The Logical Structure of Fraudulent Transfers and Equitable Subordination

David Gray Carlson
dcarlson@law.miami.edu

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THE LOGICAL STRUCTURE OF FRAUDULENT TRANSFERS AND EQUITABLE SUBORDINATION

DAVID GRAY CARLSON*

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*Professor of Law, Benjamin N. Cardozo School of Law, New York City. Thanks to Tom Briggs, Michael Herz, Tom Plank, Jeanne Schroeder, Stewart Sterk and Bill Widen for their help and comments on earlier drafts.
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INTRODUCTION

In the 1980s, foreign issuers started to sell subordinated debentures in the United States market, pursuant to indentures invoking New York law. One notorious junk bond was the subject of intense litigation in Allstate Life Insurance Co. v. Linter Group Ltd. In that case, the following crude fraud was alleged. An Australian debtor, whom I will call D, sought to issue a debenture in the United States. The underwriters, Drexel, Burnham & Lambert, advised D that the bonds could not be sold because there was too much bank debt on D's books. To disguise some of this debt, D requested a subset of its lenders, whom I shall collectively designate as X, to release its claims against D until the "junk" was peddled. The junk bonds were then issued to a class of creditors, whom I shall call C1. Soon after C1 purchased the bonds, D gave X the old claims back. None of this was disclosed to C1. Later, new lenders, C2, advanced funds to D. C2 was fully knowledgeable about X's claim and C1's claim but unaware of the fraud perpetrated by X on C1. D soon filed for bankruptcy protection in Australia.

In the Australian proceeding, X anticipated a dividend worth well into the hundreds of millions of dollars. Under the law of New York, its misconduct arguably would generate two distinct claims for C1. First, X's claim against D was a fraudulent conveyance. According to the Uniform Fraudulent Conveyance Act (UFCA) to which New York adheres, the creation of an obligation deliberately intended to defraud creditors can be "set aside." Assuming equitable subordination is a good claim under New York law, and that X's claims should be equitably subordinated, how should the remedy be administered? C2 did not deserve a remedy, because it knew all about X's claims. C1 was the only party harmed.

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1. 994 F.2d 996 (2d Cir. 1993).
2. Id. at 997-98.
The usual interpretation of fraudulent transfer law is that X's claim is simply disallowed or rescinded. Under this interpretation, C2, whose claim dwarfed that of C1, would get the lion's share of X's enormous bankruptcy dividend (even though C2 was not harmed by X's conduct). Similarly, equitable subordination is usually interpreted to mean that X is demoted to a priority below all of the creditors of D. Under this interpretation, C2 would once again capture most of the benefit, even though C2 was not defrauded.

Should C2 gain a huge windfall because X arguably defrauded C1? Certainly not. There is an alternate way of looking at the universe of fraudulent transfer law and equitable subordination that would avoid this unjustified result.

Under this alternative theory C1 is the sole beneficiary of the remedy, C2 is neither helped nor harmed by it, and X is more likely to obtain a surplus after C1's claim is paid out. According to this alternative theory, fraudulent transfer law does not set aside X's claim. Nor does equitable subordination compel X to stand in line behind all the creditors. Rather, fraudulent transfer law and equitable subordination assign X's claim exclusively to C1 as security for C1's claim.

_Linter Group_, then, invites a deep inquiry into the nature of these remedies.4 Consider first the fraudulent transfer claim. Suppose D transfers property to X or creates a fraudulent obligation. Suppose these transfers or debts are simply void. In _Linter Group_, this would mean that C1 shares the remedy with C2.

This picture, however familiar, is a metaphoric error. "Metaphors in law," Justice Cardozo once warned, "are to be narrowly watched, for starting as devices to liberate thought, they end often by enslaving it."5 Strongly indeed does this observation manifest itself in fraudulent transfer law, which has enslaved itself to the language of avoidance, rescission, and annulment, when what is

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4. In presenting the question this way, I deliberately ignore the fact that C1 had contractually subordinated itself to X and C2. C2 therefore had this additional argument: just as equitable subordination is the assignment of X's claim to C1, contractual subordination is the assignment of C1's claim to C2. See David Gray Carlson, _A Theory of Contractual Debt Subordination and Lien Priority_, 38 VAND. L. REV. 975 (1985). Because contractual subordination was present in the case, whatever rights C1 had were transferred over to C2—including C1's fraudulent transfer rights against X.

really going on is *transfer*. Avoidance is the wrong concept for fraudulent transfer. Rather, the thing is *transferred* to $C_1$. From the beginning, $X$ holds the thing in trust for $C_1$—not for $C_2$.

Under the Bankruptcy Code, it is especially clear that avoidance is the wrong concept. Avoidance of a fraudulent transfer does not mean that the transfer disappears. According to § 551:

Any transfer avoided under section 522, 544, 545, 547, 548, 549, or 724(a) of this title, or any lien void under section 506(d) of this title, is preserved for the benefit of the estate but only with respect to property of the estate.¹⁶

This section virtually confesses that avoidance is a misnomer. According to the Bankruptcy Code, avoidance means *preservation* for the benefit of the estate.⁷ Preservation, not avoidance, should be the theme of fraudulent transfer’s tongue.⁸

Likewise, demotion is the wrong concept for equitable subordination. According to the Bankruptcy Code, bankruptcy courts are invited to *subordinate* the claims of wicked creditors to the claims of those creditors with finer deportment.⁹ The usual view of the matter is that the evil creditor is demoted behind all other creditors. Yet § 510(c) specifically provides for subordination to *specific* creditors in appropriate cases. General demotion cannot serve when, as in the *Linter Group* case, only specific creditors are harmed.

This Article proposes that we jettison the metaphors of avoidance and demotion. Instead, this Article proposes that the concept that organizes these bodies of law is *transfer*. The fraudulently transferred thing is not returned to the debtor. The wicked creditor is not demoted. Rather, the property and claims of $X$ are transferred to $C_1$. Insofar as $D$ is concerned, $D$ has conveyed away her property forever, and $D$ definitely must pay the subordinated claim.

⁷. See id.
Replacing the concept of avoidance, annulment and subordination with the notion of transfer brings commercial law discourse into closer identity with its actual logical structure, while steering clear of the injustice that sometimes results when courts enslave themselves to these metaphors. The transfer concept allows for a unified account of both fraudulent transfer law and the law of equitable subordination.

Both fraudulent transfer law and the law of equitable subordination entail the same remedy of expropriation and transfer. The moral intuition behind the two doctrines, nevertheless, has come to differ. Fraudulent transfer law focuses on the debtor's intent to cheat her creditors—though intent is presumed in the so-called “constructive” fraud cases.\(^{10}\) Equitable subordination, on the other hand, focuses on creditor misconduct.\(^{11}\) Whereas the debtor's intent is examined at the time of the fraudulent transfer, creditor action unrelated to the origin of the creditor's claim can justify equitable subordination.\(^{12}\)

The concepts of rescission, avoidence, and demotion have led to a series of confusions. For example, fraudulent transfer law is subject to the notorious rule of Moore v. Bay,\(^{13}\) but equitable subordination doctrine is not. According to Moore v. Bay, a bankruptcy trustee is subrogated to an individual creditor's fraudulent transfer rights, but these rights must be used for the benefit of all the creditors equally.\(^{14}\) Moore v. Bay, then, turns on the rescission theory of fraudulent transfer. In contrast, equitable subordination expressly permits creditors to benefit individually from the subordination of a wicked creditor. If, however, equitable subordination and fraudulent transfer remedies are the same, the limitation of Moore v. Bay to fraudulent transfer cases cannot be justified. Indeed, Moore v. Bay should itself be understood as driven by metaphorical confusion as to the nature of avoidance theory.\(^{15}\)

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10. See infra text accompanying notes 26-27.
11. See infra text accompanying note 116.
12. This is the inverse of the analysis found in Robert Charles Clark, The Duties of the Corporate Debtor to Its Creditors, 90 HARV. L. REV. 505 (1977). Dean Clark found the moral intuition to be the same, but the remedies to be different. See id. at 533.
14. See id. at 5.
15. See infra text accompanying notes 128-29.
By way of a second example, courts have erroneously supposed that state law cannot effectuate equitable subordinations. Rather, equitable subordination is considered to be a uniquely federal remedy. If, however, equitable subordination is simply the fraudulent transfer remedy in the special context of a collective proceeding, this conclusion must be rejected—equitable subordination is indeed part of a state's general common law. This principle would have served greatly in Linter Group, where C1's indenture invoked New York law but not the American Bankruptcy Code.

To establish the identity of these two seemingly diverse remedies, this Article proceeds as follows. Part I describes the fraudulent transfer remedy. The laws provide for two such remedies. First,

16. The leading case on this point is HBE Leasing Corp. v. Frank, 48 F.3d 623 (2d Cir. 1995), wherein the court said:

The doctrine of equitable subordination ... simply does not apply to state-law fraudulent conveyance claims. Equitable subordination is distinctly a power of federal bankruptcy courts, as courts of equity, to subordinate the claims of one creditor to those of others ....

Unlike the Bankruptcy Code, the [state fraudulent transfer law] is a set of legal rather than equitable doctrines whose purpose is not to provide equal distribution of a debtor's estate among creditors, but to aid specific creditors who have been defrauded by the transfer of a debtor's property.

Id. at 634 (citations omitted). For this proposition, the court cited two law review articles that simply recite the history of equitable subordination as stemming from federal bankruptcy jurisprudence. Id. Nowhere do these articles maintain that equitable subordination cannot be instituted outside of federal bankruptcy court jurisdiction. See Helen D. Chaitman, The Equitable Subordination of Bank Claims, 39 BUS. LAW. 1561 (1984); Scott M. Browning, Note, No Fault Equitable Subordination, 34 WM. & MARY L. REV. 487 (1993).

17. The conclusion that state law does not provide for equitable subordination of claims is becoming common. See Greenfield v. Shuck, 867 F. Supp. 62, 70 (D. Mass. 1994) (refusing to fashion a common law rule of priority outside of the bankruptcy setting); In re SPM Mfg. Corp., 163 B.R. 411, 413 (Bankr. D. Mass. 1994) (stating that equitable subordination claims are "applicable only in bankruptcy"); Primex Plastics Corp. v. Lawrence Prods. Inc., No. 89 Civ. 2944 (JSM), 1991 WL 183367, at *6 (S.D.N.Y. Sept. 12, 1991) (explaining that equitable subordination has no foundation in New York state law); In re Poughkeepsie Hotel Assocs. Joint Venture, 132 B.R. 287, 292 (Bankr. S.D.N.Y. 1991) ("[E]quitable subordination ... is peculiar to bankruptcy law and an issue which can only be decided in a bankruptcy setting."). One court went so far as to hold that a Chapter 11 filing is per se in good faith if it is tied to an equitable subordination claim. Since equitable subordination cannot be maintained outside of a bankruptcy court, a Chapter 11 case must be sustained if equitable subordination is appropriate. 9821 Shore Rd. Owners Corp. v. Seminole Realty Co. (In re 9821 Shore Road Owners Corp.), 187 B.R. 837, 852-54 (Bankr. E.D.N.Y. 1995).

transfers of property are avoided or set aside. Second, fraudulent obligations are annulled. Each of these italicized terms will be exposed as misnomers. In actuality, fraudulent transfer law assigns the property of third parties to the defrauded creditors as security for their claims. The assignment (not avoidance) of fraudulently conveyed property is then compared to the annulment of an obligation created by a debtor. Just as “set aside” or “avoidance” presents a false picture of the fraudulent transfer remedy, so annulment of an obligation is equally misleading. Obligations are not annulled but are transferred—assigned for security—to the creditor with the fraudulent transfer right.

Armed with this insight, Part II examines the equitable subordination remedy and shows that it is precisely the same as annulment of an obligation under fraudulent conveyance law. That is to say, a creditor’s claim is not subordinated but is assigned to those creditors harmed by the creditor’s inequitable conduct. Part II also shows that the origin of equitable subordination doctrine is, historically speaking, drawn from the state law of fraudulent transfer. This further supports the point that, structurally, equitable subordination is simply the fraudulent transfer remedy in disguise and that both remedies can be considered to be within the competence of state law to achieve.

Why has this point been missed heretofore? In the average case, the proper characterization of the remedy makes no practical difference. Indeed, this is a necessary condition for deficient legal theory to survive. Most of the time the metaphors of rescission and avoidance reach the right result. Typically, a bankruptcy trustee recovers a fraudulent transfer for all the creditors, or the subordination of a creditor is total.

