowable as of the time of the transfer.<sup>173</sup> It is not clear whether the reasonableness of the debtor's post-transfer capital should be assessed in light of what the debtor or the transferee or either of them should have known at the time of the distribution, or by what they came to know with the passage of time post-transfer.

The bankruptcy definition of "claim" is inconsistent with the concept of liability reflected in standard financial accounting principles. These principles differentiate among categories of contingent liability, recognizing "probable," "reasonably possible" and "remote" liability.<sup>174</sup> Remote liability is defined as claims contingent on the occurrence of events the probability of which is "slight."<sup>175</sup> Liability is not accounted for as a charge to income unless it is "probable."<sup>176</sup>

Outside of the context of successor liability, some courts permit information about events that occurred after the transfer to inform the question of what the parties could reasonably have foreseen at the time

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172. *Id.* § 4(2)(i), (ii).

173. *See id.*

174. FINANCIAL ACCOUNTING STANDARDS BOARD, ACCOUNTING FOR CONTINGENCIES, STATEMENT NO. 5, § 3 (1975), available at <http://www.fasb.org/st/summary/stsum5.shtml> [hereinafter FASB].

175. *See id.*

176. *See* FASB, *supra* note 174, § 8(a). A financial statement must disclose the contingency "when there is at least a reasonable possibility that a loss may have occurred." *Id.* § 10.

Disclosure is not required of a loss contingency involving an unasserted claim or assessment when there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment unless it is considered probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable.

*Id.* The Securities and Exchange Commission considers FASB No. 5 as having "substantial authoritative support." Accounting Series Releases and Staff Accounting Bulletins as of June 1, 1981, 38 Fed. Reg. 1260 (Dec. 20, 1973). *See, e.g.,* Greenstone v. Cambex Corp., 975 F.2d 22, 24 (1st Cir. 1992); SEC v. Steadman, 967 F.2d 636, 645 (D.C. Cir. 1992) (considering FASB No. 5 in SEC suit alleging that company failed to disclose contingent liability); *see also* MODEL BUS. CORP. ACT § 14.06 official cmt. (2002) ("[A] claim that is contingent or has not yet matured or in certain cases has matured but has not been asserted is not a 'known' claim."). *Cf.* EDWARD P. WELCH & ANDREW J. TUREZYN, FOLK ON THE DELAWARE GENERAL CORPORATE LAW: FUNDAMENTALS § 281(b) (1997) (stating that to assure directors immunity from liability to creditors, a dissolving corporation, with court approval, can set aside assets to pay claims that "have not arisen, but that, based on facts known to the corporation . . . are likely to arise . . . within 10 years after the date of dissolution").

of the transfer.<sup>177</sup> A few courts permit introduction of evidence of post-valuation events liberally as evidence of value at the time of valuation without regard to whether the parties could have foreseen those events.<sup>178</sup> When the issue is the value of property for tax purposes, the Internal Revenue Service notes that the value of property as of a particular time is to be based on the facts “available at the time of the appraisal” and not those which are revealed later.<sup>179</sup> Leading credentialing bodies in business valuation state the same rule for appraisal of property.<sup>180</sup> At least one standard for appraisers permits consideration of facts that become known only post-valuation “as a confirmation of trends that would reasonably be considered by a buyer or seller as of that date.”<sup>181</sup>

The rationale for considering post-valuation facts in a *post-hoc* assessment of value is persuasive. Certain facts that come to light after the appraisal date illuminate the question of what the parties to a hypothetical transfer could have known at the time of the valuation.<sup>182</sup>

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177. See, e.g., *Ridgely v. United States*, 20 A.F.T.R. 2d 5946, 5954 (1967) (holding that purchase of real property from estate by General Foods for use as a Jell-O manufacturing plant after the valuation could not reasonably have been foreseen and was not considered); *Estate of Gilford v. Comm’r*, 88 T.C. 38, 52 (1987) (stating that post-valuation events can be considered only for the “‘limited purpose’ of establishing what the willing buyer and seller’s expectations were on the valuation date and whether these expectations were ‘reasonable and intelligent’”) (citing *Estate of Jephson v. Comm’r*, 81 T.C. 999 (1983)).

178. See, e.g., *Estate of Jung v. Comm’r*, 101 T.C. 412, 430-31 (1993) (noting that a sale of comparable property occurring two years after the date of valuation was not foreseeable but nonetheless was relevant on the question of value); *Estate of Cidulka v. Commissioner*, T.C. Memo. 1996-149 (stating that sale of stock relevant on valuation of stock four years earlier).

179. See, e.g., Rev. Rul. 59-60, 1959-1 I.R.B. 237, 238 (“Valuation of securities is, in essence, a prophesy as to the future and must be based on facts available at the required date of appraisal.”); see also *Ithaca Trust Co. v. United States*, 279 U.S. 151, 155 (1929) (Holmes, J.) (“Like all values, as the word is used by the law, it depends largely on more or less certain prophecies of the future; and the value is no less real at that time if later the prophecy turns out false than when it comes out true.”).

