University of Miami Law Review

Volume 46 | Number 2 Article 2

11-1-1991

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VOLUME 46 NOVEMBER 1991 NUMBER 2

A Void in Avoidance Powers? The Bankruptcy Trustee's Inability to Assert Damages Claims on Behalf of Creditors Against Third Parties

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I. INTRODUCTION

Several studies indicate that few, if any, assets are available to pay unsecured creditors in the vast majority of bankruptcies.[1] This is

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The author would like to thank Victor Gold, Lary Lawrence, Dan Schechter, and Bruce Markell for their comments on earlier drafts of this Article. The research assistance of several individuals is much appreciated, in particular Julia Kress, Jeffrey Hughes, James Orland, and Jill Olla. Finally, the author would like to thank Loyola Law School for its financial support.

1. *See, e.g.*, TERESA SULLIVAN ET AL., AS WE FORGIVE OUR DEBTORS: BANKRUPTCY AND CONSUMER CREDIT IN AMERICA 199-229 (1989); Lynn M. LoPucki, *The Debtor in Full Control—Systems Failure Under Chapter 11 of the Bankruptcy Code, Parts 1 & 2*, 57 AM.

the case even though the Bankruptcy Code provides the bankruptcy trustee[2] with an array of powers designed to maximize the property available to pay creditors of the bankruptcy estate. For example, the bankruptcy trustee may assert claims that the debtor[3] had against third parties before the debtor went into bankruptcy.[4] In addition, in order to avoid fraud[5] and preferences of one creditor over others the bankruptcy trustee is specifically empowered to avoid some transfers of property made by the debtor to third parties before the bankruptcy proceeding.[6] The trustee may even "step into the shoes" of a creditor and avoid the debtor's transfers of property or property interests that could have been avoided by the creditor outside of bankruptcy.[7]

One way to bring additional assets into otherwise barren bankruptcy estates would be to permit the bankruptcy trustee to assert claims that creditors of the debtor have against third parties. This is a viable option only if successful assertion of the claims would reduce the aggregate amount of creditors' claims against the bankruptcy estate. Many cases arise in which creditors have claims against a debtor who is jointly liable with a solvent third party. For example, a creditor (or group of creditors) may have a claim against a corporate debtor that is also assertable against the corporation's controlling shareholder on an alter ego theory. Alternatively, creditors may have an action based on fraud or breach of fiduciary duty in which the debtor and a third party are jointly and severally liable.

Consider a case of fraud in which a third party, a bank, has assisted the debtor in misleading investors.[8] Assume that the debtor is a food distribution corporation interested in raising money for its

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BANKR. L.J. 99 (1983); *see also* James W. Bowers, *Groping and Coping in the Shadow of Murphy's Law: Bankruptcy Theory and the Elementary Economics of Failure*, 88 MICH. L. REV. 2097, 2098 n.2 (1990) (arguing that the problem of zero collections in bankruptcy cannot be cured by tinkering with the bankruptcy law).

2. A debtor in possession may also perform the duties of the bankruptcy trustee in a case under Chapter 11. 11 U.S.C. § 1107 (1988).

3. Throughout this Article, the term "debtor" refers to the person who is in bankruptcy, either voluntarily or involuntarily. 11 U.S.C. § 101(12) (1988).

4. 11 U.S.C. § 541(a)(1) (1988). "Under paragraph (1) of subsection (a), the estate is comprised of all legal or equitable interest of the debtor in property, wherever located, as of the commencement of the case. . . . It includes . . . causes of action . . . and all other forms of property currently specified in section 70a of the Bankruptcy Act . . . ." S. REP. No. 989, 95th Cong., 2d Sess. 82 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5868.

5. Fraudulent transfers may be avoided under 11 U.S.C. § 548 (1988) or 11 U.S.C. § 544(b) (1988) if a creditor of the debtor exists who could avoid the transfer under state fraudulent transfer law. *See* Jack F. Williams, *Revisiting the Proper Limits of Fraudulent Transfer Law*, 8 BANKR. DEV. L.J. 55 (1991).

6. 11 U.S.C. § 547 (1988).

7. 11 U.S.C. § 544 (1988).

8. This hypothetical is roughly based on Williams v. California First Bank, 859 F.2d 664

operations and, more important, for the benefit of its promoters. The debtor sells "investment contracts" and promissory notes which guarantee a very favorable rate of return for investors. The debtor uses a bank as a depositary for the investors' funds and refers potential investors to a bank officer who provides a glowing, but inaccurate, picture of the debtor's operations. The bank officer is familiar with the details of the investment program and either knows, or should know, that the investment program is doomed to fail. Initially, the investment program is successful; many investors contribute varying amounts of money amounting to several million dollars. The initial investors are quite pleased to receive the promised high rate of return, at least initially.

Unfortunately for the investors, they were paid with funds provided by later investors through a type of pyramid scheme. Before long, not enough investors could be found to sustain the pyramid. The debtor's business eventually collapses and goes into bankruptcy. The promoters flee with substantial funds and cannot be found.

In the bankruptcy proceeding, the debtor's bankruptcy trustee oversees a bleak situation. The debtor's assets are worth only a few thousand dollars. The debtor's liabilities are substantial, including unpaid employees and food suppliers. The debtor owes money to the bank involved in the fraud in unrelated loan transactions. The creditors owed by far the most money are the disappointed investors. These creditors invested amounts ranging from a few thousand to several hundred thousand dollars with no return. Some of the investors dealt with the debtor's bank and the faithless bank officer, while others dealt directly with the unscrupulous promoters. Sophisticated investors confer with counsel about ways to retrieve their lost funds, while others are simply distraught and unaware of any possible recourse. The smaller investors do not have sufficient funds to retain counsel. The only way for the trustee to bring assets into the estate would be to assert any claims that the investors might have against the bank for assisting the promoters in defrauding the investors.

Bankruptcy trustees often attempt to assert such claims without success.[9] The problem lies in finding statutory authority that permits claim assertion. Courts are generally unwilling to permit the trustee to assert the claim unless it involves a voidable "transfer" of property

(9th Cir. 1988), in which the court denied the bankruptcy trustee standing to assert fraud claims against a third party that were assigned by the debtor's creditors to the trustee.

9. *See, e.g.*, Caplin v. Marine Grace Trust Co., 406 U.S. 416 (1972); Williams v. California First Bank, 859 F.2d 664 (9th Cir. 1988); Mixon v. Anderson (*In re* Ozark Restaurant Equipment Co.), 816 F.2d 1222 (8th Cir. 1987); *In re* E.F. Hutton Southwest Properties II, Ltd., 103 Bankr. 808 (Bankr. N.D. Tex. 1989).

or the debtor itself could have asserted it outside of bankruptcy.[10] In the above hypothetical, the debtor could not assert a securities fraud claim outside of bankruptcy because it was not defrauded; the third party and the debtor jointly defrauded some of the debtor's creditors. In addition, the securities fraud did not involve a voidable transfer of property from the debtor to the bank. Accordingly, the trustee cannot point to a provision in the Bankruptcy Code that permits such a claim.[11] As a result, there is very little available in the bankruptcy estate for the creditors. The individual investors must pursue their own claims, if any, against the bank. The small investors may not even be aware that they have a claim, and it may not be worthwhile for them to pursue such a claim even if they are aware of it.

In a case like this, it is tempting to say that the Bankruptcy Code improperly limits the powers of the trustee. The trustee's successful assertion of the investors' claim against the bank would result in a significant increase in available assets to pay the creditors, the orderly and efficient administration of the claims through their consolidation and a greater probability of asset maximization for all creditors, not simply the large investors who could be counted on to assert a claim against the bank on their own behalf.

The trustee, however, may not be the best person to assert the investors' claims. The trustee often lacks knowledge of the facts underlying specific claims, and not all of the claims are based on the same facts.[12] Assertion of the claim against the bank may cause the bank to sue the estate for indemnity or contribution, resulting in little net gain for the estate.[13] In addition, a claim against the bank belongs to less than all of the creditors of the debtor. Since the trustee represents all of the creditors, it may be an inefficient or biased use of the trustee's time and resources to prosecute the claim on behalf of the investors. Or, if all creditors may share in the proceeds,[14] it may be unfair to the investors to deprive them of the complete benefit of their claim.

The potential of a bankruptcy trustee's assertion of creditors' claims against third parties is not limited to cases of securities fraud. Several recent cases have considered whether the trustee can assert alter ego claims that creditors of a bankrupt corporation have against

10. *See infra* notes 101-22 and accompanying text.

11. *See infra* notes 68-77 and accompanying text.

12. *See infra* notes 179-81 and accompanying text.

13. *See infra* note 40 and accompanying text.

14. The current distributional rule in bankruptcy is that all creditors share in the proceeds of claims asserted by the trustee. *See infra* notes 157-61 and accompanying text.

the corporation's controlling shareholder.[15] Other cases have considered the trustee's standing to assert civil RICO claims against third parties who participated together with the debtor in a scheme to harm third parties.[16] One recent case considered whether the bankruptcy trustee could assert malpractice claims against the debtor's accountants, whose allegedly negligent work harmed estate creditors.[17] In the future, questions may arise concerning the trustee's ability to assert claims against buyers in bulk who fail to comply with revised Article 6 of the Uniform Commercial Code if the seller winds up in bankruptcy.[18] Because of the many possible situations in which a third party may be liable to creditors along with the bankrupt party, the question of the trustee's standing to assert these claims looms large.

The problem with current law is that it does not permit the bankruptcy trustee or the courts to consider whether the assertion of a damages claim against a third party would be in the best interest of the bankruptcy estate. Instead, the Bankruptcy Code compels the trustee to focus on whether a "transfer" can be avoided or on whether the debtor could assert the claim outside of bankruptcy. While current bankruptcy law might make it easier to determine which claims the bankruptcy trustee can assert and which it cannot,[19] there are other claims that do not involve voidable transfers or that are assertable by the debtor which would be best asserted by the bankruptcy trustee.

The next Part of this Article examines the "void" that exists in the powers available to the bankruptcy trustee and a congressional proposal to fill the void by expanding the trustee's powers to assert damages claims on behalf of creditors against third parties. Part III examines this proposal in light of the policies underlying the trustee's current powers to avoid transfers of property and assert claims on behalf of the bankruptcy estate. This Article proposes that in many cases the assertion of damages claims is consistent with the power to avoid transfers and to assert claims belonging to the estate, and that Congress was correct when it considered expanding the trustee's pow-

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15. *See infra* notes 103-04 and accompanying text.

16. *Compare In re* E.F. Hutton Southwest Properties II, Ltd., 103 Bankr. 808 (N.D. Tex. 1989) (trustee denied standing to assert civil RICO claim) *with* Dana Molded Products v. Brodner, 58 Bankr. 576 (N.D. Ill. 1986) (trustee given standing to assert civil RICO claim).

17. *See* Holland v. Arthur Andersen & Co., 571 N.E.2d 777 (Ill. Ct. App. 1991) (trustee could not show damage to bankruptcy estate).

18. *See infra* notes 199-239 and accompanying text.

19. As the number of cases indicate, there are still disputes over whether a claim is assertable by the trustee under current law. *See infra* notes 103-11 and accompanying text.

ers. Finally, Part IV discusses how current law will likely affect claims arising under new Article 6 of the Uniform Commercial Code, and how the Bankruptcy Code might deal with them if the trustee's powers were expanded to permit claims against third parties.

II. THE "VOID" IN AVOIDANCE POWERS

A. Caplin v. Marine Midland Grace Trust Co.

Probably the most significant case in which a court denied the trustee the power to assert a claim for damages on behalf of creditors of the bankruptcy estate is *Caplin v. Marine Midland Grace Trust Co.*[20] This case illustrates the key problems addressed in this Article and provides background for the proposed expansion of the trustee's powers that was ultimately abandoned. In *Caplin*, the United States Supreme Court ruled that a bankruptcy trustee was not empowered by then-existing bankruptcy law to assert claims on behalf of creditors against a third party, and that assertion of such a claim would not necessarily be in the best interest of the bankruptcy estate. Four justices believed that the trustee did have power to assert the claim, which was necessary in order to maximize the assets available to pay creditors and shareholders of the bankrupt entity.

In *Caplin*, the bankrupt entity was Webb & Knapp, Inc. ("Webb"), a corporation engaged in various real estate activities in the United States and Canada.[21] In 1954, Webb had executed an indenture with Marine Midland Trust Company of New York ("Marine Midland") that provided for Webb's public issuance of 5% debentures[22] in the total amount of $8,607,600. The job of the indenture trustee, in this case Marine Midland, was to make certain that holders of publicly issued debt securities were protected pursuant to the terms of the indenture and the Trust Indenture Act of 1939.[23] In particular, the indenture trustee had to monitor the issuer of the indebtedness, in this case Webb, to make certain that there was no default under the terms of the publicly issued debt.

The indenture provided that Webb would not

> incur or assume "any indebtedness resulting from money borrowed or from the purchase of real property or interests in real property . . . or purchase any real property or interests in real property"

20. 406 U.S. 416 (1972); *see also* Lawrence B. Vineyard, Jr., Note, *The Chapter X Trustee's Standing To Sue—A Pragmatic Approach*—Caplin v. Marine Midland Grace Trust Co., 27 Sw. L.J. 510 (1973).

21. *Caplin*, 406 U.S. at 417.

22. A debenture is a type of unsecured debt instrument.

23. 15 U.S.C. § 77aaa-77bbbb (1988).

> unless the company's consolidated tangible assets, as defined in the indenture, equaled 200% of certain liabilities, after giving effect to the contemplated indebtedness or purchase.[24]

The purpose of this provision was to make certain that holders of the publicly issued debt would be protected from Webb incurring too much additional indebtedness or expenditures for the purchase of real property. Webb was to maintain liquidity sufficient to pay off the holders of the debentures.

As indenture trustee, Marine Midland was required to act reasonably in monitoring Webb's compliance with the terms of the indenture, but in the absence of bad faith it could rely on the accuracy of Webb's reports and certificates of compliance.[25] Every year Webb had to provide Marine Midland with a certificate stating whether Webb had defaulted on any of its responsibilities under the indenture.[26]

From 1959 to 1965, Webb suffered substantial financial losses.[27] These losses ultimately caused Marine Midland to file a petition seeking the involuntary reorganization of Webb under Chapter X of the Bankruptcy Act, a predecessor to Chapter 11 of the Bankruptcy Code.[28] The district court approved the petition and appointed a trustee on May 18, 1965.[29]

Acting under the authority of the Bankruptcy Act and the supervision of the district court, the bankruptcy trustee conducted an investigation which revealed that Webb had total assets of $21,538,621 and total liabilities of $60,036,164 plus contingent tax liabilities of $29,400,000.[30] Included in the total liabilities were the 1954 debentures in the then-principal amount of $4,298,200 plus interest subsequent to the beginning of the bankruptcy proceeding.[31]

Based on his investigation, the bankruptcy trustee determined that Marine Midland had either willfully or negligently failed to monitor Webb's business properly as required by the indenture.[32] The trustee alleged that Webb's yearly certificates of compliance with the indenture's required 2:1 asset-liability ratio were fraudulent because

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24. *Caplin*, 406 U.S. at 417.
25. *Id.* at 418.
26. *Id.*
27. *Id.*
28. *Id.*
29. *Id.* at 419.
30. *Id.*
31. Webb had paid off some of the principal of the outstanding debentures, which were issued in the principal amount of $8,607,600. *Id.* at 419 n.9.
32. *Id.* at 419.

they were based on grossly overvalued appraisals of real estate.[33] The trustee further alleged that Marine Midland knew or should have known of the inflated appraisals, and that Webb suffered great financial loss by operating in violation of the indenture.[34] These losses impaired the ability of the debenture holders to obtain payment.

Based on these conclusions, the bankruptcy trustee sued Marine Midland on behalf of the debenture holders, seeking to recover the principal amount of the outstanding debentures.[35] By recovering the amount due on the outstanding debentures from Marine Midland, more of Webb's assets would be available for the other creditors under the reorganization plan. The debenture holders could be eliminated as a class of creditors if they could be paid in full. Marine Midland moved to dismiss the action claiming that the bankruptcy trustee had no standing to assert claims on behalf of the debenture holders. The district court and the court of appeals agreed with Marine Midland, and dismissed the bankruptcy trustee's claim.[36]

The Supreme Court affirmed the lower court rulings.[37] The majority rejected the theory that the statutes empowering the bankruptcy trustee in reorganization proceedings authorized the trustee to bring actions on behalf of creditors against third parties. The Court noted that the trustee's duties were to report potential causes of action "available to the estate" and to "collect and reduce to money the property of the estates for which [he or she is trustee]."[38] Specifically, the Court held that the trustee's power to act as a receiver in equity did not include the power to act on behalf of the debenture holders; the trustee could only assert claims that the debtor itself could have asserted outside of bankruptcy.[39] Since Webb, the debtor, could not have asserted any claim against Marine Midland for failing to moni-

33. *Id.*

34. *Id.* at 420.