The misconception is exposed for what it is, however, when a surplus exists, and when only a few (not all) creditors have rights against the lost thing. If there is a surplus, avoidance implies that the debtor obtains the surplus, not the third party to whom property was fraudulently conveyed. Furthermore, fraudulent transfer law distinguishes between present creditors, whose claims existed at the time of the fraudulent transfer, and future creditors, whose claims postdate it. Sometimes present creditors have rights

19. For examples of this distinction in action, see In re FBN Food Servs., Inc., 82 F.3d
when future creditors have none. The rescission or erasure theory of fraudulent transfer does not provide a mechanism to administer this distinction. Rescission always means that all creditors benefit. A transfer theory honors the distinction by permitting present creditors to recover while future creditors do not.

In equitable subordination, Bankruptcy Code § 510(c) directly authorizes subordination to some creditors as well as to all creditors. A general demotion theory, or standing in line, simply does not suffice when subordination is to a mere subset of creditors. These cases are rare, but marginal cases like Linter Group (which was far from marginal in terms of dollars) force us to re-theorize the center. The marginal cases demonstrate that avoidance, annulment, and subordination are misnomers. What is really going on in all cases is transfer of specific property rights. This Article presents a more complete theory—one that accounts for both the center and the margin. Because it solves more cases coherently than the existing theory, it qualifies as the more adequate explanation for the nature of fraudulent transfer law and the law of equitable subordination.

I. FRAUDULENT TRANSFER LAW

A. The Substantive Standard

Contrary to the usual stereotype, debtors are strong and creditors are weak. Debtors know they are finished, and that is their strength. To spite their creditors, they can convey their assets instantly to favored third parties, whereas creditors (if they are unsecured) must engage in expensive, time-consuming procedures in order to collect. Fraudulent transfer law evens the playing field. Fraudulent transfer permits creditors to retrieve from third parties

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1387 (7th Cir. 1996); Acequia, Inc. v. Clinton (In re Acequia, Inc.), 34 F.3d 800 (9th Cir. 1994). 20. 11 U.S.C. § 510(c) (2000).

21. Subordination to specific creditors is routine, however, under § 509(c), which governs sureties who are in competition with the creditors whose claims they have guaranteed. See 11 U.S.C. § 509(c) (2000). It is also routine in contractual subordination cases. See infra Part II.B.1.b.
property that the debtor has conveyed in order to delay or hinder collection.\textsuperscript{22}

Substantively speaking, fraudulent transfer can be divided into two types. First, there are cases in which the third party transferee pays value. These I will call “exchanges.” Second, there are transfers in which the third party does not pay value. These shall be informally referred to as “donations.”

First and most classically, transfers specifically intended to hinder, delay or defraud creditors are fraudulent—even if they are exchanges and even if the debtor is solvent at the time.\textsuperscript{23} Third party transferees, however, are accorded protection if they are good faith transferees for value.\textsuperscript{24} The paradigmatic intentional fraud on creditors is the bulk sale. In a bulk sale, the debtor sells assets to a creditor who provides the liquidity the debtor needs to flee the jurisdiction. If the creditor is not a good faith purchaser for value, the assets purchased become susceptible to the judicial liens of creditors. Many other fraudulent transfers are of this type. For example, in a leveraged buyout, a debtor typically issues a mortgage to a bank in order to provide the cash needed to redeem shares. Provision of this liquidity in order to finance dividends potentially qualifies as a fraudulent transfer of this type.\textsuperscript{25}

The second and by far most common type is the so-called constructive fraudulent transfer. A constructive fraudulent transfer is a donation\textsuperscript{26} by an insolvent person.\textsuperscript{27} As always, the adjective


\textsuperscript{23} Empire Lighting Fixture Co. v. Practical Lighting Fixture Co., 20 F.2d 295, 297 (2d Cir. 1927).

\textsuperscript{24} According to the UFTA § 8(a), “[a] transfer or obligation is not voidable under Section 4(a)(1) against a person who took in good faith and for a reasonably equivalent value or against any subsequent transferee or obligee.” \textit{Uniform Fraudulent Conveyance Act} § 8(a), 7A U.L.A. 351 (1999). The Uniform Fraudulent Conveyance Act (UFTA) limits protection to “purchasers.” \textit{Uniform Fraudulent Transfer Act} § 9, 7A U.L.A. 198 (1999). “Purchaser” usually connotes that the transferor has made a voluntary conveyance. \textit{E.g.}, \textit{U.C.C.} § 1-201(32) (2001).


\textsuperscript{26} “Donation” here is loosely used to describe transfers for no reasonably equivalent value. It comprehends dividends and stock redemptions by insolvent corporations and suretyship agreements for the benefit of strangers by insolvent debtors.

\textsuperscript{27} Insolvency draws different sorts of definitions. Under \textit{Bankruptcy Code} §
"constructive" confesses a theoretical failure. The idea of the constructive fraudulent transfer is that the courts will presume a donation is a deliberate attempt to divert assets away from creditors, even if the intent of the debtor is benevolent.

Both types of fraudulent transfers—the exchange and the donation—focus on the state of affairs at the time the fraudulent transfer is made. Intentional frauds require an inquiry into the debtor's state of mind at the time property is conveyed or an obligation is incurred. Constructive fraudulent transfers entail an examination of the debtor's solvency at the time of the transfer, coupled with the absence of a reasonably equivalent value.

Although this Article will show that the equitable subordination remedy is a fraudulent transfer remedy, the standards for equitable subordination differ from the standards of fraudulent transfer law. In equitable subordination law, courts do not necessarily limit their inquiry into the debtor's financial or mental state at the time the subordinated claim is created (although this is often relevant). Rather, they impose a forfeiture on wicked creditors for acts taken subsequent to the creation of the claim. An action for equitable subordination may not entail debtor misbehavior at all, and may involve creditor misconduct only.

B. The Remedy

The thesis of this Article is that fraudulent transfer law does not rescind transactions. Rather, it transfers debtor property directly to the creditors. This can be seen on the face of the uniform legislation that most states have adopted. According to the Uniform Fraudulent Transfer Act (UFTA), a defrauded creditor may obtain

548(a)(1)(B)(ii), for example, insolvency encompasses a debtor who:

(I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;
(II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or
(III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured.


29. See infra text accompanying notes 138-47.
“avoidance of the transfer or obligation to the extent necessary to satisfy the creditor’s claim ....”\textsuperscript{30} The emphasized language is significant. A transfer or obligation is never completely avoided. It is only avoided to the extent necessary to satisfy a designated creditor. In the older UFCA, a defrauded creditor may have the transfer “set aside or obligation annulled to the extent necessary to satisfy his claim ....”\textsuperscript{31} Once again, conveyances are not set aside absolutely. They are set aside only to the extent necessary.

Certainly as a matter of state law, the fraudulently transferred thing does not return to the debtor. Rather, fraudulent transfer law stands for the proposition that creditors may impose judicial liens on the property of non-debtors, when such property or obligation was fraudulently conveyed or created by a debtor. Insofar as the debtor is concerned, the debtor has permanently and forever alienated her property or has definitely obligated herself to pay some third party.

The UFTA is different in this regard from the Bankruptcy Code, whose language it otherwise largely replicates.\textsuperscript{32} Under Bankruptcy Code § 548(a), a trustee has a direct right to recover fraudulent transfers.\textsuperscript{33} There is no reference to “extent necessary,” though I have argued elsewhere that it should be implied.\textsuperscript{34}

Both at state law and in bankruptcy, however, courts have forgotten the dependent clause “to the extent necessary” and have instead rescinded the transfer altogether, so that what a debtor conveyed away is the debtor’s property once more.

This point will be emphasized in the illustrations to follow. In these illustrations, $D$ is a debtor who fraudulently conveys property or creates a claim on behalf of $X$. $X$ can therefore be a donee (in the

\begin{footnotesize}
\begin{enumerate}
\item One of the major stated reasons for the UFTA was to conform the language of state law to that of the Bankruptcy Code. See 7A U.L.A. 268 (1999); see also Frank R. Kennedy, The Uniform Fraudulent Transfer Act, 18 UCC L.J. 195, 198-99 (1986).
\item See generally David Gray Carlson, Bankruptcy's Organizing Principle, 26 FLA. ST. U. L. REV. 549 (1999). The thesis of this article is that bankruptcy trustees are creditor representatives, and trustee avoidance powers therefore have a quantitative limit measured by the claims the trustee represents. If a surplus exists after the trustee avoids conveyances, the surplus is beyond the bankruptcy estate because of this quantitative limit.
\end{enumerate}
\end{footnotesize}
case of a constructive fraudulent transfer), a contracting party (in the case of a fraudulent sale for cash or credit), or a creditor of D (in the case of a fraudulently created obligation). C₁ stands for a creditor of D with a fraudulent transfer right against X. C₂, C₃, and C₄ (collectively, C₂₄) are creditors of D, but unless context otherwise indicates, they have no fraudulent transfer cause of action against X.

A word should be said about why C₁ could have fraudulent transfer rights against X when C₂₄ do not. If a transfer is fraudulent, can any creditor of D avoid it? The answer is no. The state law of fraudulent transfer creates subsets of those creditors who can recover and those who cannot. For example, the UFTA, picking up a distinction introduced in the UFCA, distinguishes between the fraudulent transfer rights of present creditors and present and future creditors. Present and future creditors can obtain assets from X whenever D fraudulently conveys property or incurs an obligation:

(1) with actual intent to hinder, delay, or defraud any creditor of the debtor; or
(2) without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor:
   (i) was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business of transaction; or
   (ii) intended to incur, or believed or reasonably should have believed that he [or she] would incur, debts beyond his [or her] ability to pay as they became due.

In addition, present and future creditors can pursue X if D transferred property at a time she intended to incur a debt she


could not pay, or if $D$ is insufficiently capitalized to conduct a business.\textsuperscript{37}

Only \textit{present} creditors can pursue $X$'s property “if the debtor made the transfer or incurred the obligation without receiving a reasonably equivalent value in exchange for the transfer or obligation and the debtor was insolvent at that time or the debtor became insolvent as a result of the transfer or obligation.”\textsuperscript{38} Why does fraudulent transfer law distinguish between present and future creditors? One possible justification is that, where $D$'s only fault is that she is insolvent on her balance sheet, $C_2$ should investigate her creditworthiness and should not be allowed to subject $X$'s property to their liens as a substitute for good research. On the other hand, where $X$ is an “enabler” in an intentional fraud, is insufficiently capitalized in general, or believes a debt will arise that $X$ cannot pay, $D$ and $X$ are colluding in presenting a false economic picture of $D$'s true worth. Under these circumstances, future creditors are invited to fix their liens on $X$'s thing.\textsuperscript{39}

In the illustrations that follow, the Article first examines the plain vanilla case of a fraudulent transfer of property from $D$ to $X$. Second, the Article examines annulment of $X$'s claim against $D$.

\textbf{1. Property Is Conveyed}

Suppose, while insolvent, $D$ transfers a thing to $X$ for no equivalent value. Accordingly, $C_1$ may obtain “avoidance of the transfer or obligation to the extent necessary to satisfy the creditor's claim ....”\textsuperscript{40} As emphasized earlier, $D$'s transfer is not set

\textsuperscript{37} Id.

\textsuperscript{38} UNIF. FRAUDULENT TRANSFER ACT § 5(a), 7A U.L.A. 330 (1999). Furthermore, present (but not future) creditors can pursue $X$'s property “if the transfer was made to an insider for an antecedent debt, the debtor was insolvent at that time, and the insider had reasonable cause to believe that the debtor was insolvent.” Id. § 5(b).

\textsuperscript{39} Admittedly, this is what Duncan Kennedy once called “inducing] the premises from the data of the rules.” Duncan Kennedy, The Role of Law in Economic Thought: Essays on the Fetishism of Commodities, 34 AM. U. L. REV. 939, 955 (1985). Another possibility is that the present-future distinction in the UFCA is simply an unintentional mistake.

\textsuperscript{40} UNIF. FRAUDULENT TRANSFER ACT § 7(a)(1), 7A U.L.A. 339 (1999). The older UFCA formulation is somewhat different. It provides that a defrauded creditor may:

(a) Have the conveyance set aside or obligation annulled to the extent necessary to satisfy his claim, or
aside completely. Rather, it is set aside to the extent necessary to pay $C_1$. Beyond this necessity, $D$'s transfer is not set aside but is quite valid. If the fraudulent transfer is simply rescinded, then $C_1$'s action equally benefits $C_2$. Yet these future creditors ex hypothesi do not have any fraudulent transfer rights at all.