180. See AMERICAN SOCIETY OF APPRAISERS, BUSINESS VALUATION STANDARDS, BVS-I GENERAL REQUIREMENTS FOR DEVELOPING A BUSINESS VALUATION II(C)(1)(c)(2), at 5, available at <http://www.bvappraisers.org/standards/bvstandards.pdf> (stating that an appraisal “considers all the relevant information as of the appraisal date available to the appraiser at the time of the performance of the valuation.”); INSTITUTE OF BUSINESS APPRAISERS, BUSINESS APPRAISAL STANDARDS § 1.20, available at <http://www.instbusapp.org/catalog.asp?CatID=1&SKU=P-311B#P-311B> (explaining that an appraisal shall be based on “what a reasonably informed person would have knowledge of as of a certain date . . . Information unavailable or unknown on the date of valuation *must* not influence the appraiser or contributed to the concluding opinion of value.”).

181. UNIFORM STANDARDS OF PROFESSIONAL APPRAISAL PRACTICE, Statement on Appraisal Standards No. 3, 59 (Appraisal Standards Bd. of the Appraisal Found. 1994).

182. See *id.* (“The appraiser should determine a logical cut-off since, at some point distant from the effective date, the subsequent data will not reflect the relevant market. This is a difficult

The problem with this logic is defining the boundary between late arising information that should be considered as evidence of what the parties should have known, and that which should not. If all information about post-valuation date events are relevant to assess value without any limitation as to foreseeability as of the valuation, theoretically all valuations become tentative, and eternally subject to reassessment with the passage of time.

The real problem with the scope of successor liability has nothing to do with a mystical assessment of the presence and sufficiency of “continuity.” Indeed, the real problem is the same as that which underlies the scope of fraudulent transfer law itself—determining the boundary of the idea of “fraud.” This article argues that the outer boundary of a transferee’s liability to its transferor’s creditors, whether under fraudulent transfer law or successor liability doctrine, ought to be limited based on what the transferee could have known at the time of the transfer. The critical question is whether at the time of the transfer, the transferee had notice of facts necessary to assess the magnitude and probability of creditors claims and an opportunity to prevent or insure against loss to creditors.<sup>183</sup> Within this question is buried another. What kind of evidence supports an inference of such notice?

#### V. SUCCESSOR LIABILITY FOR THE UNKNOWABLE CLAIM

All asset transferees are always on notice that claims against their transferor *might* exist at the time of the transfer. It makes no sense to treat this kind of notice as sufficient to justify successor liability. If a claim against the debtor/transferor was, in accounting terms, “remote” at the time of the transfer, then the transferee could not have had the information necessary to protect creditors or future claimants by action at the time of the transfer. For a transferee to be an effective weapon against fraud, it must be able to quantify to some extent the expected

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determination to make.”). The same appraisal standards in another section prohibit the use of information available only after the valuation date. *See* UNIFORM STANDARDS OF PROFESSIONAL APPRAISAL PRACTICE, Statement on Appraisal Standards No. 1, 53 (Appraisal Standards Bd. of the Appraisal Found. 1994) (stating that review appraisers may have additional information that was not available to the original appraiser and that it is “appropriate for the review appraiser to use this information in estimating value” but that a review appraisal that “does not include all of the requirements contained in Standards Rule 3-2 [including the nature, extent, and detail of the review process] is in violation of the USPAP, since departure from this rule is not permitted.”).

183. Courts do not always see the distinction between notice that a risk exists and of its expected value. *See, e.g.,* *Borel v. Fibreboard Paper Prods. Corp.*, 493 F.2d 1076, 1089 (5th Cir. 1973).

value of creditors' claims so it can take them into account in striking its bargain with the transferor.<sup>184</sup>

The most vulnerable type of creditor is the holder of a "contingent unknown claim" such as one who holds a claim for injury to arise in the future from a product defect.<sup>185</sup> In some cases, this potential liability is sufficiently certain and large that transactional planners can take it into account and plot to snatch assets from creditors before the claims arise.<sup>186</sup> The debtor's shareholders can sell the corporate assets free of the future and as yet contingent claims of creditors. By the transfer, they realize the liability-free value of the assets by cutting any effective recovery for those late-arising claimants.<sup>187</sup>

Yet, if the expected liability is "remote," so that planners could not have formed a transfer strategy to escape it, a transfer that leaves creditors with loss cannot be a "fraud" on creditors. True, the post-transfer dissolution of the debtor may in fact enrich shareholders at creditors' expense, but neither the shareholders nor the transferee could have acted to prevent creditors' loss at the time of the transfer.

Professor Michael Green has argued persuasively that the problem presented by contingent future claims is best addressed by legislation.<sup>188</sup>

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184. See *supra* notes 182-83 and accompanying text; see also Green, *supra* note 3, at 39-40 (proposing that the purpose of imposing successor products liability on a transferee is to create an incentive for it to act as a "conduit" for transferor's creditors' loss.); Roe, *supra* note 67, at 565; Cupp, *supra* note 3, at 860-63. Cupp advocates imposition of successor liability on transferees who continue the business of the transferor without regard to the transferee's role in a fraud. See *id.* at 867. He asserts that insurance for products liability claimants' expected loss is "readily available and relatively inexpensive" yet he does not make the critical distinction between those claims for which the magnitude and probability of loss are estimable for purpose of pricing insurance, and unknowable claims, which are by definition uninsurable risks. See *id.* at 870.