35. The bankruptcy trustee also filed a counterclaim in the same amount against Marine Midland in the bankruptcy proceeding where Marine Midland had filed a claim for services rendered. Further, the trustee objected to the claim for services and moved to compel an accounting by Marine Midland. *Id.* at 420.

36. The district court had dismissed the bankruptcy trustee's counterclaim against Marine Midland's claim for services rendered and denied the motion for an accounting. *Id.* at 420. The district court permitted the bankruptcy trustee to object to Marine Midland's claim for services rendered, but did not permit the trustee to seek affirmative recovery. *Id.* The court of appeals upheld the district court decision on all issues. *Id.* at 421. The ability of the bankruptcy trustee to object to Marine Midland's claim for services rendered did not reach the Supreme Court for review. 406 U.S. at 421.

37. Justice Marshall delivered the majority opinion in which Chief Justice Burger and Justices Stewart, Powell, and Rehnquist joined. Justice Douglas filed a dissenting opinion in which Justices Brennan, White, and Blackmun joined. 406 U.S. at 416.

38. *Id.* at 428-29 (citing 11 U.S.C. §§ 567(3), 110, 75 (1938)).

39. *Id.* at 429 (citing 11 U.S.C. § 587 (1938)).

tor its own compliance with the terms of the indenture, the trustee had no claim against Marine Midland.

The Court stressed several practical problems with permitting the bankruptcy trustee to assert the debenture holders' claim against Marine Midland. First, the majority agreed with the appellate court that if the trustee succeeded in his action, Marine Midland would be paying the debt of another, Webb, and would be entitled to look to Webb for reimbursement.[40] Essentially, several claimants would be replaced by one big claimant. There would be no net gain for the bankruptcy estate.

Another practical problem with permitting the bankruptcy trustee to sue would be the determination of the amount of the debenture holders' claims. The Court stated that the debenture holders' claim against Marine Midland depended on how much they could recover from Webb's bankruptcy estate.[41] The debenture holders would have a claim against Marine Midland only to the extent that they failed to recover from the estate. For example, if a debenture holder with a $1,000 debenture could recover $500 from Webb, it would then have a claim for only $500 against Marine Midland. The bankruptcy trustee could reasonably assert the claim on behalf of the debenture holders only after the reorganization was far enough along so that a competent approximation could be made of the debenture holders' losses.[42] The debenture holders' recovery would not affect Webb's other creditors because nothing could be recovered from Marine Midland until the debenture holders had obtained their entitled share from the bankruptcy estate. Since the only parties affected were the debenture holders, only they could decide whether to sue Marine Midland for the balance due on the debentures, and which legal strategy to pursue.[43]

Finally, the Court noted that permitting the bankruptcy trustee to assert the action on behalf of the debenture holders could lead to inconsistent actions, because the bankruptcy trustee's suit would not preclude the individual debenture holders from bringing their own actions against Marine Midland.[44] The Court doubted that the trustee and all of the debenture holders would agree on the amount of damages to seek or on the legal strategy to pursue.[45]

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40. *Id.* at 430.
41. *Id.* at 431.
42. *Id.*
43. *Id.*
44. *Id.* at 431-32.
45. The Court noted that the debenture holders had already brought three private actions that raised claims not asserted by the bankruptcy trustee. *Id.* at 432 n.21. The Court was also

In affirming the decisions of the lower courts, the Supreme Court left to Congress the question of the bankruptcy trustee's standing to assert claims on behalf of creditors. The Court recognized that Congress could permit the bankruptcy trustee to assert claims such as those held by the Webb debenture holders but had chosen not to do so.[46] In giving the trustee the power to assert those claims, Congress could consider the practical problems raised by the Court before such issues arose in the context of litigation.[47]

The dissenters, led by Justice Douglas, believed that the bankruptcy trustee had the authority to assert the debenture holders' claims. That authority flowed from his power to "make the necessary investigations concerning the debtor, the operation of its business, and the desirability of its continuance 'and any other matter relevant to the proceeding or *to the formulation of a plan*, and report thereon to the judge.' "[48] Under Chapter X of the Bankruptcy Act, the trustee in a reorganization had to formulate a reorganization plan that determined the relative entitlements of creditors and equity security holders from the reorganized company. The dissent stated that the trustee would be unable to determine how much would be available for the creditors and equity security holders without first determining the rights of the debenture holders.[49]

The dissent noted that if the bankruptcy trustee were to prevail on his claim against Marine Midland, an entire class of creditors, the debenture holders, would be eliminated from the plan of reorganization.[50] Therefore, claims against the estate would be reduced by $4,298,200, giving the remaining claimants a larger share of the estate's assets. If there was partial recovery, there would be a pro rata change in the relative positions of the creditors.[51] In some cases, successful assertion of a claim on behalf of creditors could eliminate those creditors from the reorganization plan altogether and leave enough assets to permit even the equity security holders to participate.[52]

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concerned about the trustee suing former officers of Webb. The Court thought that in settling the cases with the officers, the trustee might take positions adverse to the debenture holders. *Id.*

46. *Id.* at 434-35.

47. *Id.*

48. *Id.* at 435 (Douglas, J., dissenting) (quoting 11 U.S.C. § 567 (1938)).

49. *Id.* at 438-39 (Douglas, J., dissenting).

50. *Id.* at 438.

51. *Id.*

52. Justice Douglas noted that the "absolute-priority rule," which requires senior interests to be made whole before junior interests can participate in a reorganization, requires the creditors' interests to be fully protected before the stockholders are paid. *Id.* at 436 n.2.

The dissent envisioned the possibility of the debenture holders taking the initiative to assert claims against Marine Midland and thus removing themselves from the reorganization plan. But the dissent argued that "such matters should not be left to happenstance."[53] After all, the Bankruptcy Act made the reorganization trustee responsible for "taking an inventory of assets available to the several claimants and providing what plan would be fair and equitable in light of the security of some claimants or the payment of claims rightfully due them."[54]

The dissent found no merit in the majority's argument that the reorganization trustee's successful assertion of the debenture holders' claim would necessarily give Marine Midland a subrogation claim of equal amount, since the claim against Marine Midland alleged willful misconduct or gross negligence.[55] Accordingly, Marine Midland as the indenture trustee may well have had its claim in bankruptcy wholly disallowed or subordinated to other creditors if it breached fiduciary obligations.[56] Moreover, under general principles of equity, courts are unlikely to subrogate a culpable indenture trustee in order to prevent unjust enrichment with funds otherwise destined for innocent creditors or stockholders.[57] Assuming that the bankruptcy trustee's allegations were true, Marine Midland could not show "clean hands."[58]

The dissenting justices would have permitted the bankruptcy trustee to assert the debenture holders' claims against Marine Midland because the assertion would be in the best interest of the reorganization proceeding. However, the dissent failed to address some of the arguments raised by the majority, such as whether the bankruptcy trustee could bind all of the debenture holders in the litigation with Marine Midland or whether an action could be brought before determining Webb's ability to pay the debenture holders.

B. *The Proposal to Fill the Void Left by* Caplin

In its comprehensive study of the bankruptcy laws, the Commis-

53. *Id.* at 439.
54. *Id.*
55. *Id.*
56. *Id.* For many years, courts have subordinated, or in some cases disallowed, claims of creditors if the creditors' misconduct harmed the other creditors. In these cases, the creditor whose claim is disallowed or subordinated usually acts with or controls the debtor in a manner that furthers the interest of the controlling creditor at the expense of other creditors. *See* Pepper v. Litton, 308 U.S. 295 (1939) (controlling stockholder's claim against debtor corporation disallowed because of inequitable conduct in dealing with creditors of the debtor).
57. 406 U.S. at 440 (Douglas, J., dissenting).
58. *Id.*

sion on the Bankruptcy Laws of the United States accepted the *Caplin* opinion's invitation to specifically empower the bankruptcy trustee to assert creditor's claims against third parties.[59] The Commission's proposal was as follows:

> The trustee may, when in the best interest of the estate, enforce any claim which any class of creditors has against any person and if necessary for that purpose, the court may stay any other pending action on such claims. If the trustee brings an action on such a claim, he shall give notice to all creditors who could have brought an action on the claim if the trustee had not done so. Any judgment entered for or against the trustee on such claim shall be binding on all such creditors and any recovery by the trustee shall be for the benefit only of such creditors after the deduction of all expenses incurred by the trustee in effecting such recovery.[60]

The commentary to the proposed section indicated the Commission's intention to overrule *Caplin*, suggesting that it is in the best interest of the estate for the trustee to assert claims if recovery would "reduce or eliminate some claims against the estate and thus enhance dividends for other creditors or improve the prospect for rehabilitation of the debtor."[61]

The Commission's proposal sought to address some of the practical problems *Caplin* raised. The proposed statute provided that the trustee's action on behalf of creditors would be binding on the creditors. Accordingly, the individual creditors would be barred from asserting individual claims against the liable third party.[62] The commentary also stated that a claim should not be asserted if successful prosecution would result in the third party's subrogation to the claims of the creditors, because assertion of the claim under those circumstances would not result in a net gain for the estate.[63]

A version of the Commission's proposal appeared in the House of Representatives' proposed new Bankruptcy Code.[64] The House proposal, which would have been Section 544(c) of the Bankruptcy Code, was somewhat more specific than the Commission's proposal. The statute (as opposed to the commentary) provided that the trustee could not assert a claim on behalf of creditors if it would lead to a valid subrogation claim of the third party against the bankruptcy

59. H.R. Doc. No. 137, 93d Cong., 1st Sess., pt. 1, at 201 (1973).
60. *Id.* pt. 2, at 160.
61. *Id.* at 161.
62. *Id.* at 160.
63. *Id.* at 161.
64. H.R. 8200, 95th Cong., 1st Sess. 416-17 (1977) (proposing section 544(c)(3)).

estate.[65] The clear intent of the proposed statute was to overrule *Caplin*.

When the House and Senate conferred to finalize the new Bankruptcy Code, the proposed section 544(c) was omitted without explanation.[66] The new Code did not contain a provision that expressly expanded the bankruptcy trustee's power to assert damages claims on behalf of creditors against third parties. It has been suggested that Section 544(c) was dropped because of opposition from the banking lobby; Marine Midland was a bank.[67] If banks were opposed to section 544(c), they may have anticipated that they would defend actions brought by trustees more often than they would benefit from such actions. Alternatively, banks may simply prefer asserting their own causes of action rather than having the trustee assert them on their

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65. Proposed section 544(c) reads as follows:

> (c) (1) The trustee may enforce any cause of action that a creditor, a class of creditors, an equity security holder, or a class of equity security holders has against any person, if—
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> (A) the trustee could not recover against such person on such cause of action other than under this subsection;
>
> (B) recovery by the trustee for the benefit of such creditor or equity security holder or the members of such class will reduce the claim or interest of such creditor or equity security holder or of such members, as the case may be, against or in the estate;
>
> (C) there is a reasonable likelihood that recovery against such person will not create an allowable claim in favor of such person against the estate; and
>
> (D) enforcement of such cause of action is in the best interest of the estate.
>
> (2) If the trustee brings an action on such cause of action—
>
> (A) the court, after notice and a hearing, may stay the commencement or continuation of any other action on such cause of action; and
>
> (B) the clerk shall give notice to all creditors or equity security holders that could have brought an action on such cause of action if the trustee had not done so.
>
> (3) A judgment in any such action brought by the trustee binds all creditors or equity security holders that could have brought an action on such cause of action. Any recovery by the trustee, less any expense incurred by the trustee in effecting such recovery, shall be for the benefit only of such creditors or equity security holders.

H.R. 8200, 95th Cong., 1st Sess. 416-17 (1977).

66. The only reference to proposed section 544(c) was as follows: "The House amendment deletes section 544(c) of the House bill." 124 CONG. REC. S17,406 (daily ed. Oct. 6, 1978) (remarks of Senator DeConcini upon introducing Senate amendment to House amendment to H.R. 8200), *reprinted in* 1978 U.S.C.C.A.N. 6525. *See* Mixon v. Anderson (*In re* Ozark Restaurant Equipment Co.), 816 F.2d 1222, 1228 n.10 (8th Cir. 1987).

67. *See* WILLIAMSBURG CONFERENCE ON BANKRUPTCY, CRITIQUE OF THE FIRST DECADE UNDER THE BANKRUPTCY CODE AND AGENDA FOR REFORM 225 (1988) (comment of Mr. Levin).

behalf. Without a written explanation for the omission of section 544(c), the motives of Congress are left to speculation.

Since the adoption of the Bankruptcy Code, most courts and commentators continue to believe that the rule of *Caplin* is still alive. For example, in *Mixon v. Anderson (In re Ozark Restaurant Equipment Co.)*,[68] the Court of Appeals for the Eighth Circuit held that the bankruptcy trustee had no standing under the Bankruptcy Code to assert creditors' claims against the corporate debtor's principal shareholders and officers using an alter ego theory. Under such a theory, creditors may pierce the corporate veil of limited liability for shareholders and officers if the individuals involved used the corporation only as an instrumentality to conduct their own personal business.[69]

Whether a shareholder may be held liable on an alter ego theory depends on the facts of the individual case and on state law. Several factors may lead to application of the alter ego doctrine, including undercapitalization of the corporation, misrepresentation of the corporate structure to creditors, failure to follow corporate formalities (such as obtaining authority to issue stock), and unauthorized diversion of corporate funds or assets.[70] In some cases, an alter ego action may bring the personal assets of corporate promoters into the bankruptcy estate, thus increasing the assets available to pay the creditors of the bankrupt corporation.

In *Mixon*, the bankruptcy trustee accused the controlling shareholders of abusing the corporation for their own personal benefit and to the detriment of the corporation's creditors.[71] The corporation was grossly undercapitalized and transacted with some of the controlling shareholder's other businesses on extremely favorable terms.[72] The court determined, however, that under relevant state corporation law, an action under an alter ego theory belonged not to the corporation but to the individual creditors of the corporation.[73] Accordingly, the trustee had no power to assert the claim on behalf of the creditors.

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68. 816 F.2d 1222 (8th Cir. 1987).

69. *See id.* at 1225 (citing 1 WILLIAM M. FLETCHER, CYCLOPEDIA ON THE LAW OF PRIVATE CORPORATIONS § 41.10 (1983)); HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS § 146 (1983).

70. *See* Associated Vendors, Inc. v. Oakland Meat Co., 26 Cal. Rptr. 806, 814-15 (Ct. App. 1962); CALIFORNIA CORPORATION LAWS § 298.01 (R. Bradbury Clark ed., 4th ed. 1991).

71. 816 F.2d at 1223.

72. Ozark Restaurant Equipment never made a profit, and its net worth plummeted from negative $1,400 in 1980 to negative $146,000 in 1982. The corporation allegedly failed to keep adequate books and records, distributed false financial statements, failed to pay taxes, and failed to hold regular meetings of the shareholders and directors. 816 F.2d at 1224 n.4.

73. *Id.* at 1225.

The Eighth Circuit noted that in enacting the Bankruptcy Code, Congress had failed to accept the *Caplin* majority opinion's invitation to empower the bankruptcy trustee to assert claims on behalf of creditors against third parties.[74] The court pointed out that section 544 of the Bankruptcy Code authorizes bankruptcy trustees to exercise the power of judicial lien creditors, to act as bona fide purchasers of real property and to avoid transfers of the debtor's property or obligations incurred by the debtor that can be avoided by an actual creditor of the debtor under state law.[75] Furthermore, the court noted that the trustee can assert causes of action that the debtor could have asserted outside of bankruptcy because those causes of action are "property of the estate."[76] None of these provisions, however, included the power to assert a claim for damages on behalf of creditors against a third party.[77]

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74. *Id.* at 1222.

75. *Id.* at 1226-30. Section 544 provides:

> (a) The trustee shall have, as of the commencement of the case, and without regard to any knowledge of the trustee or of any creditor, the rights and powers of, or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by-
>
> > (1) a creditor that extends credit to the debtor at the time of the commencement of the case, and that obtains, at such time and with respect to such credit, a judicial lien on all property on which a creditor on a simple contract could have obtained such a judicial lien, whether or not such a creditor exists;
> >
> > (2) a creditor that extends credit to the debtor at the time of the commencement of the case, and obtains, at such time and with respect to such credit, an execution against the debtor that is returned unsatisfied at such time, whether or not such a creditor exists; or
> >
> > (3) a bona fide purchaser of real property, other than fixtures, from the debtor, against whom applicable law permits such transfer to be perfected, that obtains the status of a bona fide purchaser and has perfected such transfer at the time of the commencement of the case, whether or not such a purchaser exists.
>
> (b) The trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under section 502 of this title or that is not allowable only under section 502(e) of this title.