Fraudulent transfer law never reestablishes $D$'s ownership of the thing. Rather, it is clear that $X$ and $C_1$ are the owners. $X$ has legal title, and this is held in trust for $C_1$. Classically, $C_1$'s fraudulent transfer right was strictly an in rem right against property owned by $X$. $X$ was, in effect, a nonrecourse guarantor of $C_1$'s claim against $D$. If $X$ were to convert this property to her own use, $C_1$ has the option of suing in conversion (an in personam theory) or pursuing the thing in rem in the hands of $X$'s transferee. If, however, $X$ did not wrongfully interfere with $C_1$'s property, $C_1$ had no conversion theory and no in personam right against $X$. Meanwhile, $D$ is simply out of the picture. $D$ has alienated the thing forever.

The UFTA recently altered this classical in rem concept. Under the UFTA, $C_1$ may, apparently at will, substitute an in personam remedy against $X$. Under the older UFCA, $X$ is not personally obligated to $C_1$ (unless $X$ wrongfully interferes with $C_1$'s property right). Under the UFTA, the fraudulent transfer is the wrongful act of conversion that makes $X$ personally liable to $C_1$. $X$'s liability, however, is limited to the value of the property actually conveyed.

The courts have been much confused by the language of avoidance. Instead of emphasizing avoidance to the extent necessary, courts have assumed that $D$'s transfer is set aside entirely. What $D$ gave to $X$ is now $D$'s property once again, so that $C_1$ and $C_2$ can

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(b) Disregard the conveyance and attach or levy execution upon the property conveyed.


42. If $X$'s transferee is a bona fide purchaser for value, however, such a defendant will have a valid defense. UNIF. FRAUDULENT CONVEYANCE ACT § 9(1), 7A U.L.A. 198 (1999).

43. See Phelan v. Middle States Oil Corp., 220 F.2d 593, 615 (2d Cir. 1955).

obtain judicial liens against it. Thus, to some courts, fraudulent transfer law is injunctive; it commands X to take the formal steps necessary to convey the property back to D. Once this is accomplished, D is supposedly the owner of the property again, and C's judicial liens can now be enforced.

An example of metaphoric confusion at work is Acequia, Inc. v. Clinton (In re Acequia, Inc.), where a fraudulent transfer was recovered by the bankruptcy trustee. A surplus remained after all the creditors were paid. Properly, X should have owned this surplus, because the fraudulent transfer should have been avoided only to the extent necessary to pay the creditors. The Ninth Circuit, however, ruled that D, not X, was the owner of the surplus because, in effect, the fraudulent transfer had been avoided. What was once D's thing became D's thing again. Since D was entitled to any surplus under Bankruptcy Code § 726(a)(6), X lost all status in the distributional scheme. Ownership of the surplus is one circumstance where the rescission theory of fraudulent transfers can do serious mischief.

45. United States v. Coppola, 85 F.3d 1015, 1023 (2d Cir. 1996) (ordering X to convey property back to D so that C can enforce directly against D); Glassman v. Glassman, 131 N.E.2d 721, 726 (N.Y. 1956) ("The actual effect of this suit is to set aside the fraudulent conveyance, thereby returning the ownership of the funds to the individual defendant, and plaintiff's recovery will, for all intents and purposes, be against him."); Spencer v. Hylton-Spencer, 709 N.Y.S.2d 207, 208 (App. Div. 2000) (same). For example, in North Fork Bank v. Schmidt, 697 N.Y.S.2d 106 (App. Div. 1999), C had a judgment against D and was the first to join X in a fraudulent transfer action. Id. at 107. C later obtained a judgment against D, but was the first to docket in the county where the land was actually located. Id. The Appellate Division remanded for further findings; it assumed that, by docketing against D, C docketed against X's real estate. Id. Thus, C would prevail, even though C was the first to bring the fraudulent transfer action. This could only be so if the transfer by D was totally void.

46. HBE Leasing Corp. v. Frank, 48 F.3d 623, 632-33 (2d Cir. 1995).

47. Provocatively, the UFCA also authorizes the sheriff to levy X's property as if D still owned it. Carried to its extreme, this provision would permit the sheriff to ignore X altogether, advertise the sale of X's house and foreclose on C's judgment lien as if D still owned the house. Needless to say, there are major due process concerns here. Surely X is entitled to notice and a hearing before her property is taken to satisfy D's creditors. The case law has never really addressed these concerns, possibly because no litigant has ever sought to press her luck by pushing this option too far. Instead, X is joined as a party—a confession that the transfer from D to X is not really void or annulled after all.

48. 34 F.3d 800 (9th Cir. 1994).

49. Id. at 804.

50. See Douglas v. First Nat'l Bank, 40 S.W.2d 801, 802 (Tex. 1931) (finding that X should get the surplus).
Acequia is a § 548(a) case, where the language "to the extent necessary" does not appear. Nevertheless, such words should be implied. There is no excuse for awarding the surplus to D when a fraudulent transfer is recovered in a bankruptcy proceeding.\(^{51}\)

In Mendelsohn v. Thaler (In re Faraldi),\(^ {52}\) metaphorical error had an important substantive effect. In Faraldi, D conveyed real property to X. C\(_1\) docketed a judgment against D (but took no action against X). Under New York law, docketing a judgment in a local county creates a lien on D's real estate. D, however, had no real property whatsoever at that time. Rather, it was owned by X in trust for the creditors of D, including C\(_1\).

D was soon bankrupt. The trustee correctly claimed that X's property was property of the bankruptcy estate, because the trustee could subrogate to the rights of C\(_2\) and avoid the fraudulent conveyance to X. The Faraldi court, however, ruled that C\(_1\) was a secured creditor in the bankruptcy by virtue of docketing a judgment against D.\(^ {53}\) This conclusion is purely the product of metaphorical error. If, per the metaphor, D still owned property at the time C\(_1\) docketed, then the court was right. But if D had alienated his land to X, the court was wrong.\(^ {54}\)

Faraldi can be criticized for not attending to the bona fide purchase defense in the UFCA.\(^ {55}\) If indeed C\(_1\) has a lien on X's

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51. A similar case is In re FBN Food Servs., Inc., 82 F.3d 1387 (7th Cir. 1996). In that case, the court recognized that X should properly get the surplus. Id. at 1395. There is dictum in this case to the effect that, if X must surrender the fraudulent transfer, then X has a claim in D's bankruptcy. See id. at 1391-92. This would solve the problem of getting the surplus to X, but it is hard to justify the notion that just because X is divested of property fraudulently transferred by D and therefore held in trust for the creditors, X is a creditor of D. Rather than inventing the premise that X has an allowable claim in D's bankruptcy, it would be better to acknowledge that the bankruptcy trustee can simply recover to the extent of creditor claims.

52. 286 B.R. 498 (Bankr. E.D.N.Y. 2002).

53. Id. at 503.

54. The Faraldi court found the governing law to be "sparse." Id. But it found conclusive a remark by Judge Learned Hand to the effect that "a fraudulent conveyance is void under the New York statute, and may be disregarded ...." Empire Lighting Fixture Co. v. Practical Lighting Fixture Co., 20 F.2d 295, 296 (2d Cir. 1927). In fact, the case involved a "creditor's bill in equity," where C\(_1\) was indeed in the process of avoiding D's conveyance to X. For cases following Faraldi's regrettable metaphysics, see Cullen Center Bank & Trust v. Hensley (In re Criswell), 102 F.3d 1411 (5th Cir. 1997). See also Coleman v. J&B Enters., Inc. (In re Coleman), 291 B.R. 894 (Bankr. S.D. Ga. 2003).

property upon docketing against $D$, how can $X$ convey the encumbered land to a subsequent bona fide purchaser for value? Such persons take subject to docketed liens. Indeed, Faraldi, if followed, creates havoc for title searching because, on Faraldi's logic, any docketing of a lien against a predecessor in interest might encumber $X$'s property in spite of generations of bona fide purchases.

Another example of harmful error is *Columbo v. Caiati*,\(^5^6\) where $D$ fraudulently conveyed a house to $X_1$. Thereafter, $C_1$ filed a *lis pendens* against $X_1$'s property, placing the world on notice that $C_1$ was claiming a fraudulent transfer. A *lis pendens* implies that $X_1$ could not effectively convey the land to any bona fide purchaser for value free and clear of $C_1$'s right. $X_1$ then conveyed the encumbered land back to $D$. $D$ then mortgaged the land to $X_2$. $X_2$ claimed the land free and clear of $C_1$'s fraudulent transfer right.

Properly speaking, $C_1$ should have prevailed. When $D$ alienated the land to $X_1$, $D$ terminated any and all interest in the land. $X_1$ owned the fee simple in trust for $C_1$, and $C_1$ had a nascent right to attach a lien on this property. Because of the *lis pendens*, there could be no question of a bona fide purchaser for value. When $X_1$ conveyed the land back to $D$, $C_1$'s rights were still valid and plainly present in the chain of title. $X_2$ therefore should have been deemed a bad faith purchaser (i.e., knowledgeable purchaser whose mortgage was junior to any future judicial lien that $X_1$ might obtain on $D$'s land).

The court, under the spell of metaphorical confusion, ruled that $C_1$ had no right against $X_2$.\(^5^7\) Reconveyance to $D$ was "the very relief requested by the plaintiffs in their underlying action based on a fraudulent conveyance ...."\(^5^8\) Hence, $C_1$'s nascent right went out of existence, and $D$ owned the house free and clear of $C_1$'s fraudulent conveyance right. As a result, $D$'s title was supposedly unencumbered when $D$ conveyed a mortgage to $X_2$. Such a result is possible only if setting aside a conveyance means pretending it never happened. This is not what fraudulent conveyance does, however. Rather, it makes $X$ the constructive trustee for $C_1$.

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56. 493 N.Y.S.2d 244 (Sup. Ct. 1985).
57. Id. at 247.
58. Id.
Avoidance, then, should be viewed as a misnomer. Fraudulent transfer law renders X the constructive trustee for property for the benefit of C. It does not rescind D's transfer.

At first, it might seem that the rescission theory helps to bail voidable preference law out of a conceptual difficulty that exists in the Bankruptcy Code but that did not exist in the Bankruptcy Act of 1898.

To see why, suppose C has already commenced a supplemental proceeding against X before the bankruptcy petition. These proceedings typically create a lien on X's thing in favor of C, at the time the proceeding is commenced. The existence of C's lien implies that C has become a secured creditor in D's bankruptcy—not a mere unsecured creditor with a potential avoidance right.

In the forgotten case of Metcalf v. Barker, C brought suit against X more than four months before the bankruptcy petition. At that time, the Bankruptcy Act of 1898 provided:

That all ... liens, obtained through legal proceedings against a person who is insolvent, at any time within four months prior to the filing of a petition in bankruptcy against him, shall be deemed null and void in case he is adjudged a bankrupt, and the property affected by the ... lien shall be deemed ... released ... and shall pass to the trustee as a part of the estate of the bankrupt, unless the court shall, on due notice, order that the right under such ... lien shall be preserved for the benefit of the estate; and thereupon the same may pass to and shall be

59. See generally Note, Priorities of Creditors Under Judgment Creditor's Bills, 42 YALE L.J. 919 (1933) (discussing timing issues relating to multiple creditor claims); but see In re Leonard, 125 F.3d 543 (7th Cir. 1997). In this case, C filed a suit and a lis pendens against X. The Leonard court held that these actions created no lien for C on X's property, since Illinois abolished the creditors' bill in equity in 1980. Rather, the court required C to obtain one of the remedies listed in UFTA § 8(a), which mentions attachment or "other provisional remedy," injunctions, receivers and "any other relief the circumstances may require."

In truth, Illinois did not repeal the concept of the creditors' bill so much as to change its name to "supplementary proceeding." ILL. REV. STAT. ch. 110 § 2-1402. There is no good reason to think that nominal change is accompanied by substantive change, with regard to establishing C's priority to X's property. The supplemental proceeding easily fits within UFTA § 8(a)'s "other provisional remedy" or "any other relief the circumstances may require."

Nevertheless, the result was correct in Leonard for the reasons stated infra in the text accompanying notes 73-74.

60. 187 U.S. 165 (1902).
preserved by the trustee for the benefit of the estate as aforesaid.61

In Metcalf, the Supreme Court ruled that, under New York law, C’s lien arose at the commencement of the lawsuit, prior to the four month period.62 For that reason, C was a secured creditor in D’s bankruptcy.

Bankruptcy Act § 60(f), as promulgated in 1898,63 was broad enough to bring C’s lien into the bankruptcy estate—provided C obtained the lien against X’s thing in the four month period. Unfortunately, this provision was abolished when the Bankruptcy Code was enacted.

Today, courts would like to believe that C’s lien is a voidable preference, within the meaning of Bankruptcy Code § 547(b). Yet § 547(b) requires a transfer of debtor property within the ninety day preference period. When D fraudulently transfers to X more than ninety days before bankruptcy, D creates property interests in X and C at that time and retains no property whatever in the thing. Later, when C obtains a lien in the preference period, the lien can only constitute a transfer from X, not D.