185. See GILSON & BLACK, *supra* note 7, at 1505.

186. See *id.*

187. See *id.*; see also Schwartz, *supra* note 143, at 714-716; Robert D. Cooter, *Defective Warnings, Remote Causes, and Bankruptcy: Comment on Schwartz*, 14 J. LEGAL STUD. 737, 749 (1985).

188. See Green, *supra* note 3, at 48-58. Green notes that the Model Business Corporation Act was revised in 1984 to address the problem of contingent future claims in corporate dissolution. He concludes that the revision, which imposes a five-year limitation post-dissolution on assertion of such claims "does little to alleviate the situation." *Id.* at 49. Tung argues persuasively that the transferor's bankruptcy case provides a forum for considering and safeguarding the rights of future claimants. See generally Tung, *supra* note 159. See also Alan N. Resnick, *Bankruptcy as a Vehicle for Resolving Enterprise-Threatening Mass Tort Liability*, 148 U. PA. L. REV. 2045 (2000) (discussing how bankruptcy system might be improved to respond more effectively to mass tort cases); S. Elizabeth Gibson, Comment, *A Response to Professor Resnick: Will this Vehicle Pass Inspection?*, 148 U. PA. L. REV. 2095 (2000) (arguing that Resnick overstates the utility of bankruptcy as a response to mass tort); Thomas A. Smith, *A Capital Markets Approach to Mass Tort Bankruptcy*, 104 YALE L.J. 367 (1994) (proposing use of capital market to value future claims for administration in bankruptcy cases).

He proposes a model law that would require manufacturers to make “adequate provision” for potential liability as a pre-condition to dissolution and distribution of assets to shareholders.<sup>189</sup> Green’s legislative solution is intriguing. But as he recognizes, it does not solve the problem of potential loss externalization to holders of truly unknowable contingent future claims.<sup>190</sup>

The problem with a legislative solution is the same as the problem with “fraud” generally as a limiting principle for transferee liability. Whether a transferor made “adequate provision” for future contingent claims must turn on a *post-hoc* assessment of what it knew or should have known about the magnitude and probability of such claims at the time of the transfer.<sup>191</sup> A satisfactory legislative solution would involve more than corporate law requiring insiders to make “adequate provision” for expected future claims. It would require the creation of a source of compensation for holders of unknown, unknowable future claims perhaps in the form of a corporate tax on product manufacturers, or a general tax on all of us.

Absent such a broad, and perhaps politically infeasible legislative solution, claimants have asked courts for equitable relief under the successor liability doctrine.<sup>192</sup> Although most courts have declined to expand successor liability beyond the bounds of fraud as developed here,<sup>193</sup> some courts have done so ostensibly to provide a source of compensation for claimants who cannot establish fraud.<sup>194</sup> These courts justify imposition of successor liability under theories known as “continuity of enterprise” or “product line.”<sup>195</sup>

*Turner v. Bituminous Casualty Co.*,<sup>196</sup> provides an example of the “continuity of enterprise” approach.<sup>197</sup> The majority held that policies

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189. See *Green*, *supra* note 3, at 50-51 (“[N]o corporation that has engaged in manufacturing products that it sells or leases may dissolve or distribute its assets to its shareholders in connection with its dissolution until the corporation has made adequate provision for post-dissolution products liability claims.”). The legislation suggests alternative ways to make “adequate provision.”

190. See *id.* at 58.

191. See *supra* note 153 and accompanying text.

192. See *Cupp*, *supra* note 3, at 846.

193. See RESTATEMENT, *supra* note 3, § 12 cmt. b. One commentator disputes the assertion. See *Cupp*, *supra* note 3, at 856. He argues that what he terms the “less restrictive” approach to successor liability is not a stagnant minority view. See *id.* at 852-56. He observes that the thirteen states that have adopted either the product line or the substantial continuity tests contain about forty-three percent of the national population. See *id.* at 856.

194. See generally *Cupp*, *supra* note 3, at 852-58 (asserting that the number of jurisdictions that have expanded successor liability is greater than previous estimates).

195. See, e.g., *id.* at 848-49.

196. 244 N.W.2d 873 (Mich. 1976).