11 U.S.C. § 544 (1988).

76. 816 F.2d at 1225. 11 U.S.C. § 541(a)(1) (1988) provides that the estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case."

77. 816 F.2d at 1230; *accord* E.F. Hutton & Co. v. Hadley, 901 F.2d 979 (11th Cir. 1990) (trustee did not have standing to assert fraud claims against third parties arising out of a Ponzi scheme); Williams v. California First Bank, 859 F.2d 664 (9th Cir. 1988) (trustee did not have standing to assert securities fraud claims on behalf of creditors against third party even though creditors assigned claims to trustee).

At least two courts have suggested that the bankruptcy trustee's broad power to represent creditors under Bankruptcy Code § 544 allows the trustee to assert claims that are common to all creditors, including alter ego actions. *See* Koch Ref. v. Farmers Union Cent. Exch., 831 F.2d 1339 (7th Cir. 1987); In re Western World Funding, Inc., 52 Bankr. 743 (Bankr. D. Nev.

Assuming that the Bankruptcy Code does not overrule *Caplin*, why bar the trustee from asserting creditors' claims against third parties when the trustee has other similar powers designed to maximize the assets available to pay creditors? Is there much difference between allowing the trustee to assert a claim on behalf of the debtor against a third party if the debtor could have asserted it outside of bankruptcy and allowing the trustee to assert a claim held by a substantial number of creditors if it significantly reduces the amount of claims against the debtor? In Part III, this Article examines the proposed section 544(c) in light of the policies supporting the trustee's currently existing powers. Specifically, would assertion by the trustee of creditors' claims against third parties increase assets available for distribution and lead to a more equitable distribution of those assets? Would assertion of such claims lead to more or less efficient administration of the bankruptcy estate?

III. Assertion of Damages Claims on Behalf of Creditors and the Bankruptcy Trustee's Current Powers

A. *The Role of the Bankruptcy Trustee's Avoidance Powers and Ability to Assert Claims in the Bankruptcy Scheme*

At the outset, it is useful to try to understand why the trustee may assert any claims on behalf of creditors and has some powers that no creditor can assert outside of bankruptcy.[78] It is, of course, possible to imagine a bankruptcy system in which the individual administering the bankruptcy, the trustee, could not assert any claims whatsoever against third parties. Whatever assets belonged to the debtor at the time the bankruptcy petition was filed would be distributed to the creditors according to some system of priority that may or may not be pro rata. For example, assume that the debtor had a viable $100,000 claim against a third party for breach of contract when it filed its bankruptcy petition. The trustee could distribute the claim to the creditors by assigning it to them according to the bankruptcy pri-

1985). It has been argued that *Caplin* is distinguishable from cases in which all creditors can assert a claim; the debenture holders in *Caplin* did not constitute all of the creditors holding claims against Webb. In addition, the Court in *Caplin* did not expressly consider the power of the trustee to act on behalf of all creditors of the estate. *See infra* notes 107-11 and accompanying text.

78. For example, it is generally permissible under non-bankruptcy law for a debtor to prefer one creditor over others. *See, e.g.*, Cal. Civ. Code § 3432 (West 1970). In bankruptcy, such preferential payments made within designated time periods can be avoided by the bankruptcy trustee. 11 U.S.C. § 547 (1988); *see also infra* notes 151-53 and accompanying text.

ority system. The creditors could then prosecute the claim themselves.

Several problems might exist with such a system. The claim may be assigned to a large number of creditors who disagree on the way to prosecute the claim. Furthermore, it may be difficult to determine whether the claim has merit—what might appear to be a claim worth $100,000 may be worthless either because the third party is not liable or is unable to pay. Further, the creditors who have the misfortune of receiving the purported $100,000 claim will benefit less than the creditors who receive $100,000 in hard assets, assuming any hard assets exist. In these cases, it probably makes more sense to permit the bankruptcy trustee to liquidate the claim against the third party and distribute whatever is obtained to the creditors in accordance with the bankruptcy distribution system.

Alternatively, the trustee might receive broad powers to assert claims, held by a creditor against a third party, that may reduce that creditor's claim against the debtor. For example, in cases of debts guaranteed by a third party, the trustee would assert the guarantee for the benefit of the bankruptcy estate. Assume that a debtor owes one creditor $50,000 and the debt is guaranteed by a third party. Further, assume that the debtor has defaulted and filed for bankruptcy. The trustee might be permitted to sue the third party and obtain $50,000 for the creditor or, perhaps, for the entire estate, leaving the creditor "protected" by the guarantee to stand in line with the other creditors. Such an action would either remove one creditor holding a $50,000 claim from the estate or provide $50,000 in additional assets for the rest of the creditors.

The problem with such a rule is that once the guarantor paid, it would be entitled to a claim against the estate for an equal amount.[79] One creditor of the estate would be replaced by another and there would be no net gain for the bankruptcy estate. In addition, it may be unfair to force the creditor who could enforce the guarantee outside of bankruptcy to share the proceeds with others because this creditor extended and priced the credit based on the assurance that if the debtor failed to pay, the guarantor would pay in full. Accordingly, it makes sense to prohibit the trustee from asserting the guarantee on behalf of other creditors of the estate.

Somewhere between these two situations exists a line separating claims which should be asserted by the bankruptcy trustee from those

79. 11 U.S.C. § 509(a) (1988) provides, with some exceptions, that "an entity that is liable with the debtor on, or that has secured, a claim of a creditor against the debtor, and that pays such claim, is subrogated to the rights of such creditor to the extent of such payment."

which should not. In determining where to draw the line, the bankruptcy trustee's powers should be analyzed within the policies that drive the bankruptcy system. While it is difficult to find a single policy or philosophy to explain the bankruptcy system,[80] it can be viewed as a way to facilitate the open credit economy, providing for the orderly payment of debts and for relief from overly burdensome debt.[81]

The bankruptcy system seeks to provide an orderly procedure for determining how much an entity that is unable or unwilling to pay its debts owes each entity claiming an amount due and whether in fact there is any amount due.[82] Bankruptcy law establishes a priority system for the distribution of limited assets among creditors.[83] It provides some predictability for the creditors and debtors by informing them of their respective rights in limited assets if debts cannot be paid in full.[84] To some extent, bankruptcy relieves both creditors and debtors from the destructive seizure of assets by creditors who seek full repayment when they sense that the debtor might be insolvent.[85] Loss is spread among creditors rather than assigned to any one creditor

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80. *See* H.R. DOC. NO. 137, *supra* note 59, at 61.

> Instead of striving for a comprehensive framework for assessing the bankruptcy process, such astute observers as Glenn and Radin have sought to isolate the "essentials" or "nature" of bankruptcy. Glenn has emphasized the "well worn propositions . . . [of] the fraudulent debtor . . . [and] the concept of the debtor who is within the control of the court." Radin has expanded these essentials: "Unless we intend to bring [all of] the creditors into one large group, and adjust their common claims to a fund consisting of a single debtor's property, there is no reason to have recourse to bankruptcy."

Id. (footnotes omitted).

Recently, several scholars have debated the philosophical underpinnings of bankruptcy law. Some scholars, most notably Professor Baird and Dean Jackson, seek to explain bankruptcy as an economically efficient way to divide limited assets of a financially distressed entity among diverse creditors. Accordingly, they argue that bankruptcy distribution rules should generally not vary from state debtor-creditor law unless the variance increases the pool of assets available for distribution. *See, e.g.*, THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW (1986); Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply To Warren*, 54 U. CHI. L. REV. 815 (1987). Professor Bowers suggests that if the goal of bankruptcy is to increase the amount of assets of the bankrupt entity to facilitate an efficient distribution of assets among creditors, it is doomed to failure. Debtors can do a more efficient job of distributing their own limited assets. *See* Bowers, *supra* note 1. Others argue that bankruptcy law reflects the concerns of the diverse participants in the bankruptcy process, which involves more than a question of how to distribute a pool of assets. *See, e.g.*, Donald R. Korobkin, *Rehabilitating Values: A Jurisprudence of Bankruptcy*, 91 COLUM. L. REV. 717 (1991); Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775 (1987).

81. *See* H.R. DOC. NO. 137, *supra* note 59, at 62.

82. *Id.* at 61.

83. *See* 11 U.S.C. § 507 (1988).

84. H.R. DOC. NO. 137, *supra* note 59, at 75.

85. *Id.*

alone.[86] The bankruptcy system attempts to administer claims and distribution of assets efficiently. In some cases, the debtor receives relief to enable it to become a more productive participant in the open credit economy, both as a producer and as a consumer.[87] Ideally, the system should operate at low cost and provide for a speedy and expert resolution of disputes.[88]

Some commentators have asserted that bankruptcy laws have developed because creditors prefer the collective nature of the bankruptcy proceeding.[89] Creditors would rather receive a pro-rata recovery of the debtor's estate in bankruptcy than engage in a race of diligence with other creditors in which some recover in full while others recover nothing.[90] Dean Thomas Jackson uses a fishing hypothetical to help explain why creditors would agree to the collective nature of the bankruptcy process.[91] The hypothetical posits that it is possible to catch all of the fish in a lake in one year and earn $100,000.[92] If some fish are left in the lake, however, they can multiply and perhaps provide an annual annuity of $50,000 per year with a present value of $500,000.[93] If the people who are fishing (creditors) sense that all of the fish will be taken in one year by others (a business in trouble), each person fishing will attempt to immediately catch as many fish as possible.[94] The people fishing will split $100,000 rather than $500,000, not an optimal result.[95]

The Bankruptcy Code is thus like a Fish and Game Code in which the state seeks to regulate each person fishing so as to maximize the amount of fish available. The bankruptcy trustee can be viewed as a game warden empowered to enforce the fishing regulations. The bankruptcy trustee's ability to avoid preferential transfers is similar to a game warden's power to prevent people from fishing out of season.[96]

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86. *Id.* at 76-79.

87. *Id.* at 75.

88. *Id.* at 81-82.

89. *See* JACKSON, *supra* note 80, at 7-19; Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857 (1982).

90. A collective, compulsory system of debt collection might make more assets available for distribution because sale of the debtor's business as a going concern may yield a higher price than the piecemeal dismantling of the business, which would likely result in a first-come-first-serve system. In addition, creditors tend to be risk averse and, for example, would rather receive an assurance of a recovery of $12,500 rather than a 50-50 chance of $25,000 or nothing. *See* JACKSON, *supra* note 80, at 10-16.

91. *Id.* at 11-13.

92. *Id.* at 11.

93. *Id.*

94. *Id.* at 12.

95. *Id.*

96. The trustee's ability to avoid preferential transfers arises from section 547(b) of the Bankruptcy Code, which provides:

The trustee's ability to assert claims on behalf of the estate against third parties and avoid transfers of interests in property is equivalent to the game warden's power to prevent people from fishing without a license and from exceeding the limit on fish caught.[97]

The trustee's power to assert claims on behalf of the estate and avoid some of the debtor's transfers of property plays an important role in the bankruptcy process. As a result of this power, more assets are brought into the estate, including some that have been fraudulently hidden by the debtor, permitting more of the creditors' claims to be paid. Additionally, the trustee's power to avoid fraudulent or preferential transfers of the debtors' assets provides a more even distribution of assets among creditors.[98]

In proposing section 544(c), the House of Representatives and the Commission on the Bankruptcy Laws of the United States sought to expand the bankruptcy trustee's power in a manner consistent with bankruptcy policy, especially the policies of maximizing the assets available to pay creditors and equitably distributing those assets. Proposed section 544(c) also reflected the view that not all creditors' claims should be asserted by the bankruptcy trustee. The trustee was empowered to assert claims only if success would not result in an allowable claim filed by the third party, and was otherwise in the best

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Except as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest of the debtor in property—

(1) to or for the benefit of a creditor;

(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;

(3) made while the debtor was insolvent;

(4) made—

(A) on or within 90 days before the date of the filing of the petition; or

(B) between 90 days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and

(5) that enables such creditor to receive more than such creditor would receive if—

(A) the case were a case under chapter 7 of this title;

(B) the transfer had not been made; and

(C) such creditor received payment of such debt to the extent provided by the provisions of this title.

11 U.S.C. § 547(b) (1988). For a discussion of preference rules and their role in the bankruptcy system, *see* JACKSON, *supra* note 80, at 122-46.

97. For an explanation of the trustee's ability to act on behalf of actual and hypothetical creditors in avoiding transfers of the debtor's assets, *see infra* notes 100-24 and accompanying text.

98. The trustee's power to assert claims and avoid transfers of property may have an impact on the amount of assets available to pay claims. In addition, it may provide for more equitable sharing of assets among creditors, but it does not have much of an impact on the "fresh start" rationale of bankruptcy, i.e., providing relief to the debtor from overly burdensome indebtedness. *See* Thomas J. Jackson, *Avoiding Powers in Bankruptcy*, 36 STAN. L. REV. 725, 727-31 (1984).

interest of the estate.[99] Unfortunately, the proposed section was not entirely clear about what constituted the "best interest of the estate."

The following Part examines the policies underlying the trustee's powers to determine whether proposed section 544(c) provides a more satisfactory balance of bankruptcy policies than the *Caplin* rule forbidding the bankruptcy trustee from asserting creditors' claims against third parties. It also examines the policies to determine more specifically when assertion of a claim is in the best interest of the estate.

B. *Maximization of the Estate's Property*

The trustee's powers to assert claims and avoid transfers of property are designed to maximize the amount of assets available for distribution.[100] The trustee may assert claims owned by the debtor, and recover some assets transferred by the debtor to third parties before bankruptcy. If the claim has merit, the trustee recovers more assets, so more of the creditors may be paid or the existing creditors may be paid more. Assertion of damages claims on behalf of creditors against third parties is closely analogous to the trustee's existing powers to assert claims of the debtor and to avoid transfers of property that are voidable by an actual creditor of the debtor.

As noted above, the bankruptcy trustee may assert any claims which are property of the estate.[101] For example, if the debtor goes to its financial grave with a viable cause of action for breach of contract against a third party, the trustee can assert that claim on behalf of the debtor. Assume that the claim is worth \$100,000. Had the debtor successfully asserted the claim outside of bankruptcy, \$100,000 in additional assets would have been available for all of the debtor's creditors—at least if the assets were not squandered or successfully hidden. In bankruptcy, the trustee is effectively asserting the claim on behalf of the creditors against the liable third party, even if the creditors themselves could not have asserted the claim. There is little difference between a claim that the debtor could assert outside of bankruptcy and a claim that all creditors of the debtor could assert against a third party—the ultimate beneficiaries are the same.[102]

To demonstrate the similarity between claims belonging to the

99. H.R. 8200, *supra* note 64, at 416-17.

100. *See* Morris G. Shanker, *The Abuse and Use of Federal Bankruptcy Power*, 26 CASE W. RES. L. REV. 3, 28 (1975).

101. *See supra* notes 3-4 and accompanying text.

102. *See* Richard L. Epling, *Trustee's Standing to Sue in Alter Ego or Other Damage Remedy Actions*, 6 BANKR. DEV. L.J. 191, 201-02 (1989).

debtor and claims belonging to all creditors of the debtor, consider a case similar to *Mixon v. Anderson* where the majority shareholder of a corporation has caused the corporation to be grossly undercapitalized. As a result of misusing the corporate form, the shareholder is liable to the creditors of the corporation on an alter ego theory under relevant state corporation law.[103] If the controlling shareholder is solvent, the bankruptcy trustee can bring additional assets into the estate to pay the creditors by asserting an alter ego claim against the controlling shareholder. In order to get around the *Caplin* standing problem, some courts (unlike the court in *Mixon*) have held, based on little authority, that the bankrupt corporation itself has standing to sue its own principals through an alter ego theory under state corporation law.[104] Thus, the debtor's cause of action is treated as property of the estate and can be asserted by the bankruptcy trustee.

Cases in which courts hold that the trustee has standing on behalf of the bankrupt corporation to sue the controlling shareholder are based on the unique assumption that one can sue oneself. In these cases the corporation and the shareholder are basically the same entity, and it appears highly unlikely outside of bankruptcy that a corporation would ever sue its controlling shareholder on an alter ego theory. Alter ego theory benefits creditors of shell corporations and provides an avenue for recovery from unscrupulous individuals who seek to shield themselves from liability. Federal courts interpreting

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103. *See supra* notes 68-77 and accompanying text.