Admittedly, C received an inchoate, “unperfected” transfer from D directly more than ninety days before bankruptcy, when the fraudulent transfer occurred.64 Later C “perfected” her interest by commencing a proceeding against X within the preference period. But at this time, the property was solely X’s (held in trust for D’s creditors). It was in no sense D’s property. Yet § 547(e)(2)(B) has a timing rule that must be considered. According to § 547(e):

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62. Metcalf, 187 U.S. at 172. The explanation for this is that C already has a judgment against D. The action against X therefore constitutes an “equitable execution” against X’s property. Garbard Glenn, Fraudulent Conveyances and Preferences 151 (rev. ed. 1940). Where C seeks to set aside a transfer before judgment, Professor Glenn, at least, protested that there should be no lien. Id. at 56-57. See generally Note, supra note 59, at 929-30 (considering entitlements to the benefit of a lien arising from a judgment creditor’s suit).
63. This provision was later re-numbered and modified as § 67(a). Chandler Act of 1938, 52 Stat. 840, 875 (1938). No similar provision survived in the Bankruptcy Code. Instead, C’s lien is analyzed under the voidable preference statute.
For the purposes of this section ... a transfer is made—

(A) at the time such transfer takes effect between the transferor and the transferee, if such transfer is perfected at, or within 10 days after, such time ...;

(B) at the time such transfer is perfected, if such transfer is perfected after such 10 days; or

(C) immediately before the date of the filing of the petition, if such transfer is not perfected at the later of—

(i) the commencement of the case; or

(ii) 10 days after such transfer takes effect between the transferor and the transferee.65

Perfection of a transfer is defined in § 547(e)(1)(B), which provides “a transfer of a fixture or property other than real property is perfected when a creditor on a simple contract cannot acquire a judicial lien that is superior to the interest of the transferee.”66 Applying this definition to the case at hand, one would have to admit that C obtained an unperfected lien on X’s thing more than ninety days before bankruptcy. It became perfected during the preference period. Yet, at that time, D did not even own the thing. The timing rule in § 547(e)(2)(B) simply does not function in a case where D disposes of her equity before a lien is perfected.

If we insisted on applying the timing rules as written, then, during the preference period, when D actually did perfect, we would have to pretend, at that time, that D still owned the thing. Based on this fiction, it becomes possible to conclude that C received a voidable preference. But this is an unattractive method. Surely we cannot pretend D owns property in order to get a result we want. Rather, it must be the case that D conveyed property to C and X long before the preference period.67

67. In an earlier study, I considered the following case: suppose D conveys an unperfected security interest to C, and then sells the equity to X (a bad faith purchaser) prior to the preference period. The timing rules turn to mush under this scenario. How can we say that D transferred the security interest in the preference period when D did not even own the collateral at that time? Rather, it should be the case that the security interest is deemed transferred just before D conveys the equity to X. Section 547(e) does not provide for this, but no other solution makes sense. GRANT GILMORE & DAVID GRAY CARLSON, GILMORE AND CARLSON ON SECURED LENDING: CLAIMS IN BANKRUPTCY 120-21 (2000).
In support of this conclusion, consider yet another relevant situation. Suppose \( D \) has granted a security interest to \( SP \) covering all present and future general intangibles. \( D \) then fraudulently transfers property to \( X \). If \( D \) really has an interest in \( X \)'s thing, then \( SP \)'s security interest attaches to \( X \)'s obligation to return that thing to \( D \). The presence of an Article 9 security agreement would prevent \( C_1 \) or a bankruptcy trustee from ever recovering the fraudulent transfer. If, on the other hand, \( D \) has alienated the thing forever, \( SP \)'s security interest does not attach,\(^{68}\) and the creditors are free to pursue \( X \)'s thing.

Yet many will think that \( C_1 \) has violated the spirit of creditor equality that lies behind voidable preference law. In truth, \( C_1 \) falls to the trustee, but not because \( C_1 \) has received a voidable preference. Rather, if the bankruptcy trustee has a direct § 548(a) theory against \( X \), or if she can subrogate herself to \( C_2 \) or some other creditor of \( D \), she can avoid \( D \)'s conveyance to \( X \). Bankruptcy Code § 550(a)(1) makes clear that the trustee may recover the fraudulently transferred thing from the initial transferee or from the transferee of a transferee. \( C_1 \) constitutes the transferee of a transferee, by virtue of the lien arising from her action against \( X \). Of course, transferees of transferees have a defense under § 550(b), which provides:

The trustee may not recover under section (a)(2) of this section from—

(1) a transferee that takes for value, including satisfaction or securing of a present or antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided ....

It should be apparent, however, that \( C_1 \) never qualifies for this defense, since \( C_1 \) always knows that \( D \)'s conveyance to \( X \) is voidable if a bankruptcy proceeding ensues in a timely fashion. Therefore, \( C_1 \)'s lien can never stand. There is no need for the fiction that \( D \) retains an interest in property even after she conveys the fee simple to \( X \) in a voidable transaction.

\(^{68}\) This was the result in Marquette Bank Ill. v. Covey (\textit{In re Classic Coach Interiors, Inc.}), 290 B.R. 631 (Bankr. C.D. Ill. 2002), an exceptionally well-reasoned opinion.
The court in *Cullen Center Bank & Trust v. Hensley (In re Criswell)*\(^{69}\) faced precisely these issues but had to rely on unnecessary fictions to obtain the right result. The *Criswell* court ruled that \(X\)'s property was really \(D\)'s property. \(D\) supposedly had some sort of equity interest in it, even after conveying it to \(X\). For this reason, \(C_1\)'s alleged judicial lien on \(X\)'s property was really a lien on \(D\)'s property—hence a voidable preference.\(^{70}\) Similarly, this fiction allowed the *Criswell* court to rule that \(C_1\) was the *initial transferee* of \(D\)—not the transferee of \(X\). The lower court had refused summary judgment because it thought \(C_1\) had raised a triable issue of fact on whether it was a good faith transferee or a transferee “without knowledge of the voidability of the transfer avoided.”\(^{71}\) The *Criswell* court was therefore able to impose a summary judgment on \(C_1\), but in truth \(C_1\) was a transferee of a transferee. Even so, summary judgment was appropriately imposed on \(C_1\) as transferee of a transferee. How could \(C_1\) be a bona fide transferee, when \(C_1\)'s own theory was that \(D\) had made a fraudulent transfer to \(X\)? Summary judgment could have been awarded, even without the unbelievable fictions, since an avoiding creditor (\(C_1\)) obviously has knowledge of the voidability of \(D\)'s conveyance.

These same issues may have been present in *American National Bank v. MortgageAmerica Corp. (In re MortgageAmerica Corp.)*,\(^{72}\) where \(D\) conveyed property to \(X\) more than a year before bankruptcy. One month prior to the bankruptcy petition, \(C_1\) commenced an action against \(X\) to recover a fraudulent transfer. This should have made \(C_1\) a secured creditor under Texas law.\(^{73}\) A Chapter 7

\(^{69}\) 102 F.3d 1411, 1417-18 (5th Cir. 1997).

\(^{70}\) In *Criswell*, \(C_1\) filed a transcript of a Texas judgment against \(D\) (but not against \(X\)). *Id.* at 1413. No Metcalf-style action against \(X\) had been commenced by \(C_1\). \(C_2\), another creditor, had commenced one but apparently agreed that the trustee could take the proceeds of it for the bankruptcy estate.

The *Criswell* court wondered whether \(C_1\) had a lien at all on \(X\)'s real property, but relied on the fiction that \(D\) still had an equitable interest in the real property, even after it was conveyed to \(X\). Docketing against \(D\) was therefore docketing against \(X\), because \(D\) (not \(X\)) was the real owner of the property. *Id.* at 1417. Because this occurred within the preference period, \(C_1\) was guilty of voidable preference.

\(^{71}\) *Id.* at 1418.

\(^{72}\) 714 F.2d 1266 (5th Cir. 1983).

\(^{73}\) See, e.g., *Cassaday v. Anderson*, 53 Tex. 527, 537 (1880) (“As between two creditors, if one has already obtained his judgment and instituted proceedings to set aside the fraudulent conveyance, this will give him priority of right to first have his debt satisfied out
trustee then claimed that bankruptcy's automatic stay enjoined \( C_i \) from pursuing \( X \).

So far as it went, even if \( C_i \) had a valid lien on \( X \)'s thing, \( C_i \) was subject to the automatic stay, provided \( X \)'s equity in the thing was property of \( D \)'s bankruptcy estate.\(^{74}\) Certainly \( X \)'s thing was property of the estate, since the trustee could avoid \( D \)'s conveyance to \( X \) by subrogating himself to \( C_2 \) or some other creditor of \( D \). But was \( C_i \) a secured creditor in \( D \)'s bankruptcy? The answer is no, since \( C_i \) was the transferee of a transferee of the fraudulently transferred thing.\(^{75}\)

The reasoning in *MortgageAmerica*, however, was quite different. Basically, the *MortgageAmerica* court, overlooking \( C_i \)'s lien, brought \( X \)'s thing into the bankruptcy estate on a rescission theory of fraudulent transfers:

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3. One quite confusing issue in *MortgageAmerica* was whether \( X \) even had a thing. The *MortgageAmerica* opinion indicates that the thing fraudulently transferred to \( X \) were cash payments, presumably checks. If these checks could be traced to \( X \)'s bank account, perhaps \( X \) had a thing under the usual tracing rules. But it is also possible that \( X \) dissipated these trust funds in an untraceable way. If so, then \( C_i \) had a merely in personam right against \( X \) sounding in the tort of conversion.

Nevertheless, \( C_i \) should be seen as a secured creditor in \( D \)'s bankruptcy. The collateral is \( X \)'s obligation to \( C_{i+4} \). To see why, suppose \( D \) conveys $50 to \( X \) in a fraudulent transfer. Suppose further that \( C_{i+4} \) each claim $100 against \( D \) and each has fraudulent transfer rights against \( X \)'s $50. \( X \) has effectively embezzled the trust funds, however. Suppose on Monday \( C_i \) brings a law suit against \( X \). Suppose \( C_2 \) brings a law suit on Tuesday: Surely \( X \) should pay $50 *only once*. To whom shall \( X \) pay—\( C_i \) or \( C_2 \)? I maintain that \( X \) should pay \( C_i \) because \( C_i \) filed the first complaint. At this point, \( X \)'s personal liability was *in custodia legis* for the benefit of \( C_i \). This proves that \( C_i \) is a secured creditor in \( X \)'s bankruptcy. In effect, \( C_i \) has a lien on property \( X \) holds in trust for \( C_{i+4} \).

For those who disagree with this judgment, suppose neither \( C_i \) nor \( C_j \) has filed against \( X \). Rather, \( D \) files for bankruptcy more than one year after the fraudulent transfer. Accordingly, the bankruptcy trustee cannot sue \( X \) under § 548(a). 11 U.S.C. § 548(a) (2000). The trustee must then rely on the subrogation principle in § 544(b)(1). Yet § 544(b)(1) provides that "the trustee may avoid any transfer of an interest of the debtor in property ... that is voidable under applicable law by a creditor holding an unsecured claim." 11 U.S.C. § 544(b)(1) (2000). If you think the bankruptcy trustee can sue \( X \) in personam under § 544(b)(1), then \( X \)'s in personam obligation for conversion must be a thing that is "voidable under applicable law." If, on the other hand, you think that the trustee cannot pursue \( X \) in personam under § 544(b)(1), then the result in *MortgageAmerica* is wrong for a different reason. If the trustee cannot pursue \( X \) at all, \( C_i \) is not violating the automatic stay because \( C_i \) and the trustee are not in conflict.
An action under the Fraudulent Transfers Act is essentially one for property that properly belongs to the debtor and which the debtor has fraudulently transferred in an effort to put it out of the reach of creditors. The transferee may have colorable title to the property, but the equitable interest—at least as far as the creditors (but not the debtor) are concerned—is considered to remain in the debtor so that creditors may attach or execute judgment upon it as though the debtor had never transferred it. We think that when such a debtor is forced into bankruptcy, it makes the most sense to consider the debtor as continuing to have a "legal or equitable interest[]" in the property fraudulently transferred within the meaning of section 541(a)(1) of the Bankruptcy Code.76

Under the court's rescission theory, X's thing was really D's thing. Therefore, X's thing entered the bankruptcy estate under § 541, which defines the bankruptcy estate as "[a]ll interests of the debtor ... as of the commencement of the case." Yet the MortgageAmerica court was also driven to admit that the thing was D's only insofar as the creditors were concerned. Insofar as D was concerned, the thing belonged to X. This is tantamount to confessing that D had no remaining property right in what D fraudulently conveyed. Rather, after D's conveyance, the thing belonged solely to X (who owned the surplus in the thing), to C1 (who had a lien on the thing), and to any other creditors of D with fraudulent transfer rights against X.77