197. See *Korzetz v. Amsted Indus., Inc.*, 472 F. Supp. 136, 143-44 (E.D. Mich. 1979); see also

underlying products liability law justified imposition of successor liability, entirely without evidence of fraud.<sup>198</sup> In *Turner*, an injured person sued the transferee for an injury he sustained from an allegedly defective machine the transferor had manufactured years before the transfer.<sup>199</sup> None of the transferor's shareholders maintained an interest in the transferee so the plaintiff could not establish the continuity of shareholders between the transferor and the transferee requisite for a finding of *de facto* merger.<sup>200</sup>

The court identified the issue before it as one of products liability.<sup>201</sup> It criticized the "traditional corporate law approach" to successor liability as turning on a perfunctory evaluation of "whether the transaction is labeled a merger, a *de facto* merger, or a purchase of assets for cash."<sup>202</sup> Whether the transfer was for stock or cash mattered not a bit to the injured plaintiff.<sup>203</sup> Continuity of shareholders was but "one factor to use to determine whether there exists a sufficient nexus between the successor and predecessor corporations to establish successor liability."<sup>204</sup> The court did not consider whether either of the parties could have known at the time of the transfer of the probability or

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Andrews v. John E. Smith's Sons Co., 369 So. 2d 781, 785 (Ala. 1979). See generally OWEN ET AL., *supra* note 3, § 19:6, at 390-93. For products liability cases adopting the "continuity of enterprise" approach, see *id.* at 391 n.25.

198. See *Turner*, 244 N.W.2d at 877-78. The dissent noted that the purpose of successor liability is to rectify fraud on the transferor's creditors. See *id.* at 886-87 (Coleman, J., dissenting in which Fitzgerald, J. concurred). The indicia of fraud are "inadequate consideration paid to the transferor, and/or lack of good faith." *Id.* at 887. There was "no evidence of inadequate consideration" and "only the vaguest charges of fraud through lack of good faith in structuring the particular acquisition method used." *Id.* It identified the problem for creditors as one of timing, not fraud. See *id.*

199. See *id.* at 875. Between the manufacture and sale of the machine and the injury, the manufacturer sold its assets for cash. See *id.*

200. See *id.* at 879; see also *supra* note 101 and accompanying text.

201. See *Turner*, 244 N.W.2d at 877. "This is a products liability case first and foremost." *Id.* The court rejected the ordinary rule of transferee non-liability subject to its three exceptions, because it was "developed not in response to products liability problems, but largely in the areas of creditors' protection." *Id.* at 878.

202. *Id.* at 879. See, e.g., *Travis v. Harris Corp.*, 565 F.2d 443, 447 (7th Cir. 1977); *Shannon v. Samuel Langston Co.*, 379 F. Supp. 797, 801 (W.D. Mich. 1974). See the discussion of the significance of continuity of shareholders *supra* notes 109-40 and accompanying text.

203. See *Turner*, 244 N.W.2d at 878. "To the injured person the problem of recovery is substantially the same, no matter what corporate process led to transfer of the first corporation and/or its assets." *Id.*

204. *Id.* at 880. The transferee retained the transferor's key personnel, general business operations, and corporate name, which the court found to be "sufficient nexus" to justify successor liability. See *id.* at 880, 883-84.

magnitude of the plaintiff's claim for injury from the transferor's previously manufactured product.<sup>205</sup>

Earlier, in *Ray v. Alad Corp.*,<sup>206</sup> the California Supreme Court recognized the "product line" basis for successor liability.<sup>207</sup> To establish a transferee as a "mere continuation" of the transferor, California law required proof that the transferee paid less than fair value for the assets, and that the debtor's insiders continued their interest in the transferee.<sup>208</sup> The plaintiff had not established either fact.<sup>209</sup> The court held for the plaintiff nonetheless.<sup>210</sup> "[A] party which acquires a manufacturing business and continues the output of its line of products . . . assumes strict tort liability for defects in units of the same product line previously manufactured and distributed by the entity from which the business was acquired."<sup>211</sup>

Since these cases were decided, some courts have confined the availability of fraud-free successor liability to cases involving product liability claims.<sup>212</sup> But in the opposite direction, a few courts have imposed successor liability in products liability cases even when the transferee did not continue to manufacture the relevant product line.<sup>213</sup>

When liability for environmental injury under the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA")<sup>214</sup> is at issue, some federal courts have imposed successor

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205. The transferee expressly agreed to assume the transferor's liabilities "'existing on the Closing Date,'" with the exception of certain obligations to shareholders, and expenses relating to the sale of assets. *Id.* at 875 n.1 (quoting sales agreement between transferee and transferor). The plaintiff argued that the transferee expressly assumed liability for its products claim, presumably because it was "'existing on the Closing Date'" although contingent. *Id.* at 876-77. The transferee argued that it assumed only known liability of the transferor as of the Closing Date, and not a products liability claim arising from injury that occurred four years after the closing. *See id.* at 877. The court expressly did not resolve this issue because it decided the case "on the basis of tort liability." *Id.* at 876-77.

206. 560 P.2d 3 (Cal. 1977).

207. *See id.* at 11; *see also, e.g.*, *Bogart v. Phase II Pasta Machs., Inc.*, 817 F. Supp. 547, 550 (E.D. Pa. 1993) (transferee held liable for transferor's products liability under "product line" test); *Garcia v. Coe Mfg. Co.*, 933 P.2d 243, 249-50 (N.M. 1997) (same). For cases adopting the "product line" approach, *see OWEN ET AL., supra* note 3, § 19:6, at 391 n.30.