104. In S.I. Acquisition v. Eastway Delivery Serv., 817 F.2d 1142 (5th Cir. 1987), a creditor alleged that debtor S.I. Acquisition was actually the alter ego for the personal business affairs of its principal shareholder. The creditor sought to hold the shareholder liable for the creditor's claim against the debtor. The Fifth Circuit held that the creditor was stayed because the alter ego claim qualified as property of the estate under Texas law and was assertable by the bankruptcy trustee. The court noted, "not surprisingly," that it could not find any case in which the corporation was allowed to assert an alter ego claim against its principal shareholder. 817 F.2d at 1152. Nevertheless, the court held that finding a cause of action for the corporation in these cases was consistent with the overall policy of holding a person liable who misused the corporate form for the corporation's obligations.

Likewise, in St. Paul Fire and Marine Ins. Co. v. Pepsico, 884 F.2d 688 (2d Cir. 1989), the Second Circuit found that under relevant Ohio law an alter ego claim belonged to the debtor and the bankruptcy trustee, although it conceded that "no Ohio case directly addresses whether a corporation may bring an alter ego action against its own parent." *Id.* at 703. The court stated that the corporation's claim must be recognized or "the purpose of the alter ego action would be frustrated." *Id.*; *see also* Steyr-Daimler-Puch of America Corp. v. Pappas, 852 F.2d 132 (4th Cir. 1988).

These cases are contrary to Mixon v. Anderson (*In re* Ozark Restaurant Equipment Co.), 816 F.2d 1222 (8th Cir. 1987), in which the court held that the corporate debtor did not have standing to assert the alter ego claim. *See supra* notes 68-77. The cases have also been criticized as stretching state law to reach an equitable result, because alter ego claims are really asserted by creditors of the corporation outside of bankruptcy, and not the corporation itself. *See* Epling, *supra* note 102, at 197-98.

state law may be stretching the law to permit bankruptcy trustees to maximize property available for creditors by asserting causes of action that really belong to the creditors.[105] In bankruptcy, whether the alter ego cause of action belongs to the corporation or to the creditors of the corporation, the beneficiaries are ultimately the creditors. If section 544(c) had been adopted, it would not be necessary in the alter ego cases to ask if the cause of action belonged to the corporation or to the individual creditors; the trustee could have asserted the claim as long as it was in the best interest of the estate.

Arguably, if a claim is common to all creditors, such as some alter ego claims, the bankruptcy trustee can already assert the claim under the so-called "strong arm" clause of Bankruptcy Code section 544(a).[106] That section gives the bankruptcy trustee the "rights and powers" of a hypothetical lien creditor who extends credit and obtains a lien at the time the bankruptcy petition is filed.[107] The section also gives the trustee the powers of a creditor who extends credit at the time the petition is filed and obtains a writ of execution against the debtor that is returned unsatisfied.[108] Some courts and commentators have suggested that in alter ego cases in which all creditors may assert a claim against the controlling shareholder, the bankruptcy trustee can assert the claim on their behalf as the general representative of all creditors under the strong arm clause.[109]

The trustee's ability to assert general causes of action on behalf of creditors under the strong arm clause is subject to some dispute. Congress' rejection of section 544(c) may indicate its intention to prevent the trustee from asserting such claims.[110] In addition, the strong arm clause is most frequently used to help the bankruptcy trustee take priority over unperfected security interests and avoid some transfers

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105. *See* Epling, *supra* note 102, at 197-98.

106. *See infra* note 109.

107. 11 U.S.C. § 544(a)(1) (1988).

108. 11 U.S.C. § 544(a)(2) (1988).

109. *See* Koch Ref. v. Farmers Union Cent. Exch., 831 F.2d 1339 (7th Cir. 1987); *In re* Western World Funding, Inc., 52 Bankr. 743 (Bankr. D. Nev. 1985); Steven E. Boyce, Koch Refining *and In re* Ozark*: The Chapter 7 Trustee's Standing To Assert An Alter Ego Cause of Action*, 64 AM. BANKR. L.J. 315 (1990); WILLIAMSBURG CONFERENCE ON BANKRUPTCY, *supra* note 67, at 225-27 (comments of Mr. Klee).

Some commentators propose that a creditor with an unsatisfied execution is entitled to bring a creditor's bill to reach property not leviable by a writ of execution. A creditor's bill can be used to reach property that has been fraudulently transferred, and can also be used to assert liability against the principal of a corporation through an alter ego theory. *See In re* Western World Funding, Inc., 52 Bankr. at 773; Boyce, *supra*, at 321-22.

110. *See* Mixon v. Anderson (*In re* Ozark Restaurant Equipment Co.), 816 F.2d 1222, 1229 (8th Cir. 1987); WILLIAMSBURG CONFERENCE ON BANKRUPTCY, *supra* note 67, at 226 (comment of Professor Baird).

of property interests by the debtor.[111] There is no tradition of bankruptcy trustees attempting to assert damages claims on behalf of creditors under the strong arm clause, and the ability of the trustee to assert such claims under that provision is questionable at best.

In comparison to the trustee's inability to assert damages claims, the trustee's power to assert avoidance claims on behalf of creditors against third parties is clearly established.[112] The trustee has the power to "step into the shoes" of a creditor who has the power under state law to avoid the debtor's transfer of property made prior to bankruptcy, but failed to do so before the commencement of bankruptcy.[113] This power was represented by section 70(e) of the Bankruptcy Act, and has had the effect of forcing third parties who are taking transfers of property from the debtor to disclose the transfer so others who deal with the debtor are not misled.[114] The subrogation of the trustee to creditors' avoidance claims had more significance when an unperfected security interest could be avoided by unsecured creditors.[115] Under the subrogation provision of former section 70(e), the bankruptcy trustee could thus "undo" unperfected security inter-

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111. *See Mixon*, 816 F.2d at 1229. The "strong arm clause" is important in that it gives the trustee leverage in dealing with secured creditors of the debtor. Since secured creditors may generally assert their security interests inside of bankruptcy, they can remove their collateral from the distribution scheme. As a result, they are considered to have a "super priority" over other creditors. In order for a secured creditor to be protected in bankruptcy, the security interest must be perfected—that is, the secured creditor must either have possession of the collateral or must have filed a public notice of the security interest. *See* U.C.C. §§ 9-303, -304, -305 (1989). Outside of bankruptcy, an unsecured creditor can obtain priority over an unperfected security interest by suing on its claim and obtaining a judicial lien against the property subject to the unperfected security interest. *See* U.C.C. § 9-301(1)(b) (1989). Since the automatic stay in bankruptcy prevents unsecured creditors from obtaining such liens, the trustee may obtain such a lien on behalf of the creditors generally, and take priority over an unperfected security interest on behalf of the general creditors. *See* JACKSON, *supra* note 80, at 70-74. The trustee's ability to take priority over unperfected security interests thus brings more property into the estate for the benefit of general unsecured creditors. *But see* John C. McCoid II, *Bankruptcy, the Avoiding Powers, and Unperfected Security Interests*, 59 AM. BANKR. L.J. 175 (1985) (criticizing the trustee's ability to take priority over such interests because unsecured creditors cannot take priority over such interests outside bankruptcy).

112. Section 544(b) of the Bankruptcy Code provides:

> The trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under section 502 of this title or that is not allowable only under section 502(e) of this title.

11 U.S.C. § 544(b) (1988).

113. *Id.*

114. *See Hearings on S. 235 & S. 236 Before the Subcomm. on Improvements in Judicial Machinery of the Senate Comm. on the Judiciary*, 94th Cong., 2d Sess., pt. 3, at 4, 7 (1977) (letter from Vern Countryman, Professor at Harvard Law School) [hereinafter *Hearings*].

115. *See* Vern Countryman, *The Use of State Law in Bankruptcy Cases (Part II)*, 47 N.Y.U. L. REV. 631, 656 (1972)

ests.[116] Under Article 9 of the Uniform Commercial Code, unsecured creditors cannot avoid unperfected security interests, and the bankruptcy trustee thus cannot avoid these interests under section 544(b).[117]

Today, the power to assert avoidance claims allows trustees to nullify fraudulent transfers of property that are voidable under state fraudulent transfer law but are not avoidable under section 548 of the Bankruptcy Code, illegal corporate dividends or stock purchases that state law permits unsecured creditors to avoid, and bulk sales under Uniform Commercial Code Article 6, if the jurisdiction has not adopted one of the 1988 proposed alternatives of Article 6.[118] Before 1988, Article 6 of the Uniform Commercial Code provided that a bulk sale was ineffective as against the seller's creditors if a buyer of goods failed to notify the creditors prior to transfer[119] of a seller's merchandise.[120] If the seller ultimately filed for bankruptcy, the seller's bankruptcy trustee could step into the shoes of the seller's creditors and avoid the bulk sale, thus recovering the property that was sold.[121] Under this version of Article 6, the property recovered benefits all creditors of the estate, not simply the creditor who could have asserted the violation of the bulk transfer law outside of bankruptcy.[122]

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116. *See, e.g.*, Moore v. Bay, 284 U.S. 4 (1931).

117. The Uniform Commercial Code provides that an unperfected security interest is "subordinate to," among others, a bankruptcy trustee. U.C.C. § 9-301 (1989). Under Article 9, no one may "avoid" an unperfected security interest. If the trustee wants to avoid an unperfected security interest, she can do so under section 544(a). *See supra* note 111.

118. *See* Mixon v. Anderson (*In re* Ozark Restaurant Equipment Co.), 816 F.2d 1222, 1229 n.12 (8th Cir. 1987); *see also* Buchman v. American Foam Rubber Corp., 250 F. Supp. 60 (S.D.N.Y. 1965) (alleged payment in violation of antidividend provision).

119. Under U.C.C. Article 6, in effect prior to 1988 (versions of which are still in effect in the vast majority of jurisdictions at the time of this writing), a "bulk transfer" is defined as "any transfer in bulk and not in the ordinary course of the transferor's business of a major part of the materials, supplies, merchandise or other inventory (Section 9-109) of an enterprise subject to this Article." U.C.C. § 6-102(1) (1987). Covered enterprises are "all those whose principal business is the sale of merchandise from stock, including those who manufacture what they sell." U.C.C. § 6-102(3) (1987).

120. Under the former version of Article 6, only those creditors holding claims based on transactions occurring before the bulk transfer are entitled to protection. U.C.C. § 6-109(1) (1987).

121. *See In re* Verco Indus., 10 Bankr. 347 (Bankr. 9th Cir. 1981), *rev'd in part*, 704 F.2d 1134 (9th Cir. 1983); Bryan D. Hull, *Recommendation of the UCC Committee of the State Bar of California: Article 6 Should Be Repealed*, 41 ALA. L. REV. 701, 704-07 (1990).

122. The drafters of the new version of Uniform Commercial Code Article 6 - Alternative B criticized the rule allowing recovery to all creditors as giving a windfall to those creditors who could not have asserted the bulk sales claim outside of bankruptcy. *See* U.C.C. § 6-107 cmt. 2 (1989). Under the new version, only creditors who were affected by the violation of the bulk sales law may assert the cause of action. *See infra* notes 203-08 and accompanying text.

Proposed section 544(c) would have permitted the trustee to assert damages claims, in addition to transfer avoidance claims, on behalf of creditors.[123] The proposal recognized that in many cases no practical difference exists between avoidance claims and damages claims. In fact, many avoidance claims result in a sum paid to the trustee rather than a transfer of specific property; the trustee receives the cash value of the transferred property.[124] Both types of claims are asserted against third parties on behalf of creditors who also could have asserted the claim. Both types of claims bring additional assets into the estate, although there may be some circumstances in which assertion of a claim for damages on behalf of creditors is more complicated and costly than a claim of avoidance.[125]

The *Caplin* majority pointed out that it is unnecessary for the trustee to assert claims against third parties because the creditors will assert those claims themselves.[126] To the extent that creditors successfully assert their own claims against third parties, the creditors themselves reduce their claims against the bankruptcy estate. This allows more assets to be available for other creditors of the estate.[127] There are, however, reasons why relying on creditors to assert their claims would not maximize the bankruptcy estate's assets. First, the creditors may initially look to recover from the bankruptcy estate before proceeding against the third party, or will recover from the bankruptcy estate before their action against the third party is finally decided. For example, assume that one group of creditors (Group A) have fraud claims aggregating $500,000 and have a viable cause of action against a third party that is jointly liable with the debtor. Assume also that another group of creditors (Group B) exists with claims of $100,000. This group does not have a cause of action against the third party. The debtor's assets total $50,000. Finally, assume that only some members of Group A have sued the third party, and that by the time the bankruptcy estate is resolved, not all members of Group A have settled their claims against the third party. The third party will be liable to them to the extent that they have been unable to recover their losses from the bankruptcy estate. If Group A

123. *See supra* note 65.

124. Bankruptcy Code § 550 provides that the court may award the trustee the property's value rather than the property itself. 11 U.S.C. § 550(a) (1988).

125. *See infra* notes 177-87 and accompanying text.

126. *See supra* notes 40-44 and accompanying text.

127. Certainly, creditors will assert significant claims against third parties who are more solvent than the debtor. For example, in Ashland Oil v. Arnett, 875 F.2d 1271 (7th Cir. 1989), individual creditors were permitted to assert civil RICO claims against a third party arising out of the unlawful movement of assets from the corporate debtor and failure to disclose those assets to the bankruptcy court.

had settled with the third party for the full $500,000, the debtor's assets would satisfy Group B to the extent of fifty cents on the dollar. If the creditors holding the fraud claim do not settle with the third party, the $50,000 in assets must be used to satisfy $600,000 worth of claims held by members of both Group A and Group B. After the bankruptcy proceeding is over, members of Group A would be left to proceed against the third party for the deficiency.

A second reason why leaving the creditors to assert their claims against third parties will not necessarily lead to asset maximization is that the bankruptcy trustee cannot monitor the progress of the individual creditors' actions against the third party. The trustee cannot predict recovery from the third party. Nor can the trustee deny creditors holding possible claims against third parties because of the possibility that some amount might eventually be recovered from a third party.[128] As the dissenting justices in *Caplin* indicated, the only way for the bankruptcy trustee to know the extent of a third party's liability and to know the extent to which a third party can satisfy creditors' claims is to assert the claim on behalf of the creditors.[129] Any asset maximization resulting from the action of individual creditors against third parties will be fortuitous.[130]

Perhaps the most significant argument against permitting the trustee to assert damages claims against third parties is that the third party would simply claim indemnity or contribution from the estate.[131] There would be little or no net gain for the estate because one group of creditors would simply be replaced by the third party. The drafters of proposed section 544(c) responded to this concern by denying the trustee the power to assert claims on behalf of creditors if assertion of the claim was expected to result in "an allowable claim in favor of [the third party] against the estate."[132] Therefore, under proposed section 544(c), the only claims the trustee could assert were those that in the judgment of the trustee would result in a net gain for the creditors.

Although an action against a third party occasionally results in a

128. The grounds for denial of a claim are set forth in Bankruptcy Code § 502. 11 U.S.C. § 502 (1988). None of the provisions in section 502 provide that a claim can be denied because of a third party's joint liability.

129. *See supra* notes 47-52 and accompanying text.

130. *See supra* notes 53-54 and accompanying text.

131. *See supra* note 40 and accompanying text. Under the doctrine of equitable contribution, joint wrongdoers each much pay pro-rata damages resulting from the wrong. W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 50, at 340 (5th ed. 1984). Under the doctrine of indemnification, the entire cost of wrongdoing shifts to another party. *Id.* § 51.

132. *See supra* note 65 and accompanying text.

claim by the third party against the estate for an equal amount, in many cases the third party's conduct is so inequitable that its claim is denied or subordinated.[133] A claim can be denied if it has no basis in law or is nonexistent.[134] A claim also may be denied if a creditor has acted wrongly towards the debtor in such a way that allows the debtor a defense to the third party's claim.[135] Where the third party's misconduct is directed towards the debtor's creditors, the court will not necessarily disallow the third party's claim, but may instead subordinate it to other creditor's claims.[136] The effect of subordination is similar to denial of a claim if there are insufficient assets available to pay the superior claims.