The recent case of Official Committee of Unsecured Creditors v. Chinery (In re Cybergenics Corp.) (Cybergenics I)79 dispenses with the fictions relied upon in Criswell and MortgageAmerica. In Cybergenics I, a debtor-in-possession sold all its assets under

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76. MortgageAmerica, 714 F.2d at 1275 (citation omitted).
78. For a case holding that the thing belongs to X until the trustee actually recovers it, see FDIC v. Hirsch (In re Colonial Realty Co.), 980 F.2d 125, 130-32 (2d Cir. 1992). The MortgageAmerica court more plausibly characterized a trust fund theory as property of the debtor prior to bankruptcy. It reasoned that such a cause of action could be brought by a creditor or a shareholder, but it must be brought for both groups as a whole. Individual remedies did not exist. Since the action was one that unified both the creditors and the shareholders, and since the very personhood of the corporate debtor was this unity, the action should be viewed as belonging to the unity—that is, to the debtor. MortgageAmerica, 714 F.2d at 1269-72.
79. 226 F.3d 237 (3d Cir. 2000).
Bankruptcy Code § 363(b). Both the sales contract and the court order authorizing it "referred to the sale of all assets of Cybergenics as debtor and debtor in possession." The Cybergenics I court correctly emphasized that, under New Jersey law, the fraudulent transfer right belonged to the creditors, not to the debtor. It then supposedly followed that the sale of "all assets of [the] debtor-in-possession" did not include the sale of fraudulent transfer claims. The Cybergenics I court remarked that the debtor-in-possession might have assigned fraudulent transfer rights, with court permission. But apparently no such assignment was intended. Nevertheless, there are some confusing passages in this opinion. According to the Cybergenics I court, "the avoidance powers [do not] shift ownership of the fraudulent transfer action to the debtor in possession ...." How can this be so? Unless the debtor-in-possession owns this cause of action (as a fiduciary for the unsecureds), how could the debtor-in-possession ever sell the fraudulent transfer action to anyone, as the Cybergenics I court clearly acknowledged to be possible? Nevertheless, in pointing out that, after D fraudulently transfers to X, D owns nothing, Cybergenics I is obviously correct. What Cybergenics I should be read as establishing is that, when a bankruptcy trustee or debtor-in-possession sells assets, the sale presumptively does not

80. Id. at 241.
81. Still, the sale order did refer to the sale of debtor-in-possession assets. This quite plausibly could include all avoidance actions owned as trustee for the unsecured creditor. The very bankruptcy court that issued the sale order thought so. The appellate panel in Cybergenics I somehow had better insight into the intent of the bankruptcy court than the bankruptcy court itself had!
82. Cybergenics Corp., 226 F.3d at 244.
83. This aspect of Cybergenics I has already spawned trouble. In In re PWS Holding Corp., 303 F.3d 309 (3d Cir. 2002), a trustee became subrogated to fraudulent transfer claims of C, and others. The Chapter 11 plan then took the trouble to prohibit any attempted enforcement of fraudulent transfer theories. This was a highly problematic term of the plan. Properly, if the debtor-in-possession did not wish to enforce the fraudulent transfer claims, they should have been abandoned back to C, C;'s theory was that, under Cybergenics I, the fraudulent transfer claims belonged to the creditors, not to the debtor-in-possession. The PWS court ruled that, while the debtor-in-possession did not "own" the fraudulent transfer claims, it had power to enforce them, and if it chose to benefit X by extinguishing them, this was within the competence of the debtor-in-possession to do.

Any distinction between ownership by a fiduciary and power over trust property, however, is purely formal. The legal ownership of a fiduciary and its power over the equitable interests in property are the same thing.
encompass the sale of avoidance actions, unless the court order says so expressly.\textsuperscript{84}

To summarize, then, fraudulent transfer law is quite confused as to its basic concept. Does it stand for the proposition that fraudulent transfer law \textit{rescinds} a transfer from $D$ to $X$? Or does it stand for the proposition that $D$ has alienated the thing, but $X$ holds the thing in trust for those creditors of $D$ with a fraudulent transfer right? Clearly the latter view is the more realistic description.

2. \textit{Obligation Is Annulled}

Fraudulent transfer law famously avoids transfers of property interests. More mysteriously, it also permits the annulment of $D$'s \textit{in personam} obligations. According to Section 9 of the UFCA, "[w]here [an] \textit{obligation} is fraudulent as to a creditor, such creditor, when his claim has matured, may ... have the ... obligation \textit{annulled to the extent necessary to satisfy his claim}."\textsuperscript{85} If the analysis of the plain vanilla fraudulent transfer is confusing, the analysis of annulling claims is especially underdeveloped, because annulment of $D$'s obligation serves no purpose, unless it is also accompanied by property transfers from $D$ to $X$.

To see why, suppose $D$ owes $X$ an obligation which is fraudulently created. $X$'s claim is strictly \textit{in personam}. At state law, what does $C_i$ even gain by having $X$'s claim declared null and void? $C_i$'s problem is that $C_i$ cannot locate any leviable assets. A judicial declaration that $X$ has no claim produces nothing leviable for $C_i$.

\textsuperscript{84} \textit{Cybergenics I} has gone on to engender a celebrated \textit{en banc} opinion. Official Comm. of Unsecured Creditors v. Chinery, 330 F.3d 548 (3d Cir. 2003) (\textit{Cybergenics III}), rev'd 304 F.3d 316 (3d Cir. 2002) (\textit{Cybergenics II}). After the \textit{Cybergenics I} court concluded that the fraudulent transfer causes of action still belonged to the bankruptcy estate, a creditors' committee sought standing to bring them, since the debtor-in-possession declined to do so. This was granted by the bankruptcy court, but reversed by the district court and the \textit{Cybergenics II} court. The \textit{Cybergenics III} court reversed again, allowing the creditors' committee standing. That creditors' committees have standing is obvious, except that the Supreme Court, in \textit{Hartford Underwriters Insurance Co. v. Union Planters Bank, N.A.}, 503 U.S. 249 (2000), issued a regrettable opinion superficially implying that, where the Bankruptcy Code gives the trustee standing, this can never be assigned to some non-trustee. A careful reading of \textit{Hartford Insurance} defeats this implication, however. \textit{See} David Gray Carlson, \textit{Surcharge and Standing: Bankruptcy Code § 506(c) after Hartford Underwriters}, 75 AM. BANKR. L.J. 43, 56-61 (2002).

In contrast, when $D$ conveys a thing to $X$, the thing becomes a leviable asset. If $C_I$ is the first to place a lien against it, then $C_I$ has something of value. But $X$'s purely in personam right against $X$ is no asset of $D$. From $D$'s perspective, it is the opposite of property; it is $D$'s liability. Without more, annulment of $X$'s obligation is useless to $C_I$.  

Annulment becomes analytically necessary, however, when the fraudulent obligation yields a payment or other transfer secures it. Such a necessity can arise in a variety of contexts.

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86. According to one court:

It is the rare and exceptional case where a judgment creditor who has been frustrated in his efforts to collect his judgment will again sue that debtor in a further effort to collect the same debt. Generally, it would be a futile gesture, as the creditor already has what he would hope to gain by the suit, namely, a judgment. And there would be little reason to believe that he could obtain satisfaction of the second judgment where he had failed in regard to the first. However, the fact that such a procedure is for very good reason seldom initiated neither means nor implies that it may not be done. James v. Powell, 266 N.Y.S.2d 245, 248 (App. Div. 1966).

In Posner v. S. Paul Posner 1976 Irrevocable Family Trust, 688 N.Y.S.2d 548 (App. Div. 1999), $D$ confessed a judgment in favor of $X$, and $X$ then sought to enforce it. $C_I$ sought permission to intervene on the theory that the judgment was a fraudulent transfer. Permission to intervene was granted, on the ground of fraudulent transfer law. Id. at 549. But, upon intervening, what could $C_I$ achieve?

The proper answer is that, since fraudulent transfer transfers and does not annul claims, $C_I$ should now own the confessed judgment. Stepping into $X$'s shoes, $C_I$ should be able to do whatever $X$ could have done. The Posner court, however, never reached these issues. It had fulfilled its task when it merely gave permission for $C_I$ to intervene in order to prove that the judgment was a fraudulent transfer. In all likelihood, however, the most $C_I$ could have received, in effect, was injunctive relief against $X$ or $D$ preventing the enforcement or payment of the debt.

87. Insofar as mortgages and security interests are concerned, it is possible that the obligation is honest but the security interest is fraudulent. In First National Bank v. Hooper, 48 S.W.3d 802 (Tex. App. 2001), for example, $D$ owed $X$ for a valid loan. $C_I$ obtained a judgment, but before an abstract could be filed to create a lien on $D$'s real estate, $D$ granted a mortgage to $X$ on antecedent debt. Here, the obligation was valid but the mortgage was deemed fraudulent, as it was intended to hinder, delay, or defraud $C_I$. Id. at 805.

There are some very strange aspects to this case, however. The case was litigated under the UFTA, where $C_I$ is entitled to a money judgment against $X$ for the value of the property conveyed. $X$'s valid obligation was for $400,000. $X$ bid in $247,900. The real estate was deemed by a jury worth $700,000. If the court was really striking down the mortgage, then the liability should have been capped at $400,000. If the fault was paying too little at the foreclosure sale, then liability should have been the value of $D$'s equity only ($452,100). All we really learn from the court is that the jury could plausibly impose a $700,000 liability. Id. at 811. The theory upholding this finding, however, is opaque.
Suppose $X$ has a claim that $D$ actually owes. The obligation, however, is a fraud on creditors. If $D$ is bankrupt, $X$'s claim engenders a bankruptcy dividend. In the abstract, annulment of $X$'s claim was useless. But now proceeds of the voidable claim—the bankruptcy dividend—represent a leviable asset. If $C_1$ annuls $X$'s claim, $C_1$ wins $X$'s bankruptcy dividend.

To spell out how this might work, suppose $C_{1,4}$ and $X$ each claim $100$ against $D$. By the time the bankruptcy proceeding has started, $C_1$ has already obtained a judicial lien on $X$'s claim because it was a fraudulent transfer. $C_{2,4}$ have no fraudulent conveyance rights for some reason. Nor can the trustee avoid $X$'s obligation under § 548(a), as it is over one year old at the time of the bankruptcy. Suppose further that a bankruptcy estate is worth $375, so that it yields a dividend of 75 cents on the dollar.

On these numbers, if a court were to accept the analysis proffered here, the bankruptcy trustee should allocate $75$ to $C_1$ on $C_1$'s original claim. This should be done without any reference to fraudulent conveyance law. $C_1$ now has a deficit of $25$. $X$ is also a creditor of $D$. The trustee should also allocate $75$ to $X$'s claim. But $C_1$ is now the owner of $X$'s claim, by virtue of $C_1$'s lien on it. $C_1$ therefore should receive $25$ of $X$'s dividend. A surplus of $50$ still remains from $X$'s $75$ dividend, and this should be returned to $X$. Meanwhile, $C_{2,4}$ receive $75$ apiece from the trustee. They should be neither helped nor harmed by $C_1$'s right against $X$. $X$ should receive the surplus, not $C_{2,4}$.

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88. If $C_1$ does not have a judicial lien on $X$'s claim, then $C_1$ is merely an unsecured creditor to whom the trustee is subrogated. Under the rule of Moore v. Bay, 284 U.S. 4 (1931), the trustee takes over $C_1$'s recovery and distributes it to all the creditors equally. See discussion infra Part I.B.3. On the other hand, if $C_1$ has already liened $X$'s property, $C_1$ retains the fruit of her fraudulent transfer theory. See supra notes 68-74 and accompanying text.

89. If the bankruptcy trustee has a § 548(a) theory against $X$, then $X$ would not get the surplus. If, however, $X$'s fraudulent transfer is more than one year old at the time of the bankruptcy petition and if $C_{2,4}$ have no fraudulent transfer rights under state law to which the trustee could subrogate, then $X$ could retain the surplus.

Notice that Moore does not bring $X$'s surplus into the bankruptcy estate. The trustee must subrogate herself to a real unsecured creditor with a fraudulent transfer right. $C_{2,4}$, however, have no right. And $C_1$ is a secured creditor.
If, on the other hand, annulment means rescission or general disallowance, then $X$ loses the surplus. $C_{2,4}$, who _ex hypothesi_ have no fraudulent transfer right, gain a windfall at $X$'s expense. Using the above numbers, $C_{2,4}$ obtain $93.75, when they should have received $75. The only creditor with fraudulent transfer rights—$C_1$—also obtains $93.75, when she should have received $100. Meanwhile, $X$, who should have received a $50 surplus, loses it all to $C_{1,4}$.