208. *See Ray*, 560 P.2d at 7.

209. *See id.* at 8. Like the Michigan court in *Turner*, the court did not appear to understand the significance of these requirements as proof of the transferee's role in a fraud on the transferor's creditors. It described them as "making succession to the liabilities of an acquired going business depend[] on the form and circumstances of the acquisition." *Id.*

210. *See id.* at 11.

211. *Id.*

212. *See, e.g.*, *Philadelphia Elec. Co. v. Hercules, Inc.*, 762 F.2d 303, 311-12 (3d Cir. 1985).

213. *See, e.g.*, *Rawlings v. D. M. Oliver, Inc.*, 159 Cal. Rptr. 119, 124-25 (Cal. Ct. App. 1979); *Pacius v. Thermroll Corp.*, 611 A.2d 153, 158 (N.J. Super. Ct. Law Div. 1992).

214. 42 U.S.C. §§ 9601-9675 (1994).

liability based on a finding of “substantial continuity” between a corporate transferor and transferee.<sup>215</sup> Although courts have recognized that perfect continuity is not required for successor liability, it is by no means clear that *evidence* of collusion or fraud is not required. For example, in *United States v. Mexico Feed & Seed Co.*,<sup>216</sup> the court noted that under the “substantial continuity test” whether the transferor’s shareholders continued their interest in the transferee was not critical.<sup>217</sup> It held that other indicia of continuity were equally important—for example, retention of the same name, employees, supervisors, production facilities; production of the same product; continuity of assets and general business operations; and whether the transferee holds itself out as a continuation of the transferor’s business.<sup>218</sup> The court did not impose successor liability because it found that the transferee lacked notice of potential liability and an opportunity to collude with the transferor.<sup>219</sup>

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215. See, e.g., *Andritz Sprout-Bauer, Inc. v. Beazer E., Inc.*, 12 F. Supp. 2d 391, 405 (M.D. Pa. 1998) (holding that a broader “substantial continuity” approach furthers CERCLA’s remedial purpose); *Anspec Co. v. Johnson Controls, Inc.*, 922 F.2d 1240, 1244-47 (6th Cir. 1991) (same); *Smith Land & Improvement Corp. v. Celotex Corp.*, 851 F.2d 86, 91-92 (3d Cir. 1988) (same). *But see* *John S. Boyd Co. v. Boston Gas Co.*, 992 F.2d 401, 408 (1st Cir. 1993) (declining to adopt “substantial continuity” test); *Atchison, Topeka & Santa Fe Ry. Co. v. Brown & Bryant, Inc.*, 132 F.3d 1295, 1301-02 (9th Cir. 1997) (same). Whether federal common law governs successor liability under CERCLA is in doubt after *United States v. Bestfoods*, 524 U.S. 51, 63 n.9 (1998), where the Court noted that circuit courts disagree on this matter, but declined to reach the issue. For further discussion of the “substantial continuity” approach in the context of CERCLA, see generally Lawrence P. Schnapf, *CERCLA and the Substantial Continuity Test: A Unifying Proposal for Imposing CERCLA Liability on Asset Purchasers*, 4 ENVTL. LAW. 435 (1998) and Michael D. Green, *Successors and CERCLA: The Imperfect Analogy to Products Liability and an Alternative Proposal*, 87 NW. U. L. REV. 897 (1993). When the liability at issue is to the transferor’s pension fund, under federal common law, a transferee incurs successor liability if it had notice of the fund’s claim against the transferor and there is “substantial continuity” between the transferor’s business operations and those of the transferee. See, e.g., *Upholsterers’ Int’l Union Pension Fund v. Artistic Furniture of Pontiac*, 920 F.2d 1323, 1327 (7th Cir. 1990).

216. 980 F.2d 478 (8th Cir. 1992).

217. See *id.* at 488 & n.10.

218. See *id.* The court did indicate that the transferee’s good faith may not be a complete defense to successor liability. “Even in cases of good faith, a bona-fide successor reaps the economic benefits of its predecessor’s use of hazardous disposal methods, and, as the recipient of the benefits, is also responsible for the costs of those benefits.” *Id.* at 487.

219. See *id.* at 489-90. *Cf. Atchison, Topeka & Santa Fe Ry. Co.*, 132 F.3d at 1301-02 (9th Cir. 1997) (noting that where the broader “substantial continuity” test has been applied “there has almost always been some fraudulent intent and collusion present, in which case the purchaser would have likely already been liable under another traditional exception—the fraudulently-entered transaction exception”); *United States v. Carolina Transformer Co.*, 978 F.2d 832, 840-41 (4th Cir. 1992) (applying the “substantial continuity” test when “the record . . . [left] the unmistakable impression that the transfer . . . was part of an effort to continue the business in all material respects yet avoid the environmental liability arising from” transferor’s business practices).