Equitable subordination of claims occurs where the claimant engages in inequitable conduct that confers an unfair advantage on the claimant or injures other creditors and subordination is not inconsistent with any other provision of the Bankruptcy Code.[137] While many different types of conduct may lead to equitable subordination, courts pay careful attention to cases in which a corporate insider asserts a claim against the bankrupt corporation. If the insider has misused the corporate form for improper advantage, perhaps by failing to provide the corporation with proper capital, the court may subordinate the insider's claim.[138]

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133. *See supra* notes 55-57 and accompanying text. If a third party who is liable with the debtor pays the creditors the amount owed after the filing of the bankruptcy petition, the third party may have a claim against the bankruptcy estate for indemnity or contribution. 11 U.S.C. § 502(e)(2) (1988). If the third party wishes, it can subrogate its rights to those of the creditors it paid instead of asserting its own independent claim for indemnity or contribution. 11 U.S.C. § 509 (1988). In both cases, however, the third party's claim may be subject to subordination under section 510. 11 U.S.C. § 509(b)(1)(C) (1988). Until the third party's liability to the creditors is fixed, however, the bankruptcy trustee can deny the third party's claim for indemnity or contribution. 11 U.S.C. § 502(e)(1)(B) (1988); *see also In re* Provincetown-Boston Airlines, Inc., 72 B.R. 307 (Bankr. M.D. Fla. 1987) (underwriters' claims for indemnity arising out of securities fraud claims were contingent and properly denied under 502(e)(1)(B)); 3 COLLIER ON BANKRUPTCY ¶¶ 502.05, 509.02-.03 (1991) (Lawrence P. King ed., 15th ed. 1991). At least one commentator has criticized the power of the bankruptcy trustee to deny these claims because it unfairly denies claim holders of the right to participate in the bankruptcy process simply to expedite the estate's distribution. *See* Donald E. Korobkin, *"Killing The Husband": Disallowing Contingent Claims for Contribution or Indemnity in Bankruptcy*, 11 CARDOZO L. REV. 735 (1990).

134. *See* 3 COLLIER ON BANKRUPTCY, *supra* note 133, ¶ 510.02.

135. *Id.*

136. *See* 11 U.S.C. § 510(c) (1988) (providing that under principles of equitable subordination, the bankruptcy court may subordinate all or part of an allowed claim to all or part of another allowed interest); Benjamin v. Diamond (*In re* Mobile Steel Co.), 563 F.2d 692 (5th Cir. 1977); Malissa K. Stull, Annotation, *Bankruptcy: Equitable Subordination, Under 11 USCS § 510(c)(1), of Federal Tax Claims*, 102 A.L.R. FED. 867 (1991).

137. *See* 11 U.S.C. § 510(c) (1988); *Benjamin*, 563 F.2d 692; Stull, *supra* note 136.

138. In Machinery Rental v. Herpel (*In re* Multiponics, Inc.), 622 F.2d 709 (5th Cir. 1980), the court subordinated a corporate director and sole shareholder's claim against the

In *Caplin*, Justice Douglas would have denied or subordinated Marine Midland's subrogation claim because the success of the bankruptcy trustee's action depended on a showing of Marine Midland's bad faith.[139] Similarly, if creditors have an alter ego cause of action against a controlling shareholder of a debtor corporation because of that shareholder's inequitable conduct, the shareholder would not have an allowable claim against the bankruptcy estate resulting from those creditors' claims. In these cases, an action brought by the bankruptcy trustee against the third party will serve to maximize assets available to pay creditors. To deny the bankruptcy trustee the ability to assert claims on behalf of creditors against third parties in all cases because the third parties will sometimes have a claim against the bankruptcy estate seems inconsistent with the policy favoring maximization of assets available to pay creditors.

Courts may achieve the same policy objective of asset maximization by permitting the creditors themselves to decide whether the trustee can assert the claim. The Bankruptcy Code could allow the trustee to assert claims against third parties that the creditors voluntarily assign if the trustee deems that assertion of the claim is in the best interest of the estate. The trustee could then assert the claims on behalf of the assigning creditors, and to the extent the trustee recovers funds, the assigning creditors' claims against the estate would correspondingly deminish.[140]

A rule permitting voluntary assignment of claims would eliminate squabbling between creditors and the trustee over which party is entitled to assert the claim. Such a rule probably favors creditors with claims against third parties because they may decide whether to assert the claim themselves or assign it to the trustee. Allowing the individual creditors to assign their claims to the trustee, however, would leave estate asset maximization to happenstance; some creditors may not assign their claims to the trustee, opting to assert the claim them-

corporation to claims of other creditors because the corporation was undercapitalized. The director and sole shareholder's claim arose from guarantees given by the director and shareholder of the bankrupt corporation's debt. The court believed that the undercapitalization was a cause of the corporation's failure and that the payments on the guarantees made by the director and sole shareholder were actually belated contributions to the corporation's capital. The undercapitalization was inequitable and harmed the corporation's creditors. *See also* Pepper v. Litton, 308 U.S. 295 (1939) (subordinating the dominant stockholder's claim because of fraudulent activity designed to harm the debtor corporation's shareholders); 3 COLLIER ON BANKRUPTCY, *supra* note 133, ¶ 510.05[4].

139. Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416, 430 (1972).

140. At least one court has held that the trustee's powers do not include the ability to assert claims for damages against third parties, even if the creditors assign their claims to the trustee. *See* Williams v. California First Bank, 859 F.2d 664 (9th Cir. 1988).

selves.[141] Other creditors may wait for recovery from the estate and then proceed for any deficiency against the third party.[142] Unless all creditors with claims against third parties assign their claims to the trustee, fewer assets will be available for all creditors.[143] In addition, a voluntary assignment rule is not as desirable as a rule giving the trustee authority to assert claims without assignment in two other aspects: voluntary assignments do not lead to equitable sharing of assets among creditors,[144] and are not as effective in preventing multiple litigation and its costs because the trustee would assert some claims and individual creditors would assert others.[145]

Another way to maximize assets is to require that creditors with claims assertable against both the estate and a third party first pursue the claim against the third party. Such a rule is similar to the equitable doctrine of marshaling assets and makes additional assets of the debtor available to pay creditors who do not have claims against third parties.[146] For example, if a creditor or group of creditors has a claim

141. The *Caplin* majority suggested that the aggrieved creditors could reduce the amount of their claims against the estate by pursuing the liable third parties. 406 U.S. at 431-34. This leaves property available to satisfy other creditors. For example, if the disappointed investors in the introductory hypothetical all successfully asserted their claims against the bank, this reduces claims against the debtor. The estate would then pay the creditors with the remaining debtor's assets. The problem with this approach is that the trustee cannot force the creditors to sue the third party, and cannot easily monitor the progress of individual suits by creditors against the third party. Some creditors may be unaware of a possible action against a third party, and may simply file a claim in bankruptcy. Others may not find it worthwhile to sue a third party, and will pursue the easier, albeit possibly less lucrative, course of filing a bankruptcy claim. Relying on the individual creditors to assert their claims against the third party will not necessarily maximize the assets available to pay all of the debtor's creditors in bankruptcy.

Justice Douglas noted the additional possibility that the individual bondholders could form a committee to proceed against the indenture trustee, accomplishing the same result as if the bankruptcy trustee had asserted the claim. He noted, however, that such concerted assertion of a claim should not be left to "happenstance." *Id.* at 439.

142. *See supra* notes 126-31 and accompanying text.

143. Assume that a debtor has four creditors, each with a claim of $1,000. Assume that the debtor's assets are only $1,000. Assume that two out of the four creditors' claim against the debtor arose out of a fraudulent sale of securities by the debtor in which a promoter of the debtor is also liable. If the bankruptcy trustee may assert the claim against the promoter and does so successfully, two of the four creditors claims will be satisfied. The other two creditors will receive $500. If the trustee may not assert the claim, the four creditors will receive only $250 from the estate, and the two creditors with claims may proceed against the promoter for the deficiency.

144. *See infra* notes 154-55 and accompanying text.

145. *See infra* notes 185-88 and accompanying text.

146. Under the doctrine of marshaling assets, if one creditor is entitled to resort to all funds for satisfaction of its claim, and a second creditor is entitled to resort to some, but not all, of those funds, the first creditor is first required to satisfy its claim using those funds to which the second creditor has no claim. The marshaling doctrine does not apply if it will impair the right of the first creditor to complete satisfaction or harm third parties. For a discussion of the

against the bankruptcy estate that is also assertable against the controlling shareholder of the debtor on an alter ego theory, the creditor(s) could be required to assert the alter ego claim before asserting their claim against the limited assets of the debtor corporation.

The problem with such a rule is that it would prejudice creditors with claims against third parties by forcing them to assert claims that might have questionable merit before asserting a claim against the estate. If the claim lacks merit, the creditors will have expended significant time and money in pursuing it. Further, administration of the estate stalls while creditors assert their claims against the third parties; ultimate distribution of assets could not be determined until those claims are resolved. Assertion of the individual claims can also be more costly because each creditor would bring its own suit rather than a unified action brought by the trustee. In many of these cases, it is simply more efficient to have the bankruptcy trustee assert the claim, and such actions can bring substantial additional assets into the bankruptcy estate.

C. *Equitable Distribution of Debtors' Assets*

This Part examines whether permitting the trustee to assert damages claims on behalf of creditors against third parties would lead to a more equitable distribution of the debtor's assets and a greater recovery of creditors' claims. As noted, pro-rata distribution of assets among creditors within the same priority class is one of the fundamental tenets of bankruptcy. This practice is based on the commonsense notion that similarly situated creditors should be treated similarly.[147] Thus, one creditor will not bear the entire loss resulting from the debtor's insolvency while others are paid in full.

1. THE TRUSTEE'S POWERS

Since colonial times, state and federal insolvency laws have reflected the policy of spreading the risk of loss from insolvency

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use of marshaling in bankruptcy proceedings, see Moses Lachman, Note, *Marshaling Assets in Bankruptcy: Recent Innovations in the Doctrine*, 6 CARDOZO L. REV. 671 (1985).

147. *See* Max Radin, *The Nature of Bankruptcy*, 89 U. PA. L. REV. 1 (1940); Morris G. Shanker, *The Abuse and Use of Federal Bankruptcy Power*, 26 CASE W. RES. L. REV. 3, 28 (1975); Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 791 (1987).

Professor Baird notes that there are other ways to distribute the debtor's assets, such as dividing the amount available by the number of creditors. The impact of this type of distribution would be to favor smaller lenders, which would encourage creditors to extend only small amounts of credit. The debtor would then have many creditors instead of a few. Under another type of repayment system, creditors would have to spend time trying to position themselves favorably with respect to other creditors. *See* Douglas G. Baird, *Avoiding Powers Under the Bankruptcy Code*, A.L.I.-A.B.A. CONF. ON BANKR. 305, 307-08 (1988).

among creditors generally in order to prevent the collapse of any one creditor, which could in turn lead to more widespread failures.[148] As a simple example, assume that a debtor owes $1,000 to each of ten similarly situated creditors, but has only $5,000 in assets. Without bankruptcy, five of the creditors might be able to recover in full, leaving the other creditors unpaid. This result may be disastrous to the five unpaid creditors, who in turn might now have to file for bankruptcy. Under bankruptcy policy, the debtor's assets are distributed pro-rata so that each creditor recovers $500, or fifty cents on the dollar.[149] Because a pro-rata recovery may still be disastrous to the creditors who need to recover more than a pro-rata share in order to remain solvent, it is hard to determine whether the spreading of the risk of a debtor's insolvency is beneficial to creditors as a whole. It is difficult, however, to imagine another system of distribution that would be more efficient or equitable.[150]

The bankruptcy trustee's power to avoid preferential transfers leads to a more even distribution of assets among creditors. Outside of bankruptcy, a debtor generally may prefer one creditor over another.[151] But if the debtor makes payments to creditors for antecedent debts within certain specified periods of the commencement of the bankruptcy proceeding, the payments may be recovered by the bankruptcy trustee.[152] Without this preference power, favored creditors would retain the funds paid by the debtor before bankruptcy and there would be less to distribute in the bankruptcy proceeding. Yet it is uncertain whether the preference power is effective because creditors may still seize assets if they think that they can get away with it; the worst that will happen is that they will be required to hand the assets over to the trustee.

Further, it is difficult to tell exactly when a debtor will file for bankruptcy and thus whether the debtor's transfer of assets is preferential.[153] Nevertheless, in some cases the preference power provides

148. *See* PETER J. COLEMAN, DEBTORS AND CREDITORS IN AMERICA 12-13 (1974).

149. *See* 11 U.S.C. § 726(b) (1988). In this hypothetical, each of the creditors is owed the same amount of money, so each receives the same amount in bankruptcy. If one creditor was owed $1,500 and another was owed $750, the one owed $1,500 would receive $750 while the one owed $750 would receive $375.

150. *See* Baird, *supra* note 147, at 307-08.

151. For example, California Civil Code § 3432 provides that a "debtor may pay one creditor in preference to another, or may give to one creditor security for the payment of his demand in preference to another." CAL. CIV. CODE § 3432 (West 1970).

152. *See supra* note 96.

153. Some studies indicate that the power to avoid preferences is fairly ineffective anyway because many estates have few, if any, assets available for distribution. It may also be the case that debtors can more efficiently distribute assets among creditors than the bankruptcy system. *See* Bowers, *supra* note 1.

incentives for creditors to work with the debtor rather than force the debtor into premature bankruptcy; if there is substantial certainty that seizure of assets will be preferential, it may be better to let the debtor keep the assets and try to work out an arrangement in which creditors will be paid off over a period of time.[154] Perhaps more important, the preference power subjects more of the debtor's assets to the bankruptcy pro rata system of distribution and thus results in a more even distribution of those assets among creditors.

Permitting the trustee to assert claims on behalf of creditors rather than leaving it up to the individual creditors to assert their own claims would tend to equalize recovery among creditors and lead to the spreading of risk. Returning once again to the alter ego cases, assume that creditors have claims they can assert against a debtor corporation and the debtor corporation's controlling shareholder. Remaining assets of the corporation are insignificant. The debtor owes each creditor a different amount of money. Assume that the alter ego claim is not property of the bankruptcy estate, and that the bankruptcy trustee is barred from asserting the claim under *Caplin*.

The creditors owed the larger amounts are likely to have a more sophisticated knowledge of debtor/creditor law and corporation law and can easily proceed against the controlling shareholder. Accordingly, these larger creditors are more likely to settle with the controlling shareholder. Thus, by the time that the smaller creditors assert their actions against the shareholder, the shareholder is more likely to be insolvent. Under this scenario, the larger creditors will receive a much larger recovery while the smaller creditors will be forced to look to the meager assets of the corporation's bankruptcy estate and perhaps the shareholder's individual bankruptcy estate.[155] A similar result arises if the only claims that could be asserted by the bankruptcy trustee were those voluntarily assigned by creditors; those creditors not assigning their rights might be able to strike a settlement allowing them a greater share of assets. A more equitable result occurs if the trustee of the corporation's bankruptcy estate is permitted to assert the alter ego actions on behalf of all the creditors.

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154. In the context of Dean Jackson's fishing hypothetical, the preference avoidance rules permit people to continue fishing a little bit longer and, hopefully, catch more fish overall. *See supra* notes 91-97 and accompanying text.

155. If the settlements with the larger creditors occur within the preference period of the shareholder's filing of the bankruptcy petition, the smaller creditors may be able to force the larger creditors to disgorge their settlements. However, since the normal preference period is 90 days, the larger creditors may have been paid outside the preference period and the smaller creditors may have no recourse. *See supra* note 94 and accompanying text.

2. DISTRIBUTION OF THE PROCEEDS

Who should share in the proceeds of the trustee's successful claim against a third party if not all creditors could assert the claim outside of bankruptcy? Consider the fraud hypothetical, discussed in the introduction, in which not all of the creditors could assert the fraud cause of action against the bank. Proposed section 544(c) provided that anything recovered by the trustee under that section would be distributed only to those creditors who could have asserted the claim outside of bankruptcy.[156] Arguably, the proposed distribution rule is contrary to bankruptcy policy; certainly, it is contrary to the distribution of proceeds from other actions by the trustee, in which all creditors may share in the proceeds based on their bankruptcy priority.[157] Was the proposed distribution rule under section 544(c) appropriate, or would it have led to an inequitable sharing of assets among only select creditors?

The rule for the distribution of proceeds from trustee avoidance actions dates back to the frequently criticized case of *Moore v. Bay*.[158] In that case, the bankruptcy trustee sought to step into the shoes of an unsecured creditor and, under former section 70(e), avoid a security interest that was avoidable under then-existing California law.[159] Writing for the Court, Justice Holmes held that the trustee was not limited to the amount of the claim to which he was subrogated; the entire security interest could be avoided even though actual creditors could only partially avoid it outside of bankruptcy. The Court characterized the avoided property interest as being for the benefit of the entire bankruptcy estate.[160] The proceeds of the avoided security interest were then shared both by creditors who could have and those who could not have avoided the security interest outside of bankruptcy. The rule of *Moore* continues under the current Bankruptcy

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156. *See supra* note 65.

157. *See infra* note 161 and accompanying text.

158. 284 U.S. 4 (1931). For a thorough discussion of the background and criticism of the case, see Jackson, *supra* note 98, at 742-50 (suggesting an alternative interpretation of the case); *see also* Frank R. Kennedy, *The Trustee In Bankruptcy As a Secured Creditor Under the Uniform Commercial Code*, 65 MICH. L. REV. 1419 (1967) (criticizing the case).