This example proves that, just as the language of the fraudulent transfer statutes with regard to property transfers was misleading, so it is misleading with regard to the creation of fraudulent obligations. In fact, $X$'s obligation is not annulled. Properly, it is _transferred_ to $C_1$.

Notice that, according to the UFCA, $C_1$ may annul a claim, but only to the extent necessary to satisfy $C_1$'s claim. In the above example, $C_1$ and $X$ each claimed $100. $C_1$ was entitled to a dividend of $75 without any reference to fraudulent transfer law. $C_1$ was therefore entitled to annul only $25 of $X$'s claim. Annulment in the ordinary sense of erasure would benefit mostly those creditors with no fraudulent transfer rights.

### b. Judgments and Res Judicata

Another important utility for obligation annulment is the destruction of res judicata—an essential concept when $D$ fraudulently confesses judgment to $X$, based on a fictitious or otherwise defective debt. Prior to the judgment, there is no sense in saying that a fictional debt is a fraudulent transfer. It is simpler to say that $X$ has no claim. The matter changes once $X$ obtains a judgment against $D$. The judgment establishes res judicata against $D$, who thereafter can no longer claim that $X$'s obligation is a fiction. At this point, it becomes necessary for $C_1$ to show that $D$'s obligation is a fraudulent transfer.

Judgments, of course, engender liens. Once $X$ has a lien on $D$'s property, $X$ has a thing that $C_1$ can levy. But $C_1$ can reach this lien only if the underlying obligation is annulled. If the obligation is

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91. Chandler v. Thompson, 120 F. 940, 940-41 (7th Cir. 1902).
valid, so is the judicial lien, since antecedent debt is always "reasonably equivalent value," in UFTA terms.92

An illustrative case is Newman v. First National Bank of East Rutherford.93 In Newman, X (a bank) held D's promissory note for $3000. C1, a creditor for $75,000 whom D wished to "hinder, delay, or defraud."94 D and X agreed that D would execute a new promissory note for $6500, though X did not advance any new funds.95 A month later, the note was due and D defaulted. X sued and obtained a judgment. Pursuant to this judgment, X obtained a judicial lien on D's property. At the execution sale, X bought property worth $58,000 by bidding in only $1500 of his judgment.

Apparently, D and X had a side deal. X was supposed to give back the land to D once the coast was clear and D had paid back the legitimate $3000 loan to X.96 X, however, reneged on the deal. Angry, D exposed the conspiracy to C1. C1 brought a creditor's bill in equity97 against X in order to have the judgment and the sale proclaimed a fraudulent transfer. The court accorded C1 the remedy it sought:

We find [X's] judgment wholly void. Therefore, the whole of it should be set aside. Setting aside only the more vicious part (the $3,500 sham loan) is not enough. It was the act of [X] in

93. 76 F.2d 347 (3d Cir. 1935).
95. The purpose of this was to discourage any other bidders from bidding against X at the foreclosure sale. Newman, 76 F.2d at 349. To be absolutely precise, D's promissory note bore the amount $7000. $4000 was placed into a bank account for the benefit of D's son. X permitted a withdrawal of $500 from the son's account. In any case, the court went on to treat X's claim as one for $6500, $3000 of which related to a genuine loan, and $3500 related to a purely fictitious loan. Id.
96. The statute of frauds would have prevented D from claiming an equitable interest in the real estate, since the contract was not in writing. If this "contract" were enforceable, C1,4 would not require fraudulent transfer law to reach X's land. The doctrine of equitable conversion independently established D as the owner of the real estate, and C1,4 could reach this equity through a creditor's bill in equity.
97. Newman, 76 F.2d at 347-50. A creditor's bill in equity was an ancient equity form, which a creditor could use if the legal remedy of execution did not suffice. It was a popular means of pursuing property fraudulently conveyed to X. See United States v. Kensington Shipyard & Drydock Corp., 187 F.2d 709, 712 (3d Cir. 1951). In a fraudulent transfer case, filing a creditor's bill in equity establishes a lien for C1 on X's property. See Metcalf v. Barker, 187 U.S. 165, 172 (1902).
obtaining the judgment by fraud not the amount of the judgment that defeated \([C,]\) recovering on its judgment.\(^98\)

As a remedy, the court ordered a sale of X's property.\(^99\) The proceeds of the sale were to be distributed to court costs, taxes, X (for the amount of taxes paid and repairs made), \(C,\), and then to X (but only for $3000). Any further surplus was to be held by the court and disposed of in some undetermined way.\(^100\)

To what extent did the Newman court annul an obligation and to what extent did it avoid transfers of property? Before the judgment, there was no fraudulent transfer at all—only fictional debt that D did not owe. But once the judgment for $6500 was entered, D owed a fraudulent obligation. Under principles of res judicata, D could no longer dispute the existence of a $6500 claim. \(C,\), however, could and did obtain a declaration that X's obligation should be annulled as a fraudulent transfer.\(^101\)

That D owed a fraudulent obligation was initially of no concern to \(C,\). But once X's judgment was docketed, the matter changed. Under New Jersey law, a money judgment engenders a lien on real estate "from the time of the actual entry of such judgment on the

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99. Id. at 351.
100. Id.
101. Id. Notice that the false loan infected the valid part of the loan, making the whole judgment invalid. This was justified because the UFCA defines fair consideration as consideration paid in good faith. The antecedent debt of $3000 was paid (by X to D in good faith), but it was replaced by a new promissory note in bad faith. See Furlong v. Stortch, 518 N.Y.S.2d 216, 217-18 (App. Div. 1987).

Total avoidance seems to have been required prior to the UFCA. According to Frank Kennedy, the UFCA's chief contribution is (1) to provide that fraudulent transfers might be only partially voidable, and (2) to permit creditors without judgments to bring fraudulent transfer proceedings prior to judgment. Frank R. Kennedy, Involuntary Fraudulent Transfers, 9 CARDOZO L. REV. 531, 540-41 (1987).

What would have happened if the judgment was only partially avoided? One answer might be that X and \(C,\) are partners. The lien is held by X with 46% for the benefit of \(C,\) and 54% for itself; accordingly, the proceeds purchased from bidding in the lien are split on the same basis. Alternatively, the entire judgment can be viewed as fraudulent, but X purchased the judgment with a valid $3000 claim. This purchase would entitle X to claim the lien provided for in UFCA § 9(2): "A purchaser who without actual fraudulent intent has given less than a fair consideration for the conveyance or obligation, may retain the property or obligation as security for repayment." UNIF. FRAUDULENT CONVEYANCE ACT § 9(2), 7A U.L.A. 199 (1999). This provision would permit X to obtain $3000 back from the sale of the real estate on a basis senior to the judicial lien of \(C,\).
minutes or records of the court." Lien creation is a mode of transferring property. Was this lien a fraudulent transfer? That depends on what annulment means. If annulment means erasure, then the case became one in which $C_1$ must avoid the lien because it was a fraudulent transfer. On this assumption, the attendant lien constituted a "donation"—a transfer for no fair consideration at a time when $D$ is insolvent. If the lien had secured a valid debt, it would be a transfer for fair consideration, because securing old debt is considered value.

Annulment, however, does not mean erasure. It means that $C_1$ became the assignee of $X$'s judgment. So conceived, the judicial lien is the proceeds of $C_1$'s judgment. No avoidance of the lien occurs. Rather, the lien belongs to $C_1$ on a standard proceeds theory, an ordinary incident of trust law. Therefore, obligation avoidance was crucial to the outcome of the case. As a result of avoidance, the judgment was transferred to $C_1$, not annulled. $C_1$ became owner of the lien on a proceeds theory.

But something else must be added in order to justify the conclusion that $C_1$'s lien attached to the fee simple of $X$'s real property. Separate and apart from the fraudulent obligation, the foreclosure sale itself constituted a fraudulent transfer, because $X$ paid too little for $D$'s equity. Let's pay very close attention to the effect of this foreclosure sale. In a foreclosure sale, $X$ (as lien creditor) and $D$ sell their respective interest to $X$ (as buyer). These interests merge to make $X$ (as buyer) the owner of a fee simple estate. Notice that $X$'s fee simple estate consists of two parts: (1) $X$'s lien, which is held in trust for $C_1$ as proceeds of a fraudulent judgment, and (2) $D$'s equity. $D$'s equity is not proceeds of $X$'s fraudulent judgment. If $C_1$ is to have $X$'s equity as well as $X$'s lien, $C_1$ must have a new and separate fraudulent

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105. Rabin v. Delacruz (In re St. Clair Clinic, Inc.), No. 94-3943, 1996 WL 6531, at **3-4 (6th Cir. Jan. 8, 1996) (finding that fraudulently conveyed funds were used to purchase real property belonging to defendant, and were therefore part of the bankruptcy estate).
106. $X$'s interest was subject to some senior mortgage unaffected by $C_1$'s litigation. For a time, it was denied that the foreclosure sale was a transfer at all, but, of course, the sale constitutes the transfer of a potentially valuable debtor equity to a buyer at the sale. See Kennedy, supra note 100, at 554-59.
transfer theory that applies only to the sale of the equity. In other words, the fraudulent transfer of D's equity has nothing whatsoever to do with avoidance of the fraudulent obligation.

Why can we not say that X's equity is the proceeds of the fraudulent judgment? To see why, imagine that a good faith purchaser (Y) shows up at the auction and outbids X by bidding $6501. Assuming transaction costs are zero, these proceeds are allocable to X, as constructive trustee for C,\textsuperscript{107} with one dollar going to D. When Y is the bidder, Y buys the judicial lien from X for a reasonably equivalent value and the equity from D, for one dollar. These two interests—X's lien and D's equity—merge to form Y's fee simple absolute. With regard to X's lien, this was held in trust for C,. Nevertheless, as a bona fide purchaser, Y buys it free and clear of the constructive trust. The $6500 X received is the proceeds of the lien held for the benefit of C,. The matter is different with regard to debtor equity. Y is the initial transferee of D's equity. So conceived, this equity is not the proceeds of a fraudulent transfer. Rather, Y's purchase must be separately scrutinized to determine whether it is a fraudulent transfer.

Can underpaying at a foreclosure sale constitute a fraudulent transfer? This was the issue in \textit{BFP v. Resolution Trust Corp.},\textsuperscript{108} where the Supreme Court held that whatever a buyer pays at a foreclosure sale is always a reasonably equivalent value. This holding is not necessarily binding in state law; \textit{BFP} is an interpretation of the phrase "reasonably equivalent value," as that phrase appears in Bankruptcy Code § 548(a).\textsuperscript{109} The UFTA, however, legislated the \textit{BFP} holding in advance. According to UFTA § 3(b), "a person gives a reasonably equivalent value if the person acquires an interest of the debtor in an asset pursuant to a regularly conducted, noncollusive foreclosure sale ...."\textsuperscript{110} Nevertheless, under the UFCA, it is still open for C, to recover


\textsuperscript{108} 511 U.S. 531 (1994).

\textsuperscript{109} Id. at 535.

\textsuperscript{110} UNIF. FRAUDULENT TRANSFER ACT § 3(b), 7A U.L.A. 295 (1999).
debtor equity from $Y$, if $Y$ did not pay fair consideration for debtor equity.

If, per the $BFP$ case, $Y$ paid consideration for debtor equity when she paid $1$ for it, then is it not the case that $X$ is likewise off the hook, when $X$ bids in the judgment? Not necessarily; $BFP$ contains a collusion exception. According to the $BFP$ Court: “Although collusive foreclosure sales are likely subject to attack under § 548(a)(1), which authorizes the trustee to avoid transfers ‘made ... with actual intent to hinder, delay, or defraud’ creditors, that provision may not reach foreclosure sales that, while not intentionally fraudulent, nevertheless fail to comply with all governing state laws.”

Perhaps because $X$ colluded with $D$, the $BFP$ holding no longer applies, and it is now permissible for $C_f$ to reach $X$'s equity interest.  

At the foreclosure sale, then, something new emerged. Before that point, $D$ (not $X$) owned the equity interest in the fee simple estate. By virtue of the judicial lien, $X$ was empowered to sell $D$'s property interest to a buyer who also happened to be $X$. In effect, $D$, regardless of his consent, was forced to convey his valuable equity interest to $X$ for nothing—a transfer for no fair consideration while $D$ was insolvent.