Courts who have imposed successor liability under one of the continuity-based theories described above have not satisfactorily explained why, in a particular case, the interest of the plaintiff creditor should prevail over that of the transferee.<sup>220</sup> Like the proponents of a fraud-free theory of fraudulent transfer law,<sup>221</sup> courts and commentators would rest successor liability on ad hoc assessments of fairness.<sup>222</sup>

The failure is understandable. If the transferee's role in a fraud on the transferor's creditors is not relevant to whether the transferee is to be liable, then transferee liability can be bound only by vague, untestable pronouncements of "sufficient" continuity, which in turn reveals the "fair" result in a given case.

Professor Richard Cupp, Jr. has recently conceded that the most persuasive justification for continuity-based successor liability is to "channel[] responsibility back to the [transferor]."<sup>223</sup> He asserts that while product consumers have little or no ability to plan for loss following dissolution of their debtor, a transferee, who in some respects continues the business of the debtor, "is in as good or better a position as the [debtor] to determine whether products made by [the debtor] are

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220. See generally Cupp, *supra* note 3, at 858-67 (describing variety of rationales offered for continuity-based approaches to successor liability); Green, *supra* note 3, at 28-40 (same). See also, e.g., *Cyr v. B. Offen & Co.*, 501 F.2d 1145, 1153-54 (1st Cir. 1974) (finding that because transferee "holds itself out" to the public as the transferor's successor, thereby "exploiting all of the accumulated good will" of transferor, it should be estopped from denying the transferor's liability); *Ray v. Alad Corp.*, 560 P.2d 3, 9 (Cal. 1977) (holding that where transferee destroys plaintiff's remedies against transferor, is capable of spreading risks, and enjoys use of the "goodwill" of the transferor, it should also be liable for the transferor's debts); *Ramirez v. Amsted Indus. Inc.*, 431 A.2d 811, 820 (N.J. 1981) (holding that transferee should be liable in part because it played a part in the destruction of the creditor's remedies).

221. Some commentators believe that the constructive fraud grounds for fraudulent transfer avoidance similarly ought to be understood as a kind of "strict liability designed to redress creditor injury." See *supra* notes 103-40 and accompanying text; see also Williams, *supra* note 59, at 64 (arguing that fraudulent transfer law protects creditors from "significant[] harm" unless that harm is not "unjust"); Kennedy, *supra* note 50, at 534-35 (similar); TABB, *supra* note 43, at 424 (noting that the focus of fraudulent transfer law is on the creditors). Tabb observes that courts have found constructive fraud without a hint or even possibility of debtor misbehavior. See *id.* at 423.

222. See, e.g., Cupp, *supra* note 3, at 869-70.

The continuity of enterprise and product line approaches are merely points further down the spectrum of relationship between the old corporation and the new. When the successor's enterprise is sufficiently similar to the predecessor's for a court to find a continuity of enterprise, the court is in effect saying that the successor is similar enough that justice demands holding it responsible. Likewise, continuing to sell a predecessor's product line creates a powerful nexus of identity between the old corporation and the new that may make the imposition of successor liability seem fair . . . . Any burden on corporations is appropriate if on balance it is good for society.

*Id.* (citations omitted).

223. *Id.* at 861.

defective and will lead to liability.”<sup>224</sup> He observes that the “burden of successor liability [on such a transferee] is mitigated by the existence of readily available and relatively inexpensive insurance.”<sup>225</sup>

Cupp’s model of the transferee as the least cost insurer of creditors’ loss misses an important limitation on the transferee’s capacity to channel or internalize creditors’ risk of loss to the debtor. If a transferee could have purchased “relatively inexpensive insurance” against creditors’ future loss, it must also be true that creditors’ future claims were insurable risks at the time of the transfer. When the debtor or the transferee could have purchased insurance coverage for risk of loss to creditors at the time of a transfer, it is entirely reasonable to infer that a transferee *should have known* that the transferor’s creditors faced a high risk of post-transfer fraud loss. By insisting that the debtor provide insurance for such claims, or by providing such insurance itself at the debtor’s expense, the transferee effectively internalizes the risk of loss to the debtor’s shareholders.<sup>226</sup>

But, that is the easy case. Cupp does not consider the hard case where neither the transferor nor transferee could have known either the magnitude or the probability of loss from future claims against the transferor.<sup>227</sup> Insurance coverage for such a risk would by definition not be available at all. And the transferee, regardless of the similarity of its business operations, could have done nothing to protect creditors from loss. Imposition of successor liability on the transferee in such a case will not create an incentive to internalize creditors’ loss onto the transferor’s shareholders.<sup>228</sup> Nor will it reduce the likelihood that creditors will bear externalized loss. It will only shift wealth from one group of investors to another.<sup>229</sup>

A continuity-based theory of successor liability that eliminates the role of fraud will probably not result in too little transferee liability.

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224. *Id.* at 867-68. *But see* Green, *supra* note 3, at 34 (observing that transfers at issue in several high profile products liability cases occurred before the risks of the particular product were understood).

225. Cupp, *supra* note 3, at 870. Cupp does not explain how he determines when insurance coverage is “relatively inexpensive.”

226. *See id.* at 862-63.

227. *See id.* at 867-73.