159. Under current law, the trustee cannot use section 544(b) to avoid security interests because unsecured creditors cannot take priority over unperfected security interests. U.C.C. § 9-301(1) (1989).

160. Dean Jackson proposes that the Supreme Court simply intended to overrule the lower court (the Ninth Circuit) on the issue of whether the entire estate was to benefit from the avoided transfer. The Court may not have intended to overrule the Ninth Circuit's holding that the trustee could only avoid the transfer to the same extent as the actual creditors whose avoidance claim the trustee was asserting. Dean Jackson notes that the "virtually universal" reading of *Moore* is that the trustee could avoid the transfer entirely and that the money recovered was for the benefit of the entire estate. *See* Jackson, *supra* note 98, at 744-48.

Code.[161]

Assume that the bankruptcy trustee could assert the hypothetical fraud claim and that the *Moore* rule applies to the distribution of the proceeds. Under the distributional rule of *Moore*, creditors other than the defrauded investors can share in the proceeds of the fraud claim along with the investors. Arguably, the creditors other than the investors receive a windfall from the bankruptcy process because they are able to assert a right to proceeds in bankruptcy that they could not reach outside of bankruptcy. Certainly, the defrauded investors are worse off in bankruptcy because they must share the proceeds of their claim with creditors who were not defrauded.[162] This windfall effect may encourage inefficient use of the bankruptcy process[163] because the creditors who gain from the windfall may prefer to force the debtor into bankruptcy rather than attempt to work with the debtor outside of bankruptcy.

Bankruptcy law operates together with non-bankruptcy debtor and creditor rules in determining the relationships of creditors inter se and the relationship of creditors to debtors.[164] In collecting a debt, a creditor can attempt to enforce the obligation in the appropriate state court. In some situations, the creditor may be able to force the debtor into bankruptcy and resort to the collection procedures utilized in bankruptcy court.[165] To a great extent, bankruptcy law defers to non-bankruptcy debt-collection law in determining whether a creditor has an enforceable claim against the debtor and the extent to which some

161. *See* 11 U.S.C. § 551 (1988). At the time Congress was considering the Bankruptcy Code, the Commission on the Bankruptcy Laws of the United States recommended overruling *Moore*. The Commission was opposed by the National Bankruptcy Conference, which asserted through Professor Countryman that the avoiding powers should be exercised for the benefit of all creditors, not simply for those few who might have been able to assert a claim outside of bankruptcy. The views of the National Bankruptcy Conference ultimately prevailed. *See* Jackson, *supra* note 95, at 748-49.

162. Assume that 25 creditors hold the securities fraud claim against the third party and that the aggregate amount of the claim is $50,000. Assume also that 30 other creditors (e.g., suppliers) hold claims against the estate, and that outside of bankruptcy these creditors would not be able to assert the securities fraud claim. All of the creditors are classified as general unsecured creditors and are not entitled to any priority. Under *Moore*, if the trustee asserts the $50,000 claim and recovers, the proceeds will be distributed on a pro rata basis both to the 25 creditors who could have asserted the claim outside of bankruptcy and to the 30 who could not.

163. *See* Jackson, *supra* note 98, at 749-50.

164. *See* Theodore Eisenberg, *Bankruptcy Law in Perspective*, 28 UCLA L. REV. 953, 955-59 (1982); *see also* Countryman, *supra* note 114; Shanker, *supra* note 147.

165. A debtor may effectively be forced into bankruptcy if creditors refuse to extend additional credit necessary for the running of a business or if creditors aggressively begin to collect outstanding indebtedness. In some cases, creditors may force a debtor into bankruptcy through the filing of an involuntary petition. 11 U.S.C. § 303 (1988).

creditors have priority over other creditors.[166]

If bankruptcy law alters these relationships, there will be incentives for parties to attempt to have disputes resolved where the rules are more favorable to them.[167] This could result in an inefficient use of the bankruptcy forum in cases that would be more efficiently handled outside of bankruptcy. Recognizing this potential disparity, several commentators have argued that bankruptcy distributional rules should differ from non-bankruptcy rules only if there is a bankruptcy policy that mandates the difference.[168] Since the *Moore* distributional rule does not significantly add to the amount of assets available to distribute among creditors, it may not be justified.

The *Moore* distributional rule does have its defenders.[169] They argue that the trustee works on behalf of all creditors, not just those who have claims against third parties. Permitting only some creditors

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166. *See* Butner v. United States, 440 U.S. 48 (1979); JACKSON, *supra* note 80, at 20-27.

167. *See* Baird, *supra* note 80, at 825-28 (1987); Eisenberg, *supra* note 164, at 957-59.

168. An example of a defensible difference between non-bankruptcy law and bankruptcy law is the rule regarding preferences. Debtors are allowed to prefer one creditor over another outside of bankruptcy, but are not allowed to make such preferential payments in the time immediately preceding the bankruptcy proceeding. *Compare* CAL. CIV. CODE § 3432 (West 1970) (expressly permitting preferential payments outside of bankruptcy) *with* 11 U.S.C. § 547 (1988) (permitting the bankruptcy trustee to avoid preferential payments). This difference between bankruptcy and non-bankruptcy law is defensible because permitting preferences before bankruptcy would encourage a race among creditors once insolvency was detected, leaving little for the bankruptcy estate. *See* Charles Seligson, *The Code and the Bankruptcy Act*, 42 N.Y.U. L. REV. 292 (1967); JACKSON, *supra* note 80, at 124 (deeming preference law "part and parcel of the substitution of collective remedies for individual remedies"); Eisenberg, *supra* note 164, at 963.

One area in which bankruptcy law's difference from non-bankruptcy law has been criticized is in the treatment of security interests in after-acquired collateral (i.e., collateral acquired by the debtor after the initial grant of the security interest). *See, e.g.*, Eisenberg, *supra* note 164, at 958-71. Secured parties generally may obtain security interests in after-acquired collateral, while under bankruptcy law the trustee may avoid security interests in some after-acquired collateral that is acquired during the preference period because the transfer of the security interest is deemed to occur at the time the collateral is acquired. *See* U.C.C. § 9-204 (1989); *see also* 11 U.S.C. § 547(c)(5), (e)(3) (1988) (special rules for accounts receivable and inventory). The different bankruptcy treatment has been criticized because it is not justified by the policy supporting preference avoidance generally—deterring creditors from grabbing assets shortly before the bankruptcy filing. The act of obtaining a security interest in after-acquired property (i.e., the execution of the security agreement) is likely to have occurred before the preference period. *See* Eisenberg, *supra* note 164, at 963-71. As a result of this different treatment, secured lenders with after-acquired property clauses have an increased aversion to the debtor's possible commencement of a bankruptcy proceeding, while unsecured creditors may have an increased desire for such a proceeding. *Id.* at 958. *But see* Steven L. Harris, *A Reply to Theodore Eisenberg's Bankruptcy Law in Perspective*, 30 UCLA L. REV. 327, 333-38 (1982) (arguing, among other things, that the Bankruptcy Code's treatment of security interests in after-acquired property was designed to prevent secured parties from manipulating the debtor to improve their position prior to the filing of bankruptcy, a policy that generally supports the power to avoid preferences).

169. *See Hearings*, *supra* note 114, at 4, 7.

to share in the proceeds from the trustee's claim contradicts normally applicable distributional rules when the trustee avoids fraudulent transfers and preferences, which allow creditors who first extended credit after the preference or fraudulent transfer to share in the proceeds of the avoidance with creditors who extended credit beforehand.[170] To permit only those creditors who have claims against third parties to share in the proceeds would effectively make the trustee the private attorney for those creditors.[171]

A rule permitting all creditors to share in proceeds of the trustee's action is also easier to administer.[172] The trustee does not have to distinguish which creditors could have asserted a claim outside of bankruptcy. For example, in a case of fraud it may be difficult to determine exactly how many creditors were defrauded.

It may be inequitable, however, to require creditors who were wronged by a third party to share the proceeds of their bankruptcy claims with creditors who could not assert the claim outside of bankruptcy. The bankruptcy policy favoring equitable treatment of all creditors does not mean that all creditors have the same priority. For example, claims by employees for wages have priority over general unsecured claims.[173] In addition, secured creditors may retain their security interests, making it much more likely that they will be paid in full.[174]

The *Moore* distributional rule should not be extended to further alter non-bankruptcy allocations of proceeds. A creditor who has been defrauded by one of the principal shareholders of the debtor corporation should not have to share proceeds of its claim with a creditor who was never misled and simply took a credit risk that the debtor would be able to pay debts when due. Likewise, a creditor who extended credit to the debtor based on the personal guarantee of a third party should not have to share recovery from that third party

170. *See* Schwartz, Moore v. Bay - *Should Its Rule Be Abolished?*, 29 J. NAT'L ASS'N REF. BANKR. 67 (1955).

171. *See Hearings, supra* note 114, at 4, 7.

172. *Id.*

173. *See* 11 U.S.C. § 507 (1988) (describing priorities); *see also* Warren, *supra* note 80, at 786.

174. Some commentators have questioned whether secured parties should be entitled to a special priority. Others, such as those with personal injury claims, may have a stronger moral claim that they should be paid first. Rather than reflect a societal consensus of which parties should be paid first, the bankruptcy priority rules reflect which groups of claimants have greater political clout. *See* Philip Shuchman, *An Attempt at a "Philosophy of Bankruptcy,"* 21 UCLA L. REV. 403, 444-49 (1973). The utility of secured lending is also the subject of some controversy. *See* Alex M. Johnson, Jr., *Adding Another Piece to the Financing Puzzle: The Role of Real Property Secured Debt*, 24 LOY. L.A. L. REV. 335 (1991).

with other creditors who extended and priced credit solely on the basis of the debtor's creditworthiness.

Proposed section 544(c) did not alter the non-bankruptcy relative entitlements of the creditors.[175] In addition, if the debtor has some assets, even those creditors who are not entitled to share in proceeds of the action against the third party will benefit. For example, if the trustee had successfully asserted the claim on behalf of the debenture holders in *Caplin*, claims against the bankruptcy estate would have been reduced by more than $4 million, leaving remaining creditors a larger share of the debtor's $29.4 million in assets.[176] Although the distributional rule of 544(c) differs from that in *Moore*, permitting the bankruptcy trustee to assert creditors' claims against third parties is consistent with the policy of spreading loss equitably among the debtor's creditors.

D. *Economical Estate Administration*

As noted, one of the goals of bankruptcy is to provide for efficient resolution of claims and speedy distribution of available assets.[177] Permitting the trustee to assert damages claims on behalf of creditors against third parties may not be consistent with that goal. Assertion of the claim may be costly because the trustee would have to hire attorneys and gather the information needed to assert the claim, especially if many creditors are involved with claims based on different operative facts.[178] Further, the distribution of assets might be delayed while the trustee asserted the claim, which in some cases might take several years to resolve.

In some cases, the individual creditors will be in a better position to assert claims than the trustee. If the claim arises out of a number of complicated transactions between a third party and several creditors, those creditors will have greater knowledge of the facts underlying the claim and thus may be in a better position to prosecute. In a complicated securities fraud case in which a third party and a debtor corporation have conspired to defraud investors, some of the investors may have claims against the third party while others may not. The claims may differ—some creditors may have claims based on violation of federal and state securities laws, while others may have claims based on common law fraud and negligence.[179] The third party's rep-

175. *See* proposed 11 U.S.C. § 544(c)(3), *supra* note 65.

176. *See supra* notes 30-31 and accompanying text.

177. *See supra* note 88 and accompanying text.

178. *See* 11 U.S.C. § 327 (1988).

179. The *Caplin* majority noted that individual debenture holders had filed claims against Marine Midland based on theories of liability not asserted by the bankruptcy trustee. Caplin v.

resentations to some of the investors may differ from the ones made to others. All these factors make it difficult and costly for the bankruptcy trustee to determine the facts giving rise to each of the various claims.

Assertion of creditors' claims by the bankruptcy trustee will result in more expenses for the estate. Accordingly, there will be less funds available to pay the debtor's creditors.[180] If the trustee's claim is successful, however, the proceeds of the claim may exceed the expense incurred. Proposed section 544(c) provided that expenses would be paid out of the proceeds of the claim.[181] Of course, the fees incurred will sometimes exceed the amount of recovery even if the claim is successful. Thus, if the bankruptcy trustee may assert damages claims on behalf of creditors, the trustee may to some extent gamble with estate assets in the hope of increasing them.

Because of the difficulties and costs of asserting general damages claims on behalf of creditors, the Bankruptcy Code's distinction between avoidance and damages claims may make sense. Avoidance claims are easier to assert than some general claims for damages.[182] The amount of an avoidance claim is probably easier to determine than the amount of a general claim for damages against third parties because the avoidance claim is limited to the value of the property transferred. For example, under the pre-1988 version of U.C.C. Article 6, the trustee merely had to show that one creditor entitled to notice of the bulk transfer was not properly notified, and the bulk transfer could be avoided in its entirety.[183] The property to be recovered was identifiable and the theory of recovery was clear. In a widespread fraud, however, the amount of damages and the theory of liability are all more difficult to identify. The costs of asserting such a complex claim are also likely to be greater.

Alternatively, in circumstances involving a third party's generalized misconduct that affects a large number of creditors, the trustee may be in the best position to discover the misconduct and assert the

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Marine Grace Trust Co., 406 U.S. 416, 431-32 (1971); *see also supra* notes 44-45 and accompanying text.

180. The bankruptcy trustee may employ attorneys to assist in the administration of the estate. 11 U.S.C. § 327 (1988). The attorneys are entitled to compensation from the estate. 11 U.S.C. § 330 (1988). These types of administrative expenses are entitled to priority in payment over claims of other creditors. 11 U.S.C. §§ 503(b)(2), 507(a)(1) (1988).

181. *See supra* note 65.

182. *See Hearings, supra* note 114, at 7-8 ("Under present § 70e as interpreted in *Moore*, the trustee need identify only one creditor with a provable claim who could have avoided the transfer in order to avoid it for the estate.").

183. *Id.*; *see also* Hull, *supra* note 121, at 707.

claims.[184] For example, if a controlling shareholder has misused the corporate form to such an extent that creditors of the bankrupt corporation have an alter ego action against the shareholder, the trustee may be in the best position to discover the facts giving rise to the action and to assert the claim against the shareholder. If the claims of the individual creditors are not sufficient to justify pursuit by any one creditor, the claim may not be pursued at all except by the trustee. In such situations, the trustee's pursuit of the claim is similar to a class action and may result in a net reduction of claims against the estate which would not result if the claim were left to the individual creditors.[185]

Who should decide whether the trustee is in the best position to assert a claim? Perhaps those creditors who have claims against the third party could vote on whether the trustee should assert the claim. Certainly those creditors are most familiar with the circumstances surrounding the claim, and they are the ones who will be giving up the right to assert it. The trustee, however, is in a better position to determine whether assertion of the claim is in the best interest of the estate as a whole, which includes both creditors with claims against third parties and creditors with claims only against the debtor. The trustee tries to maximize assets available to pay the claims of all creditors, and must decide whether to gamble estate assets by suing third parties. If the creditors with claims against third parties vote against the trustee's assertion of the claim, it is possible that assets will not be maximized for all creditors.[186]

Multiple litigation may be avoided by permitting the trustee to assert the claim. Proposed section 544(c) would have permitted the trustee to bind the creditors in any litigation against a third party.[187]

184. The trustee, through his investigative powers, was able to discover the claim in *Caplin*, but his argument that he was in the best position to assert the claim did not persuade the majority of the Court. Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416, 427-28 (1972). Similar investigative powers exist under Chapter 11 of the Bankruptcy Code. 11 U.S.C. § 1106(a)(3) (1988).

185. Class actions are appropriate where a large number of people have been injured by another person's conduct, when the injury to many of the individuals is not sufficient to justify the litigation costs. The class action permits the joinder of the injured parties at low cost and provides for reimbursement to the individuals prosecuting the action to prevent free riders. *See* Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1 (1991); *see also* Paul C. Wohlmuth, *The Class Action and Bankruptcy: Tracking the Evolution of a Legal Principle*, 21 UCLA L. REV. 577, 598-99 (1973) (arguing that permitting the trustee to assert these claims is consistent with the principles supporting class actions generally).

186. *See supra* notes 127-30 and accompanying text.

187. *See supra* note 65.

The trustee's assertion of claims common to a number of creditors may result in substantial cost savings, and thus additional funds to satisfy creditors. For example, assume that ten creditors have an alter ego claim against the controlling shareholder of a corporate debtor. Assume that it would cost each creditor $10,000 in attorneys' fees to prosecute the claim. If the trustee were allowed to assert the claim on the behalf of creditors, assume that the trustee would incur $20,000 in fees. In this circumstance there is an aggregate saving of $80,000 in fees, which provides a greater recovery for the creditors. Although certain claims may be so complex that it would cost the trustee much more to assert the claim than it would the individual creditors, in cases involving claims based on common facts, it would be in the best interest of creditors to permit the trustee to assert the claim on their behalf.