The entire fee simple estate of $X$, then, was a fraudulent transfer. Part of the fee simple stemmed from annulment of an obligation. Part of it—the transfer of debtor equity to $X$—did not stem from annulment of the obligation and perhaps was voidable even if the judgment was totally valid. As a result of these two distinct acts of avoidance or annulment, $X$'s land was held in trust for $C_f$, pending $C_f$'s affixation of its private judicial lien on $X$'s property. Annulment of the obligation was necessary, but not sufficient, for this result.

111. $BFP$, 511 U.S. at 545.

112. It is beyond the scope of the current Article, but it should be noted that “collusion” is a deeply troublesome concept. If $D$ and $X$ collude in a foreclosure sale, but they follow the procedural rules, does not $X$ pay a reasonably equivalent value all the same, relying on $BFP$’s logic? For a recent example of collusion, see Voest-Alpine Trading USA Corp. v. Vantage Steel Corp., 919 F.2d 206 (3d Cir. 1990). In Voest-Alpine, $D$ defaulted on a mortgage agreement with $X$. At $X$'s foreclosure sale, $Y$ was the buyer. $Y$ financed the purchase with a secured loan from $X$. The shareholder of $Y$ was also the shareholder of $D$. Precisely where was the collusion here? Did $D$, who was insolvent, collude by defaulting? Did $X$ collude by lending to $Y$? What was wrong with this transaction, given that $Y$ paid “reasonably equivalent value” per $BFP$?
c. Secured Obligations

Annulment of obligations again plays a confusing role in cases where $D$ also grants $X$ a security interest or mortgage for the fraudulent obligation. Are these fraudulent transfers of property or the fraudulent creation of an obligation?

As before, the borderline between fictional debt and fraudulent obligation is hard to theorize. In the case of purely fictional debts, there is no need for a fraudulent transfer theory, because $D$ owes nothing. If $D$ owes nothing, then no security interest can attach to $D$'s property.\textsuperscript{113} If, on the other hand, $X$ has a claim against $D$ which is fraudulent as to $C$, the attendant security interest exists as such. Whether $C$, can become subrogated to $X$'s security interest often depends on annulment of the obligation. Once annulled, the obligation belongs to $C$, and the security interest for the obligation must follow along.

Dean Robert Charles Clark, however, presents the following example of a mortgage based in part on real advances and part on pure fiction:

Debtor $[D]$ grants $[X]$ a mortgage of his small factory in return for a loan of $160,000, which $[X]$ actually makes to $[D]$. $[D]$, wishing to discourage unpaid trade creditors having $30,000 of claims from litigating them to judgment and seeking execution against the factory, prevails upon $[X]$ to have the recorded mortgage recite that it secures a debt for $200,000 .... The trade creditors' attorneys search the real estate records, discover and give credence to the false mortgage, and, knowing that $[D]$ has few assets other than the factory, become discouraged and cease pursuing $[D]$.\textsuperscript{114}

In Clark's example, $40,000 of the mortgage is entirely fictional. This, Clark says, "is a case of Ur-Fraud, that primeval fraud on creditors than which no greater can be thought."\textsuperscript{115}

\textsuperscript{113.} The Uniform Commercial Code (UCC) makes extension of value an element of attachment (that is to say, of lien creation). U.C.C. § 9-203(b)(1) (2001).


\textsuperscript{115.} Id. at 509. Theologians will detect here a sly reference to St. Anselm's ontological
It is possible that Clark's fraud is no fraud at all. In his example, is the fraud the secured obligation or the mortgage lien (a transfer of the property)? It is hard to say because a mortgage is always the qualitative power to sell D's fee simple in the property. So long as one dollar of valid obligation exists, the mortgage as such is valid. What is really at issue in Clark's example is the quantitative aspect of the mortgage, which determines how much of the proceeds X can validly keep following the sale.

It is not clear in Dean Clark's example that C, needs a fraudulent transfer theory to reach D's equity. In New York, for example, C, could seek declaratory relief under New York Civil Practice Law Rule 5239, which provides: "Prior to the application of property or debt by a sheriff or receiver to the satisfaction of a judgment, any interested person may commence a special proceeding against the judgment creditor or other person with whom a dispute exists to determine rights in the property or debt." Using this provision —without any reference to fraudulent transfer law—C, can obtain any surplus above $160,000. Perhaps Clark's Ur-Fraud is no fraudulent transfer law at all!

The point has practical import. If Dean Clark has given us a true fraudulent transfer case, then C, are subject to the fraudulent transfer statute of limitations, which at least in New York is basically six years. If, on the other hand, this is not a fraudulent transfer example, C, can reach D's equity so long as their judgments are still valid. In New York, judgments are good for twenty years, and they are perpetually renewable.

The matter changes if X obtains a judgment of foreclosure based on the fictional debt. In that case, D is bound by res judicata. X's claim then graduates from mere fiction to a fraudulent transfer. At proof of God. ST. ANSELM, MONOLOGION AND PROSLOGION WITH THE REPLY OF GAUNILO AND ANSELM 100 (Thomas Williams trans., Hackett Pub. Co. 1996).

116. Since Clark's mortgage is an intentional fraud on creditors, both present and future creditors have fraudulent transfer rights, if indeed Clark has given us a true fraudulent transfer case.


this point, \( C_1 \) need fraudulent transfer theory to establish that the real debt is $160,000—not $200,000. In \( BSL \) Development Corp. v. Aquabogue Cove Partners, Inc.,\(^{121}\) \( D \) issued a mortgage on antecedent debt to \( X \), an insider, on the eve of \( C_1 \)'s judgment. A large part of \( X \)'s claim was fictional. On this basis, \( C_1 \) was permitted to intervene in \( X \)'s foreclosure sale, where \( C_1 \) was fully subrogated to \( X \)'s mortgage lien. \( C_1 \)'s intervention therefore culminated both in a judgment binding against \( D \) and \( C_1 \)'s simultaneous subrogation to \( X \)'s mortgage.\(^{122}\)

Mortgages for fictional debts, then, are difficult to analyze. But clearly when they are intended to hinder or delay specific creditors, courts are prepared to proclaim them fraudulent transfers. Easier to analyze are fraudulent obligations when \( D \) clearly owes the mortgage debt.

Leveraged buyouts present the classic example. \( United States v. Tabor Court Realty\)^{123} represents what was earlier called an exchange. \( D \) borrowed from \( X \) in exchange for mortgages. \( X \) knew that some of the money would be used to cash out shareholders and certainly should have known that, given the extreme drain on cash flow caused by debt service, \( D \) could not long survive. \( D \) soon defaulted on a tax debt (which generated a lien junior to \( X \)'s mortgage), and, in a foreclosure sale, a co-conspirator purchased the collateral for a pittance. The fraudulent transfer remedy sought by the IRS was aimed at the mortgage and also at the transfer of debtor equity as a result of the tax foreclosure sale. The nature of the fraud was a species of exchange for the purpose of financing \( D \)'s fraudulent transfer to the departing shareholders.\(^{124}\) Mortgages are a means of liquifying assets so that the dollars can flee the grasp of unpaid creditors.

In \( Tabor Court Realty \), the debt \( D \) owed was not fictional. \( X \) actually advanced funds, and \( D \) chose to use the funds to redeem

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122. \textit{Id}. at 254. To complicate matters, the case might equally be viewed as an insider's voidable preference, which New York dubs a fraudulent transfer. \textit{See} HBE Leasing Corp. v. Frank, 48 F.3d 623 (2d Cir. 1995). If so, then \( BSL \) is a fraudulent transfer case, even if the obligation is totally valid.
123. 803 F.2d 1288 (3d Cir. 1986).
124. \textit{Id}. at 1291-94. The \( Tabor \) court, however, chose to view it as a donation case. It collapsed the transaction so that, although \( X \) received a mortgage, \( D \) received no funds since the funds were dividended out to the departing shareholders. \textit{Id}. at 1302-03.
common stock. If $X$ had foreclosed on the mortgage, $D$ could not claim this debt was a mere fiction. Leveraged buyouts are therefore legitimate fraudulent transfer cases. They turn on annulling the obligation. The mortgage itself is proceeds of that obligation, and its expropriation by $C_1$ followed accordingly. As always, annulled does not mean erased. Rather, it means transferred from $X$ to $C_1$.\textsuperscript{125}

3. Moore v. Bay

In the above examples, $C_1$ had fraudulent transfer rights against $X$'s property, but $C_2$ did not. These examples proved that avoidance and annulment are misleading metaphors that must not be taken literally. Rather, fraudulent transfer law transfers $X$'s rights over to $C_1$ (but not to $C_2$).

There is a reason this point has been overlooked: Moore v. Bay.\textsuperscript{126} In effect, Moore v. Bay converts fraudulent transfer theory into general rescission in a bankruptcy proceeding.

Since 1898, federal bankruptcy has been the dominant mode of debt collection. The strange rule of Moore v. Bay holds sway here. This case is an interpretation of what is now § 544(b)(1), which subrogates the trustee to any avoidance power of an unsecured creditor.\textsuperscript{127} For example, if $D$ conveys a thing to $X$, and if $C_1$ has a fraudulent transfer right against $X$'s thing, $D$'s bankruptcy implies that the trustee steps into the shoes of $C_1$ in order to recover $X$'s thing for the bankruptcy estate.\textsuperscript{128}

Moore v. Bay is yet another manifestation of the metaphorical error caused by terms like “avoid” or “set aside.” In Moore v. Bay, the Supreme Court, in a rare moment of confusion, imagined that $D$'s transfer to $X$ should be literally set aside in the sense of erased.\textsuperscript{129} What was once $D$'s thing is $D$'s thing once again. The entire thing is treated as if it had always been in $D$'s estate. $X$ loses

\textsuperscript{125} In Tabor Realty, $D$ retained about 44% of the LBO loan and only used 56% of it to redeem shares. Nevertheless, the entire mortgage was held a fraudulent transfer. Id. at 1293. The case therefore resembles Newman v. First National Bank of East Rutherford, 76 F.2d 347 (3d Cir. 1935), in giving the secured creditor no credit for funds actually advanced and used within the debtor's estate.

\textsuperscript{126} 284 U.S. 4 (1931).

\textsuperscript{127} 11 U.S.C. § 544(b)(1) (2001); see also Bankruptcy Act of 1888 § 70(e) (repealed 1978).


\textsuperscript{129} Moore, 284 U.S. at 5.
the surplus because, in effect, there was no transfer to X in the first place.\textsuperscript{130} When *Moore v. Bay* applies and a surplus in the bankruptcy estate exists, the bankruptcy estate, not X, wins back the surplus. *Moore v. Bay* effectively licenses $C_{24}$ to a free ride on $C_i$'s private right.

Strictly speaking, the trustee may not always need to invoke subrogation. The trustee has her own direct, independent fraudulent transfer right under §548(a), regardless of state or nonbankruptcy law.\textsuperscript{131} If the trustee recovers under §548(a), the proceeds go into the bankruptcy estate and are shared equally by $C_{14}$, even if $C_{24}$ had no state law rights. $C_i$ cannot claim any unique right of recovery just because $C_i$ also has a private right of recovery under state law.

But §548(a) has a stingy one-year statute of limitations.\textsuperscript{132} If $D$ conveyed the thing to $X$ one year before bankruptcy, §548(a) is useless for recovery of it. State law usually has a longer statute of limitations. It is usually said that §544(b)'s principal utility in modern times is to harness the advantage of the longer statute of limitations.\textsuperscript{133} A key difference between direct recovery under §548(a) and subrogation under §544(b)(1) is that, for the subrogation theory to work, the trustee must actually identify a real flesh-and-blood creditor (like $C_i$) who could have avoided the transfer to X under nonbankruptcy law.\textsuperscript{134}

Without more, subrogation under §544(b)(1) merely suggests that the trustee has only what $C_i$ had. If $X$ owns a surplus beyond $C_i$'s claim, this would continue to belong to $X$, under the logic of subrogation. *Moore v. Bay*, however, does violence to subrogation theory in two ways. First, subrogation, as transformed in *Moore*, means the bankruptcy trustee can recover all of $X$'s surplus. For example, if $X$'s thing is worth $150 and $C_i$'s claim against $D$ is $100,
the trustee recovers $150 from X—the entire thing. Second, the proceeds of X's thing belongs to the bankruptcy estate, not to C_I.  

Congress pondered a repeal of Moore v. Bay in 1977 when it enacted the Bankruptcy Code. Moore was saved from obscurity by the testimony of Professor Vern Countryman who observed that it spared bankruptcy trustees the trouble of tracking down and subrogating to the rights of sufficient creditors to get back all of X's thing. If C_I could be located, the trustee's victory over X was assured, and estate assets were preserved. For this reason Moore v. Bay is still with us.  