228. Alan Schwartz argued that for purposes of its duty to warn consumers, a firm should be treated as ignorant of a risk of a product defect when the product turns out to be more dangerous than the firm could have discovered had it conducted a cost-justified research program to ascertain the risk. *See* Schwartz, *supra* note 143, at 694.

229. *Cf.* DiLeo v. Ernst & Young, 901 F.2d 624, 627 (7th Cir. 1990) (Easterbrook, J.) (“Shifting these losses from one group of investors to another does not diminish their amplitude, any more than rearranging the deck chairs on the Titanic prevents its sinking.”).

Fraudulent transfer law will pick up the slack. As discussed earlier, a *fraudulent* transferee who does not “sufficiently continue” the business or other attributes of the transferor will nonetheless be vulnerable to transfer avoidance under fraudulent transfer law.<sup>230</sup> And, as we have seen, when the transferee is “different” than the transferor, transfer avoidance is a more efficient remedy than imposition of successor liability.<sup>231</sup> The real danger of judicial rhetoric that elevates continuity as a fraud-free justification for successor liability is the risk of unpredictable, and potentially huge, transferee liability.

Whatever might be said for broad successor liability on wealth distributive grounds, such policy cannot seriously be justified by evidence of continuity, or effectively concealed behind pronouncements of “fairness.” Stripped bare of metaphors, a court must balance the rights of creditors with those of a transferee. Without any reason to suspect the bona fides of the transferee in a particular case, there simply is no reason to impose creditors’ loss on it, short of imposing creditors’ loss on *all* transferees simply because they are transferees. Observations of continuity cannot define the boundaries of successor liability without a clear understanding of what evidence of continuity tends to show.

Bulk transfer legislation illustrates the intrinsic tautology. A commentator writing in 1928 noted that during the last decade of the nineteenth century, trade creditors were losing their shirts to debtors who liquidated their stock then headed for the hills with the cash without paying creditors.<sup>232</sup> Recourse against the absconding debtor was no comfort to creditors, because the debtor was difficult to locate or insolvent. Although courts were willing to find that buyers lacked good faith on circumstantial evidence of collusion,<sup>233</sup> fraudulent transfer law afforded no relief against a good faith purchaser who acquired the assets

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230. See *supra* notes 96-112 and accompanying text.

231. See *id.*

232. See Thomas Clifford Billig, *Bulk Sales Laws: A Study in Economic Adjustment*, 77 U. PA. L. REV. 72, 76 & n.18 (1928). Billig observed that the economic panic of 1893 “proved disastrous to those retailers who had stocked up with goods at pre-panic prices, especially in the agricultural communities, and the temptation was great to unload for even a small percentage of the original cost of the merchandise.” *Id.* at 77. An advocate for creditors saw these “panic” sales in a malevolent light and described them as “[a] favorite indoor sport . . . [which the debtor could play] without fear of punishment whenever the debtor felt the urge of the deceitful method.” 29 CREDIT MONTHLY 11, 12 (1927) (J. Harry Tregoe, Executive Manager, National Association of Credit Men) as quoted in Billig, *supra*, at 75.

233. Under pre-bulk transfer legislation fraudulent transfer analysis, the transferee’s complicity could rest on facts of which he should have been aware. See, e.g., *Coder v. McPherson*, 152 F. 951, 953-54 (8th Cir. 1907); *In re Pease*, 129 F. 446, 448 (E.D. Mich. 1902); *Hennequin v. Naylor*, 24 N.Y. 139, 141 (1861); *O’Leary v. Duvall*, 39 P. 163, 165 (Wash. 1895).

for value, and without notice of the transferor's fraudulent intentions.<sup>234</sup> From creditors' perspective, the requirement that they prove, even indirectly, the transferee's complicity in the debtor's fraud was an intolerable obstacle to the just result—recovery for them.<sup>235</sup>

The result of creditors' lobbying was widespread enactment of bulk transfer legislation.<sup>236</sup> These laws rendered certain transfers in bulk void or voidable unless the transferor and transferee complied with prerequisites intended to give the transferor's creditors information in advance of the proposed transfer.<sup>237</sup> The laws replaced the question of the transferee's role in a fraud with that of the scope of the legislation.<sup>238</sup> For example, one variety of bulk sales laws applied to transfers in bulk of "merchandise" other than in the ordinary course of business.<sup>239</sup> In one jurisdiction, the term "merchandise" included horses and carriages sold by one whose business was trading horses.<sup>240</sup> In another, the same term did not include assets comprising a livery stable.<sup>241</sup> Courts attempting to discern the legislative meaning of "merchandise" were left without guidance, other than a feeling that the legislature intended to curb transfers that were "unfair" to creditors. Under successor liability doctrine, courts endeavor to find the requisite level of continuity against the same blank slate.