To some extent, the bankruptcy trustee's claims against third parties may lead to delays in the final distribution of assets of the estate. Until it is determined exactly how much can be recovered from the third party, the debtor's assets should not be distributed to the creditors with the claim against the third party and to other creditors. For example, assume that a debtor has assets of $100,000. There are creditors with claims against both the debtor and a third party in the amount of $500,000 (Group A). The debtor also has other creditors with equal priority with claims solely against the debtor who are also owed $500,000 (Group B). If the trustee decides to assert Group A's claim against the third party, funds must be reserved to prosecute the claim; accordingly, the trustee must wait until the end of the case before the exact amount payable to creditors can be determined.

This problem, however, already exists to some extent, because the trustee is empowered to assert claims on behalf of the debtor against third parties. In some cases, it may be possible to distribute some assets to creditors pending final resolution of the claim. The Bankruptcy Code is not clear regarding the timing of distribution of assets.[188] In our hypothetical, creditors in Group A and Group B would receive approximately ten cents on the dollar if the debtor's

188. "Little, if any, statutory authority covers the nature and mechanisms for distributions to be made in cash or property, tangible or intangible, under a plan of reorganization under Chapter 11 of the Bankruptcy Code." COLLIER BANKRUPTCY PRACTICE GUIDE ¶ 92.02 (Asa S. Herzog & Lawrence P. King eds., 1991). A plan of reorganization can provide for the enforcement by the trustee of a claim owned by the estate. 11 U.S.C. § 1123(b)(3)(B) (1988). The bankruptcy court has broad discretion over the time of distribution of assets in a Chapter 7 liquidation as long as the creditors are paid as promptly as practicable. 11 U.S.C. app. rule 3009 (1988).

assets are distributed while the trustee asserts the claim against the third party, taking into account some assets reserved for prosecution of the claim. If the trustee's claim against the third party is successful, the trustee can distribute the proceeds of the claim among members of Group A and B to place the creditors in the positions they would have held had all the estate's assets been distributed after the lawsuit's completion. If the trustee recovers all that is owed to members of Group A, including attorney's fees, members of Group B would receive twenty rather than ten cents on the dollar. In this case, the significant increase in assets available for creditors justifies the delay in the final distribution.

It cannot fairly be said that in every case administrative difficulties and expense justify denying the bankruptcy trustee the authority to prosecute creditors' claims against third parties. In some circumstances, the trustee can bring substantial assets into the estate while equitably spreading loss and incurring less expense than would the creditors themselves if they separately pursued their own actions.

E. *The Effectiveness of Proposed Section 544(c) in Properly Balancing Bankruptcy Policies*

The drafters of proposed section 544(c) sought to empower the trustee to assert claims in order to further the policies of asset maximization and equitable distribution. The drafters specifically declined to empower the trustee to assert a claim if it was likely that the third party would be able to counter-claim against the estate for an equivalent amount. Otherwise, the drafters provided little guidance about which claims should be asserted: the claim could be asserted if it was in the "best interests of the estate." This Part examines whether the drafters could have provided better guidance to the trustee as to when claims should be asserted, or whether this is a circumstance in which an unclear rule best furthers the drafters' intentions.[189]

If we assume that there are some cases in which the bankruptcy trustee should be empowered to assert claims on behalf of creditors, it is necessary to examine whether proposed section 544(c) went far enough in defining such cases. The proposal did suggest that a claim that would result in an allowable claim asserted by the third party

189. For a discussion of the never-ending conflict between clear rules that compel predictable decisionmaking and more flexible rules that provide less predictable (but perhaps more equitable) results, see Carol M. Rose, *Crystals and Mud in Property Law*, 40 STAN. L. REV. 577 (1988).

against the estate would *not* be in the best interest of the estate.[190] The proposal did not permit the trustee to assert claims in those cases even if the third party's claim would be equitably subordinated to the claims of others because of the third party's wrongdoing.[191] In those cases, assertion of the claim arguably benefits the vast majority of participants in the estate and the claim of the third party would properly result in little recovery, if any.

Consider, for example, the claim of the debenture holders in *Caplin v. Marine Midland.* If the trustee was permitted to sue the indenture trustee Marine Midland on behalf of the debenture holders and succeeded in showing that the indenture trustee had acted in bad faith in failing to monitor the debtor's conduct, Marine Midland's inequitable behavior might have caused the bankruptcy court either to deny or subordinate its claim.[192] Bad faith failure to make certain that the debtor had lived up to its commitment not to incur excessive indebtedness arguably harmed the company to the detriment of all creditors. If the court allowed Marine Midland's claim against the estate but subordinated it to the claims of other unsecured creditors, those creditors would still benefit from the trustee's assertion of the claim. Even though the estate would not obtain a net benefit from the trustee's actions because technically Marine Midland would have a claim in equal amount to the claim of the debenture holders, it still may make sense for the trustee to sue because the "innocent" creditors would receive larger payments from the estate.[193]

The proposed statute did not make clear whether assertion of a claim might not be in the best interests of the estate because of admin-

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190. *See* proposed 11 U.S.C. § 544(c)(1)(C), *supra* note 65.

191. *See supra* notes 132-37 and accompanying text.

192. *See* Caplin v. Marine Grace Trust Co., 406 U.S. 416, 440 (1972) (Douglas, J., dissenting).

193. In determining whether claim assertion is in the best interest of the estate as a whole, the trustee must consider whether the creditors holding the claim against the third party also hold claims against the bankruptcy estate that are already subordinated. For example, subordinated debentures may provide that their holders will be paid only after all other creditors. In bankruptcy, the holders of subordinated debentures cannot improve their position to one of general unsecured creditors by attempting to assert securities fraud claims, because those types of claims are subordinated to claims of general unsecured creditors. *See* 11 U.S.C. § 510(b) (1988); Kira v. Holiday Mart, Inc., 715 F.2d 430 (9th Cir. 1983). Asserting fraud claims on behalf of subordinated debenture holders will not help the position of other unsecured creditors who already have priority.

By contrast, holders of unsubordinated notes have claims that are on a par with general unsecured creditors. *See In re* Blondheim Real Estate, Inc., 91 B.R. 639 (Bankr. D.N.H. 1988) (holding that section 510(b) does not require subordination of claims by noteholders for money due). The trustee may be able to help other unsecured creditors if the trustee can assert those claims held by noteholders against third parties that reduce the amount owed by the bankruptcy estate to the noteholders.

istrative difficulties. As noted, some claims may involve so many different factual scenarios for so many different creditors that it would be excessively costly for the trustee to assert the claim. Success in asserting some claims may be problematic either because the third party has a good defense to the creditors' claims or because the third party is itself insolvent. If a disputed claim of liability is complex, the suit will substantially delay the administration of the estate. In other cases, the cost of pursuing the claim may be great and the chances of success may be questionable. In those cases, if the trustee unsuccessfully asserted the claim, the administrative costs would erode the assets available to pay creditors and result in a net loss to the estate. Thus, assertion of the claim would not be in the best interests of the estate. A statute empowering the bankruptcy trustee to assert claims should perhaps describe such limitations to the power.

Another question that arises with respect to proposed section 544(c) is whether the trustee should assert claims on behalf of some creditors if no assets are available for other creditors. For example, assume that a debtor has no assets to distribute while having four creditors with claims aggregating $100,000, which are also assertable against a third party, and other creditors with claims aggregating $500,000. In such a case, action by the trustee will not benefit the majority of creditors holding claims; they receive nothing whether the trustee asserts the claim or not. In this situation, the individual creditors should be allowed to sue the third party outside of bankruptcy. Alternatively, if a substantial number of creditors hold a claim against a third party, the bankruptcy policy favoring equitable sharing of loss might support the bankruptcy trustee's assertion of the claim even though the debtor has no assets available to pay others with claims against the estate.

Section 544(c) did not provide much guidance for determining what is in the "best interests of the estate," nor did it expressly provide for judicial oversight of the trustee's decision of whether to assert a claim on behalf of creditors. Perhaps it is best simply to leave the decision of whether to assert a claim in the sound discretion of the bankruptcy trustee. The trustee already has broad powers to investigate the affairs of the debtor and to recover the debtor's assets.[194] In some cases, however, the court has the power to review actions taken by the trustee.[195]

194. *See* 11 U.S.C. §§ 704, 1106 (1988) (detailing the powers of the bankruptcy trustee in liquidation and reorganization).

195. For example, the court reviews a decision to abandon property that is of inconsequential value and benefit to the estate. 11 U.S.C. § 554 (1988).

With so many factors to consider in determining whether the trustee is in the best position to assert the claim, it is likely that situations will arise in which creditors or third parties will disagree with a trustee's decision that the suit is in the overall best interest of the estate. The individual creditors should be allowed to go into court and seek a determination that they, not the trustee, are in a better position to assert the claims themselves, or at least assist in the suit, because of their superior knowledge of the facts underlying the claim. Because the trustee, rather than the individual creditors or the court, is generally in the best position to determine whether assertion of a claim would benefit creditors of the estate as a whole, courts should not overturn the trustee's decision unless it is clearly contrary to statutory authority.

If the Bankruptcy Code is changed to permit the trustee to assert damages claims on behalf of creditors against third parties, the trustee's failure to sue should not preclude the individual creditors from asserting the claim. Some cases have held that the bankruptcy trustee's failure to assert a claim of avoidance on behalf of creditors under section 544(b) bars the individual creditors from proceeding since the claim is property of the bankruptcy estate.[196] Although it makes sense to vest the exclusive right to assert bulk sales and fraudulent transfer claims in the trustee because such claims belong in bankruptcy to all creditors of the estate, damages claims against third parties may not belong to all creditors, and it may not make sense for the trustee to assert such claims. Proposed section 544(c), which provided that the court could stay actions brought by individual creditors if the trustee decided to assert the claim, should have explicitly provided that the trustee's failure to assert damages claims against third parties does not preclude the individual creditors from asserting them.

Any proposal requiring a balance of the various factors supporting or opposing the assertion of a claim can be criticized as a murky rule requiring analysis on a claim-by-claim basis. Such a rule would bring uncertainty and expense to bankruptcy administration, because creditors, trustees, and third parties may dispute whether the claim is one which should be asserted by the trustee. A more certain rule, however, such as one prohibiting the trustee from asserting claims on behalf of creditors, gives too much weight to some policies and no weight to others. Are the costs incurred in litigating the issue of the

196. *See In re* Mortgage America Corp., 714 F.2d 1266 (5th Cir. 1983) (holding that fraudulent transfer action was property of the bankruptcy estate and could only be asserted by bankruptcy trustee); *In re* Munoz, 111 B.R. 928 (Bankr. D. Colo. 1990) (holding that fraudulent transfer action was property of the estate and could not be asserted by creditor after debtor's discharge).

trustee's standing to assert claims under an uncertain rule outweighed by the benefits of the trustee's additional assertion of claims? As it is, under the more "certain" rule provided by *Caplin*, litigation still occurs over the trustee's standing to assert claims, because questions arise under state law over whether a claim belongs to the debtor or to the creditors.[197] It is probably worthwhile to experiment with a more flexible rule and see if it is administratively operable. Only a discretionary rule with operative guidelines provides hope that competing policies will be balanced in a given case.

In sum, Congress was on the right track when it considered giving the trustee authority to sue third parties on behalf of creditors, although there should have been more guidance about what constitutes "the best interests of the estate." The proposal should have indicated that it may be in the best interests of the estate to sue if any possible claim by the third party against the estate would be subordinated to claims of the other creditors. In addition, the statute should have indicated that some cases may be so complex that they must be left to individual creditors to pursue. The trustee should not assert claims unless other creditors besides those holding claims will benefit or a large number of the estate's creditors will share in the proceeds. There should be some judicial oversight so that interested parties can participate in the decision of whether the trustee should assert a claim.[198]

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197. *See supra* notes 103-17 and accompanying text.

198. A better version of a section 544(c) might read as follows (additions are italicized):

> (c)(1) The trustee may enforce any cause of action that a creditor, a class of creditors, an equity security holder, or a class of equity security holders has against any person, if—
>
> (A) the trustee could not recover against such person on such cause of action other than under this subsection;
>
> (B) recovery by the trustee for the benefit of such creditor or equity security holder or the members of such class will reduce the claim or interest of such creditor or equity security holder or of such members, as the case may be, against or in the estate;
>
> (C) there is a reasonable likelihood that recovery against such person will not create an allowable claim in favor of such person against the estate *that is not reasonably likely to be subordinated to the claim of all or part of another allowed claim*; and
>
> (D) enforcement of such cause of action is in the best interest of the estate. *In determining whether enforcement of such cause of action is in the best interest of the estate, the following factors shall be considered—*
>
> *(i) whether it is probable that enforcement of the claim will be successful;*
>
> *(ii) whether it is probable that the administrative expense in asserting the claim will be exceeded by the recovery;*
>
> *(iii) whether the facts and theories of liability underlying the claim are sufficiently common to all creditors and equity security holders who are*

To illustrate how current law works and to compare how results might differ under a statute approximating section 544(c), Part IV considers the trustee's standing to assert bulk sales claims under the revised Article 6 of the U.C.C. This analysis is relevant because the drafters of the new Article 6 sought to deprive the trustee of the ability to assert such claims on behalf of injured creditors. The following analysis examines whether the drafters were successful in limiting the trustee's ability to assert bulk sales claims under current law and whether assertion of bulk sales claims would be in the best interest of the bankruptcy estate.

IV. Proposed Section 544(c) and the Trustee's Assertion of Bulk Sales Claims Arising Under New Article 6 of the UCC

The uniform law governing bulk transfers, located in Article 6 of the U.C.C., has recently been revised.[199] The new law, with several exceptions, applies if an entity that is in the business of selling goods from stock sells over 50% of its inventory to a buyer who knows or should know that the seller is going out of business.[200] If Article 6 applies to a transaction, the buyer must notify the seller's creditors

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entitled to assert the claim outside of bankruptcy, such that the trustee is in as good a position to assert the claim as are those creditors and equity security holders; and

(iv) whether assertion of the claim will benefit all or substantially all creditors and equity security holders.

(2) If the trustee brings an action on such cause of action—

(*A*) the clerk shall give notice to all creditors or equity security holders that could have brought an action on such cause of action if the trustee had not done so;

(B) upon objection of any party with an allowed claim or interest or of the party against whom the cause of action is asserted, and after notice and a hearing, the court may order the trustee not to proceed with the action if the court determines that the cause of action is not properly enforceable by the trustee under paragraph (1) of this subsection; and

(*C*) the court, after notice and a hearing, may stay the commencement or continuation of any other action on such cause of action.

(3) A judgment in any such action brought by the trustee binds all creditors or equity security holders that could have brought an action on such cause of action. Any recovery by the trustee, less any expense incurred by the trustee in effecting such recovery, shall be for the benefit only of such creditors or equity security holders. *If the trustee does not assert a cause of action subject to the provisions of this subsection, any creditors or equity security holders who are entitled to bring the action outside of bankruptcy are free to do so.*

See H.R. 8200, 95th Cong., 1st Sess. 416-17 (1977).

199. U.C.C. art. 6, alternative B (1989). Alternative A recommends repeal of Article 6. *See* Fred H. Miller, *The Scope of Uniform Commercial Code Article 6: A Tale of Two Proposals*, 41 ALA. L. REV. 587 (1990).

200. U.C.C. § 6-102(c) (1989). The exceptions are located in U.C.C. 6-103 (1989). Among

either directly or through filing notice before the closing of the transaction.[201] The statute is intended to inform creditors if a debtor-seller is liquidating inventory so that they can protect themselves, perhaps by initiating judicial proceedings against the seller.[202] Failure to give notice may result in the buyer's liability to the seller's creditors.[203] Unlike former law, the new Article 6 does not provide that the sale is ineffective as against the seller's creditors; the remedy under new Article 6 is a damages claim against the buyer.[204]

As previously noted, under the prior version of Article 6 a non-complying bulk transfer was voidable by the seller's creditors.[205] If the seller went into bankruptcy, the seller's bankruptcy trustee could step into the shoes of the seller's creditors and avoid the entire sale.[206] Under *Moore v. Bay*, the trustee could avoid an entire sale on the strength of a creditor holding an insignificant claim, and the recovered assets would benefit the entire bankruptcy estate.[207] Thus, the filing of a bankruptcy petition by the transferor could increase the transferee's liability dramatically. Outside of bankruptcy, only creditors who held claims pre-dating the bulk transfer could avoid the transfer.[208]

The new Article 6 seeks to remedy this perceived injustice by giving aggrieved creditors a personal claim for damages against the non-complying buyer, rather than the right to avoid the sale in rem.[209] The official commentary indicates the drafters' intent to deprive the bankruptcy trustee of a *Moore* right to upset an entire non-complying bulk sale on behalf of creditors holding only insignificant claims.[210]

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the exceptions are sales in which the value of the assets sold exceeds $25,000,000, or the value of the assets net of liens and security interests is less than $10,000. U.C.C. § 6-103(3)(l) (1989).