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234. See Billig, *supra* note 232, at 77-80; see, e.g., *Carter v. Richardson*, 60 S.W. 397, 399 (1901); see also U.C.C. Art. 6 prefatory note (1999). The drafters noted that the law of fraudulent conveyances ameliorated the creditors' plight but "to a limited extent." *Id.* "[F]raudulent conveyance law provided no remedy against persons who bought in good faith, without reason to know of the seller's intention to pocket the proceeds and disappear, and for adequate value." *Id.*

235. See Billig, *supra* note 232, at 78-79.

236. See *id.* at 81.

237. See *ALCES*, *supra* note 19, ¶ 4.02. The laws generally provided creditors with an avoidance action against a transferee who acquired merchandise or stock in trade without compliance with the statutory requisites, and without specific proof of the transferee's participation in a fraud on creditors. See Frank W. Miller, *Bulk Sales Laws: Businesses Included*, 1954 WASH. U. L.Q. 1, 2 ("[T]he statutes provide either that a sale of the type proscribed may be avoided by existing creditors of the seller if the statute is not complied with, or that a presumption of fraud is raised by non-compliance."). In *Wright v. Hart*, 35 N.E. 404 (N.Y. 1905), the New York Court of Appeals found the New York bulk sales law unconstitutional, in part because it did not distinguish fraudulent from non-fraudulent transfers. See *id.* at 407. Eleven years later, the same court reversed itself and found an identical law constitutional in part because "[t]he unanimous, or all but unanimous, voice of the judges of the land, in federal and state courts alike, has upheld the constitutionality of these laws." *Klein v. Maravelas*, 114 N.E. 809, 810 (N.Y. 1916) (Cardozo, J.).

238. See Miller, *supra* note 237, at 14.

239. See *id.* at 9-15; see also, e.g., *Patmos v. Grand Rapids Dairy Co.*, 220 N.W. 724, 725 (Mich. 1928) (involving Michigan bulk sales law).

240. See *Tupper v. Barrett*, 124 N.E. 427, 428 (Mass. 1919).

241. See *Everett Produce Co. v. Smith Bros.*, 82 P. 905, 906-07 (Wash. 1905).

The drafters of the *Restatement (Third) Torts: Products Liability*<sup>242</sup> missed an important opportunity to clarify the role of fraud in successor liability cases. The Restatement restates the often-cited list of bases for imposition of successor liability.<sup>243</sup> In the commentary, the drafters assert that successor liability is appropriate if the transferee “is implicated in the transfer of assets in a way that, without such liability, would unfairly deprive future products liability plaintiffs of the remedies that would otherwise have been available against the predecessor.”<sup>244</sup> The drafters describe the traditional *de facto* merger and mere continuation bases for successor liability as those in which the transferee “can be said to have sold or distributed the defective products because [it] constitutes the same juridical entity as the predecessor, perhaps in a somewhat different form.”<sup>245</sup>

This explanation of successor products liability dislocates the transferee’s role in a fraud from the transferee’s appearance as “the same juridical entity” as the transferor.<sup>246</sup> The Restatement fails to explain how a court should ascertain whether the transferee “constitutes the same juridical entity” as the transferor so as to make the transferee’s non-liability “unfair.”<sup>247</sup> It does, however, reflect case law which in turn reflects misunderstanding of the role of fraud in successor liability cases.<sup>248</sup>

## VI. CONCLUSION

A transferee should be liable as a successor not because it continues some attributes of the transferor, but rather because it colluded with the transferor in fraud of creditors, or at the time of the transfer reasonably should have known that the debtor/transferor planned to hide assets from creditors. Evidence of continuity—of shareholders or other insiders, business operations, or product line—can be probative on the question of collusion and on that of the transferee’s access to information about a future fraud on creditors. Absent this critical evidence, the fact that a transferee uses the acquired assets in the same way as the transferor did, or continues to manufacture a similar product line, does not make the

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242. See generally RESTATEMENT, *supra* note 3, § 12.

243. See *id.*

244. *Id.* § 12 cmt. b.

245. *Id.* § 12 cmt. a.

246. *Id.*

247. See *id.* § 12 cmts. f-g.

248. See *id.*

transfer sufficiently “unfair” to the transferor’s creditors to justify imposition of their loss on the transferee.

As the law of fraud evolves, frauds become more sophisticated. That fraud in the transfer of assets may be more subtle than in the past, does not justify the conclusion that fraud is irrelevant to successor liability doctrine. The appropriate response to increased sophistication of frauds is to expand the sophistication of inquiry into what kind of conduct should be embraced within the meaning of the term “fraud.”

This is a formidable challenge. It demands that we update our understanding of fraud itself to take into account the diverging incentives of corporate shareholders, managers, creditors, and transferees. No matter how tempting it may be to sidestep the task, courts must evaluate what actors could have known at the moment they took the actions that ultimately affected the transferor’s creditors. Courts have been looking for fraud in this way for at least four centuries. Once they are clear about what it is, they are highly adept at detecting it.

By bringing the meaning of “fraud” into focus, we confront directly the conflict between the interests of claimants who have suffered loss and the rights of transferees who could have done nothing to prevent it. These challenges are worth confronting, and should not be sublimated in favor of an empty assessment of “continuity.” Although creditors’ claims in a given case may be worthy, we must not lose sight of the effect of boundless, fraud-free successor liability on asset value generally, and on the delicate balance of risk and reward among claimants against an enterprise.