201. If the seller has or gives a verified statement to the buyer that it has 200 or more claimants, excluding claimants holding claims for employment compensation, the buyer may comply with Article 6 by filing the notice of sale in a central office. U.C.C. § 6-105(2) (1989). Otherwise, the buyer must give notice by sending the notice of sale to known claimants. U.C.C. § 6-105(1) (1989).

202. *See* Hull, *supra* note 121, at 704-05.

203. *See* U.C.C. § 6-107 (1989).

204. A buyer's failure to comply with the requirements of Section 6-104(1) does not (i) impair the buyer's rights in or title to the assets, (ii) render the sale ineffective, void, or voidable, (iii) entitle a creditor to more than a single satisfaction of his (or her) claim, or (iv) create liability other than as provided in this Article.

U.C.C. § 6-107(8) (1989).

205. *See* U.C.C. § 6-105 (1987).

206. *See supra* notes 119-22 and accompanying text.

207. *See supra* notes 158-61 and accompanying text.

208. *See* U.C.C. § 6-109(1) (1987).

209. *See* U.C.C. § 6-107(1) (1989).

210. The change in the theory of liability [from in rem to in personam] in the available remedy should be of particular significance if the seller enters

The question remains whether the trustee retains any power to assert creditor's claims arising out of a defective bulk sale in the event of the seller's bankruptcy.

Assuming *Caplin* is still good law, the trustee could not argue that the claim belongs to the debtor outside of bankruptcy because the seller of goods in bulk does not have a claim against the buyer for failure to comply with Article 6. Thus, the bankruptcy trustee could not assert the claim under Bankruptcy Code section 541 as property of the estate.[211] Article 6 claims belong to injured creditors,[212] and any power that the trustee might have would arise out of the "strong arm clause" of section 544(a), or under the subrogation clause of section 544(b).[213]

Although the "strong arm clause" gives the trustee the rights and powers of hypothetical creditors who extend credit at the commencement of the bankruptcy case,[214] the trustee could not challenge a non-complying bulk sale under this provision because not all creditors can challenge a defective bulk sale. In fact, Article 6 provides that only those who were adversely affected by the failure to give notice may complain.[215] A creditor who extends credit after the bulk sale would have difficulty arguing that the creditor's claim would be less had the buyer complied with Article 6. Presumably, the creditor based its decision to extend credit on the seller's condition after the bulk sale had already taken place.[216] Hence, as a hypothetical creditor extending credit after the defective bulk sale, the bankruptcy trustee could not claim a loss resulting from the failure to give notice of the bulk sale.

Historically, the trustee relied on the subrogation provision[217] to

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> bankruptcy after the sale is consummated. When an aggrieved creditor of the transferor has a nonbankruptcy right to avoid a transfer in whole or in part, as may be the case under Article 6 (1987 Official Text), the transferor's bankruptcy trustee may avoid the entire transfer. *See* Bankruptcy Code § 544(b), 11 U.S.C. § 544(b). Under this Article, a person who is aggrieved by the buyer's noncompliance may not avoid the sale. Rather, the person is entitled only to recover damages as provided in this section. Because no creditor has the right to avoid the transaction or to assert a remedy that is the functional equivalent of avoidance, the seller's bankruptcy trustee likewise should be unable to do so.

U.C.C. § 6-107, cmt. 2 (1989).

211. *See supra* notes 3-4, 101-02 and accompanying text.

212. *See* U.C.C. § 6-107 (1989).

213. 11 U.S.C. §§ 544(a), (b) (1988).

214. *See supra* note 75.

215. U.C.C. § 6-107(1) (1989).

216. "This Article makes explicit what is implicit in Article 6 (1987 Official Text): only those persons as to whom there has been noncompliance are entitled to a remedy." U.C.C. § 6-107 cmt. 3 (1989).

217. The subrogation provision is now codified as 11 U.S.C. 544(b) (1988).

avoid bulk transfers.[218] The new Article 6 clearly seeks to foreclose the ability of the trustee to step into the shoes of aggrieved creditors and avoid defective bulk transfers by making liability of non-complying buyers in bulk personal, rather than allowing avoidance of the bulk transfer.[219] Because the trustee only has the power to avoid transfers that an actual creditor could avoid "under applicable law," and "applicable law," namely Article 6, says that no one can "avoid" a defective bulk transfer,[220] the trustee is unable to assert creditors' claims under any provision of the Bankruptcy Code. Instead, Article 6 defines these claims as personal claims of creditors against the non-complying buyer which, under *Caplin*, the bankruptcy trustee cannot assert.[221]

A creative trustee might argue, with some difficulty,[222] that because the cause of action arises as the result of an improperly noticed transfer of the debtor's property, it should be encompassed within the avoidability of section 544(b).[223] Since recovery is limited to the value of the property transferred,[224] the remedy is the functional equivalent of avoidance. In fact, the statutory remedy under revised Article 6 and the practical remedy under former Article 6 are similar because the trustee or aggrieved creditor normally received the monetary equivalent of the property transferred rather than the property itself.[225] If courts focus on the nature of the wrong rather than the remedy, the trustee may still assert creditors' claims under revised Article 6, because the nature of the wrong remains the same—failure to notify the seller's creditors of an impending bulk sale.

In addition, there are limits to a state legislature's ability to alter the power of a bankruptcy trustee. Whether a cause of action vests in

218. *See supra* notes 119-22 and accompanying text.

219. *See supra* note 210.

220. *See* U.C.C. § 6-107(8) (1989).

221. *See supra* notes 20-58 and accompanying text.

222. Courts generally look to the label of the remedy provided by state law in determining whether a voidable transfer exists. For example, in Dabney v. Chase Nat'l Bank, 201 F.2d 635 (2d Cir. 1953), Judge Learned Hand held that the bankruptcy trustee, acting on behalf of the creditors of the bankruptcy estate, could not recover allegedly improper payments made by the debtor to a third party, because under state law the payments were not transfers of property voidable *ex proprio vigore* ("of its own force"). The payments were voidable only indirectly, and thus the trustee could not assert the claim. *Id.* at 639. Since the drafters of new Article 6 have clearly indicated that sales of goods in violation of Article 6 are not voidable directly, the trustee can only argue that they are indirectly voidable.

223. *See* State Bar of California, Report of the Uniform Commercial Code Committee of the State Bar of California on Proposed Revisions to Article 6 Regarding Bulk Sales 1, 9-10 (July 11, 1988) (unpublished report, on file with the author) [hereinafter U.C.C. Committee Report].

224. *See* U.C.C. § 6-107(4) (1989).

225. *See* U.C.C. Committee Report, *supra* note 223, at 12-13.

the trustee under section 544 is an issue of federal law. In other settings, conflicts between the U.C.C. and the Bankruptcy Code have been resolved in favor of federal law. For example, a question existed for some time whether a security interest in property acquired by the debtor during the preference period but after execution of the security agreement was voidable as a preference in bankruptcy. Some creditors argued that such security interests in property acquired by the debtor in ordinary course were valid because they were "deemed" for new value under U.C.C. § 9-108.[226] Congress ultimately decided the issue by providing that security interests in after-acquired property might be preferences to the extent that the secured party improved its position during the preference period.[227]

Section 544, however, looks to "applicable" non-bankruptcy law in determining the trustee's power.[228] Therefore, the characterization of creditor's remedies under Article 6 should determine the extent of the trustee's remedy inside bankruptcy.[229] If it wanted to, a state legislature could repeal Article 6 and not provide a remedy for creditors in the event of a bulk sale.[230] Alternatively, a legislature could take a less drastic step and alter the available remedy or limit the transferee's liability. Courts should not permit the bankruptcy trustee to avoid non-complying bulk sales under section 544 because of the drafters'

226. Section 9-108 provides as follows:

> Where a secured party makes an advance, incurs an obligation, releases a perfected security interest, or otherwise gives new value which is to be secured in whole or in party by after-acquired property his security interest in the after-acquired collateral shall be deemed to be taken for new value and not as security for an antecedent debt if the debtor acquires his rights in such collateral either in the ordinary course of this business or under a contract of purchase made pursuant to the security agreement within a reasonable time after new value is given.

U.C.C. § 9-108 (1989).

227. 11 U.S.C. § 547(c)(5), (e)(3) (1988).

228. 11 U.S.C. § 544(b) (1988).

229. Courts have carefully scrutinized state legislation that has the effect of modifying rights in bankruptcy proceedings. *See, e.g.*, Cheeseman v. Nachman (*In re* Cheeseman), 656 F.2d 60 (4th Cir. 1981) (a state exemption statute which prohibits one spouse from claiming an exemption in a joint bankruptcy violates federal policy); *In re* Stacey, 24 Bankr. 97 (Bankr. S.D. Cal. 1982) (holding a California statute designed to prohibit exemption "stacking" in bankruptcy, despite prior decisions approving stacking, violated the Supremacy Clause of the United States Constitution); *In re* Lee, 22 Bankr. 977 (Bankr. C.D. Cal. 1982) (same). These cases, however, dealt with statutes having an impact only in bankruptcy, and, thus, are unlike Revised Article 6, which has significant impact on creditors outside of bankruptcy.

U.C.C. Committee Report, *supra* note 223, at 13.

230. The revised Article 6 is Alternative B proposed by the National Conference of Commissioners on Uniform State Laws and the American Law Institute in 1988. Alternative A repeals Article 6. *See supra* note 199.

specific expression that the remedy of aggrieved creditors under revised Article 6 is not avoidance.

Would the result be different under a rule approximating proposed section 544(c)? A bulk sale claim successfully asserted on behalf of non-notified creditors would reduce the claims of those creditors, perhaps freeing additional assets for others. However, successful assertion of the bulk sale claim might not result in a net gain for the bankruptcy estate because a buyer liable for failing to comply with Article 6 who pays the seller's creditors has a claim against the seller.[231] For example, if a buyer in bulk fails to notify creditors, as required by Article 6, and incurs liability to the seller's creditors in the amount of $10,000, and pays that $10,000, the buyer has a $10,000 claim against the seller. In the bankruptcy context, the seller's creditors' claims of $10,000 are simply replaced by the buyer's claim of $10,000. Under proposed section 544(c), the trustee could not assert the claim because of the reasonable likelihood that the third party could assert a claim against the bankruptcy estate.[232]

It may be, however, that the buyer's claim against the bankruptcy estate would be subordinated to claims of other creditors. The new Article 6 exempts from liability non-complying buyers in bulk who either mistakenly believe that Article 6 does not cover the transaction or who inadvertently fail to properly comply, if such mistake or failure is in good faith and is commercially reasonable.[233] The possibility exists that the non-complying buyer might act in concert with the seller to make it even more difficult for the seller's creditors to secure payment. If the buyer knew it had to notify creditors of the sale and willfully opted not to do so, a court could subordinate the buyer's claim for reimbursement to the claims of the harmed creditors.[234] If a new statute empowered the trustee to assert claims against third parties when any corresponding claim by the third party was likely to be subordinated, the trustee might be able to assert some bulk sale claims.

The question remains whether assertion of bulk sales claims would otherwise be in the best interests of the estate. The nature of the claim itself is not inordinately complex. It should not be difficult to determine whether the buyer gave the required notice of sale. Any defense that the buyer might have, such as that it acted with a good faith belief that the sale was exempt, is likely to apply to all creditors

231. *See* U.C.C. § 6-107(10) (1989).

232. *See* proposed 11 U.S.C. 544(c)(1)(C), *supra* note 65.

233. *See* U.C.C. § 6-107 (1989).

234. *See supra* notes 133-39 and accompanying text.

or to none.[235] The burden is on the non-complying buyer to show that the creditors would not have recovered even if the buyer had complied, and the trustee should be able to counter such a defense as well as any individual creditor.[236] It may be that permitting the trustee to assert the claim is the only practical way of assuring that the claim will be asserted at all, because the individual creditors may not have claims large enough to justify pursuing them on an individual basis. Thus, creditors will save significant expenses in having the trustee assert the claim on their behalf.[237] Permitting the trustee to assert the claim will also further the policy of treating like creditors alike through equitable distribution of any proceeds derived from the bulk transfer claim.[238]

Permitting the bankruptcy trustee to assert the bulk sale claim under new Article 6 would not necessarily contradict the intent of new Article 6, at least as long as the trustee is limited to asserting the amount of claims of creditors. Under former law, existence of one creditor with a $50 claim who was not notified could result in a bankruptcy trustee's avoidance of a $100,000 transaction in its entirety. The new Article 6 was intended to limit the liability of the buyer to the amount of harm caused by the failure to comply with Article 6.[239] If the trustee's claim was limited to $50 rather than avoidance of the entire $100,000 sale, it should not make much difference to the buyer whether the trustee or an injured creditor asserts the claim.

A final point worth noting is that in many cases, a non-complying bulk sale may also be a fraudulent transfer.[240] If a buyer acted in bad faith in failing to comply or acted in a commercially unreasonable manner, such conduct may be evidence of a sale with the intent to

235. Revised Article 6 provides a number of defenses that a buyer can assert. The buyer may try to assert that the transaction was exempt from Article 6 under section 6-103. The buyer may assert that, after inquiry, it did not have notice that the seller was going out of business, and that the transaction is not a "bulk sale" under section 6-102. The buyer may also assert that it had a good faith and commercially reasonable belief that the transaction was not subject to Article 6, or that the buyer made a good faith and commercially reasonable attempt to comply with the law. *See* U.C.C. § 6-107(3) (1989).

236. While the creditor has the burden of proving the amount and validity of the claim, the buyer has the burden of showing the amount that the creditor would not have realized if the buyer had complied. U.C.C. § 6-107(2) (1989).

237. *See* U.C.C. Committee Report, *supra* note 223, at 15.

238. *Id.*

239. "Unlike Article 6 (1987 Official Text), which imposes strict liability upon a noncomplying transferee, this Article imposes liability for noncompliance only when the failure to comply actually has injured a creditor and only to the extent of the injury." U.C.C. § 6-107 cmt. 4 (1989).

240. *See* Peter A. Alces, *Fraud Bases of Bulk Transferee Liability*, 63 TEMP. L. REV. 679 (1990); Peter A. Alces, *The Confluence of Bulk Transfer and Fraudulent Disposition Law*, 41 ALA. L. REV. 821 (1990).

defraud creditors or for less than the fair value of the business.[241] The bankruptcy trustee can assert the fraudulent transfer claim under sections 548 or 544. If the trustee is denied the ability to assert the bulk sales claim, it may simply be forced to try to upset the suspect transaction on a fraudulent transfer ground. Therefore, there appears to be little merit in denying the trustee the ability to assert a bulk sale claim that is so closely related to a fraudulent transfer.

In sum, it appears under the current statutory formulation and judicial interpretations of the trustee's powers that the trustee cannot assert creditor's claims under new Article 6. Therefore, those powers should be changed to permit assertion of bulk sale claims, at least as long as any corresponding claim by the buyer would be subordinated to claims of other creditors and the trustee is limited to asserting the amount of actual harm caused by the failure to comply with Article 6.

V. CONCLUSION

The exact scope of the trustee's avoidance powers and ability to sue third parties for damages on behalf of creditors has been subject to controversy and confusion. The statutes and the cases interpreting them are not always consistent with the policies underlying the avoidance powers. The trustee's powers should be amended to permit an inquiry into whether assertion of a specific claim against a third party would maximize assets available to pay creditors generally without imposing an undue administrative burden on the bankruptcy estate. If assertion of a claim would provide a net benefit to the estate, the trustee should have the power to assert it even if it is a claim for damages rather than transfer avoidance.

The Commission on Bankruptcy Laws of the United States properly recommended to Congress that the power of the trustee be extended to assert creditor's claims in the best interest of the estate. Unfortunately, Congress ultimately declined to take the Commission's recommendation. This decision should now be reexamined. While the proposal considered and rejected by Congress should perhaps be changed to provide more guidance to trustees about when a claim should be asserted,[242] a more flexible rule that provides the power to assert some claims for money damages against third parties is preferable to the current rules, which generally limit the trustee to asserting claims of transfer avoidance and claims belonging to the debtor outside of bankruptcy.

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241. *See* 11 U.S.C. § 548(a)(1), (2) (1988).

242. *See supra* note 198 and accompanying text.