But Moore v. Bay is an interpretation of § 544(b)(1) only. Equitable subordination is legislated into existence by Bankruptcy Code § 510(c). It expressly authorizes subordination to specific creditors, which implies that the questionable dynamic of Moore v. Bay has no purpose there. Accordingly, all the distinctions developed above about C_I's right (and C_2's lack of right) can be used to analyze the equitable subordination remedy, which is not subject to the rule of Moore v. Bay. Given the fact that equitable subordination and fraudulent transfer are the identical remedy, this distinction makes no sense.

135. See Thomas H. Jackson, Avoiding Powers in Bankruptcy, 36 STAN. L. REV. 725, 749-50 (1984) (asserting that Moore v. Bay "is unprincipled to the extent that it forces a particular creditor to share the valuable right to avoid a property interest with the entire class of unsecured creditors").

136. This story is recounted in Nancy L. Sanborn, Note, Avoidance Recoveries in Bankruptcy: For the Benefit of the Estate or the Secured Creditor?, 90 COLUM. L. REV. 1376, 1381-82 (1990).


138. See id.
II. EQUITABLE SUBORDINATION

A. The Substantive Standard

Invented by the Supreme Court in Pepper v. Litton, equitable subordination was eventually codified in Bankruptcy Code § 510(c), which provides that a court may:

(1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or
(2) order that any lien securing such a subordinated claim be transferred to the estate.\(^\text{140}\)

Whereas a fraudulent transfer can be summarized as being either a deliberate fraud on creditors or a donation,\(^\text{141}\) equitable subordination cannot so neatly be captured. Virtually any inequitable conduct by a creditor can be used to justify an equitable subordination. The classic formulation of the standard is found in the oft-cited Benjamin v. Diamond (In re Mobile Steel Co.).\(^\text{142}\) According to the Mobile Steel test, equitable subordination is appropriate if, (1) the claimant engaged in some type of inequitable conduct,\(^\text{143}\)

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139. 308 U.S. 295 (1939). A few months before, the Supreme Court decided the famous "Deep Rock" case that is the staple of corporate finance casebooks. Taylor v. Standard Gas & Elec. Co., 306 U.S. 307 (1939). In this case, open accounts of a holding company were transformed into capital contributions and the holding company was reduced to the rank of common shareholder below preferred shares. The phrase "subordinated" is occasionally used there, but the notion of subordination as an equitable power of the bankruptcy courts comes from Pepper. Even Pepper does not use the phrase "equitable subordination" as such, but equity and subordination are often used in the same sentence. See, e.g., Pepper, 308 U.S. at 296 ("We granted certiorari because of an apparent restriction imposed by that decision on the power of the bankruptcy court to disallow or to subordinate such claims in exercise of its broad equitable powers.").

It is also possible to find cases before Pepper in which the equitable subordination remedy was imposed on a misbehaving creditor without using the phrase "equitable subordination." See, e.g., Miller v. Borton (In re Bowman Hardware & Elec. Co.), 67 F.2d 792 (7th Cir. 1933).


141. See supra notes 22-29 and accompanying text.

142. 563 F.2d 692 (5th Cir. 1977).

143. One exception to this proposition is that courts are apparently willing to subordinate debt when it is swapped for stock, if the debt is still outstanding at the time of the
(2) the conduct caused injury to the creditors or conferred an unfair advantage on the claimant, and (3) subordination is otherwise consistent with all the provisions of the Bankruptcy Code.\textsuperscript{144}

Most often insider creditors are the ones punished by equitable subordination. Ordinary creditors may likewise be subordinated,\textsuperscript{145} but it is often said that their conduct must be especially egregious to justify the remedy.\textsuperscript{146} Nevertheless, even lawful conduct may constitute egregious conduct justifying equitable subordination.\textsuperscript{147}

Although a survey of wicked conduct is beyond the scope of this Article, a few points deserve emphasis in considering the structure of the remedy. Whereas fraudulent transfer law concerns itself with the debtor’s intent to hinder, delay or defraud creditors (although intent is presumed in insolvent donation cases), equitable subordination concerns itself with creditor misconduct. Accordingly, while fraudulent transfer law focuses solely on the origin of \(X\)'s claim, equitable subordination “need not ... be specifically related to the creditor’s claim, either in its origin or its acquisition, but it may equally arise out of \textit{any unfair act} on the part of the creditor, which affects the bankruptcy results to other creditors ....”\textsuperscript{148}

\section*{B. The Remedy}

What is usually said about equitable subordination is that \(X\)'s claim is not disallowed.\textsuperscript{149} It is merely demoted behind all the other

\textsuperscript{144} Mobile Steel, 563 F.2d at 693.
\textsuperscript{145} See generally Andrew DeNatale & Prudence Abram, \textit{The Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors}, 40 BUS. LAW. 517, 519 (1985) ("Where a claimant’s conduct in relation to other creditors is contrary to equitable principles, the equity powers of the bankruptcy court may be exercised to subordinate the claim of that claimant to the claims of the others of the same class").
\textsuperscript{146} See, \textit{e.g.}, Capital Bank & Trust Co. v. 604 Columbus Ave. Realty Trust (\textit{In re 604 Columbus Ave. Realty Trust}), 968 F.2d 1332, 1356 (1st Cir. 1992).
\textsuperscript{148} \textit{Id.} at 838 (emphasis added).
\textsuperscript{149} See, \textit{e.g.}, Mishkin v. Siclari (\textit{In re Adler}, Coleman Clearing Corp.), 277 B.R. 520, 563
creditors and stands in line behind them.\textsuperscript{150} Such a description suffices when $X$ harms all the creditors. In such a case, demotion produces the same result as assignment. Yet Bankruptcy Code § 510(c) authorizes subordination to less than all of the creditors in appropriate cases.\textsuperscript{151} If equitable subordination means demotion, then $C_{2,4}$, not harmed by $X$'s malice, receive a windfall. $C_1$, the only creditor harmed, has a more difficult time getting paid because she must share with $C_{2,4}$.

The better view of equitable subordination is that it constitutes the assignment of $X$'s claim to the creditors harmed by $X$'s conduct. This is precisely what fraudulent transfer law achieves when it annuls $D$'s obligations. As we have seen, annulment does not mean disallowance. Rather, it means that $X$'s claim is transferred to $C_1$. This insight proves that equitable subordination is simply a fraudulent transfer remedy.

Because of this insight, \textit{Moore v. Bay}\textsuperscript{152} (itself the product of metaphorical error) is irrationally limited to fraudulent transfer cases under § 544(b)(1). Also, the equation of fraudulent transfer and equitable subordination proves that equitable subordination is a remedy that can be instituted under state law when appropriate.

As with fraudulent transfer law, fictional debts in bankruptcy must be distinguished from real-but-fraudulent debts. If a debt is purely fictional, the proper remedy is to disallow it because it is not enforceable against $D$.\textsuperscript{153} It makes sense to subordinate a claim, or proclaim it a fraudulent transfer, if and only if it is otherwise allowable against $D$. If $X$'s fictional claim is allowed but subordinated, $X$ (not $D$) would gain any bankruptcy surplus after all creditors are paid. Yet $X$ has no entitlement against $D$ at all.

Significantly, the very case that invented equitable subordination was a fictional debt case. In \textit{Pepper v. Litton},\textsuperscript{154} $X$ obtained a

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{150} E. Minerals & Chems. Co. v. Mahan, 225 F.3d 330, 338 (3d Cir. 2000).
\item \textsuperscript{151} 11 U.S.C. § 510(c) (2001).
\item \textsuperscript{152} 284 U.S. 4 (1931).
\item \textsuperscript{153} Federal Rule of Bankruptcy Procedure 3007 describes the procedure for claims objections. See \textit{FED. R. BANKR. P.} 3007.
\item \textsuperscript{154} 308 U.S. 295 (1939).
\end{itemize}
\end{footnotesize}
judgment against D. Without an avoidance theory, X's fictional claim had to be allowed as a matter of res judicata. Equitable subordination therefore was invented to be and continues to exist as a reproach to res judicata—a function it shares with fraudulent transfer law.

In Pepper, the Court permitted complete disallowance of X's claim, an act the Pepper Court called subordination. The legislative history to the Bankruptcy Code specifically endorses the disallowance remedy as a mode of equitable subordination. Properly, however, X's claim should not have been simply avoided or annulled (i.e., disallowed) but rather transferred to the creditors harmed by X's action. Disallowance meant that D would get the surplus, not X. Yet X's claim against D was vested with the dignity of res judicata. An assignment theory, however, would have allowed X to obtain the surplus in recognition of the fact that X's claim against D was valid though voidable by creditors. If, on the other hand, equitable subordination consists of assigning X's claim to C, exactly what fraudulent transfer law demands—then C

155. Id. at 297.
156. Id. at 302-05.
157. Id. at 303.
158. According to the legislative history:

[Section 510] permits the court to subordinate, on equitable grounds, all or any part of an allowed claim or interest to all or any part of another allowed claim or interest, and permits the court to order that any lien securing claims subordinated under this provision be transferred to the estate. This section is intended to codify case law, such as Pepper v. Litton, 308 U.S. 295 (1939), and Taylor v. Standard Gas and Electric Co., 306 U.S. 307 (1938), and is not intended to limit the court's power in any way. The bankruptcy court will remain a court of equity, proposed 28 U.S.C. 1481; Local Loan v. Hunt, 292 U.S. 234, 240 (1934). Nor does this subsection preclude a bankruptcy court from completely disallowing a claim in appropriate circumstances. See Pepper v. Litton, supra. The court's power is broader than the general doctrine of equitable subordination and encompasses subordination on any equitable grounds.

H.R. 595, 95th Cong., § 510 (1979) (emphasis added). For some reason, courts simply overlook this point. See, e.g., Mishkin v. Siclari (In re Adler, Coleman Clearing Corp.), 277 B.R. 520, 563 (Bankr. S.D.N.Y. 2002) ("The equitable subordination doctrine, codified in part in Section 510(c) of the Bankruptcy Code, is limited to reordering priorities; it does not permit disallowance of claims.").

159. In Pepper, it turns out that X was the "dominant and controlling stockholder" of D, so no harm was done. Pepper, 308 U.S. at 297. As shareholder, he was destined to get any surplus left after C was paid. But in some future case, that may not be so.
receive no windfall, $C_1$ is more likely to be paid, and $X$ is more likely to receive a surplus.\footnote{160}

The following sections establish that an assignment theory of equitable subordination is superior to a demotion theory when $X$'s wicked blows rain upon $C_1$'s shoulders only. Assignment theory works equally well as demotion when $X$ is generally subordinated to all creditors. Because assignment theory works better in the unusual case and functions perfectly in the general case, it should be adopted as the true nature of equitable subordination.

1. Specific Subordination

   a. Under Bankruptcy Code § 510(c)

   Suppose $C_1$ is the only creditor harmed by $X$. $C_{24}$ are unaffected or perhaps even helped by the wrong visited upon $C_1$. Bankruptcy Code § 510(c) refers directly to the possibility of subordination to $C_1$, but not to $C_{24}$, as it invites a bankruptcy court to "subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim ...."\footnote{161} Therefore, $C_1$ alone may be entitled to the benefits of equitable subordination to the exclusion of $C_{24}$. What this means is that $C_1$ is the assignee of $X$'s claim. This entitles

\footnote{160. A rather different view of the matter was presented by Dean Clark in his classic comparison of fraudulent transfers and equitable subordination. He viewed equitable subordination to be a “functional equivalent” of fraudulent transfer law. Clark, supra note 12, at 536. Naturally, since fraudulent transfer law is merely an equivalent, it is portrayed as different from equitable subordination law.

   In Clark's example, $X$ is an inside creditor claiming $100. X$ competes with $C$, an outside creditor, claiming $100. D$ has assets of $150. D$ then conveys $70$ to $X$ in a fraudulent transfer. Clark then compares recovering the $70$ directly from $X$ and equitably subordinating $X$'s valid claim of $100. See id. at 521-22.

   Clark's example prevented him from reaching the conclusion here—that fraudulent transfer law and equitable subordination are precisely the same thing. If the fraudulent transfer in Clark's example was the very creation of the $100 claim being asserted by $X$, then the exact equivalence of the two areas of law would have revealed itself.

   Nevertheless, cases such as the one posed by Clark undoubtedly exist. In In re Thompson, 276 F. 313 (W.D. Pa. 1921), a secured party bought collateral at an obviously too low price and then made an application to recover cash collateral held by the bankruptcy estate. Id. at 314-15. The court in effect disallowed the secured party's claim to compensate for the fraudulent transfer that the secured party received. Id. at 318-19 (noting that "the claimant here has been already much overpaid").

C, to the dividend that otherwise would have been payable to X. In effect, C, obtains double dividends.

By way of example, suppose D has five creditors: C, and X. Every creditor claims $100. The estate has $375. If X's claim is simply disallowed or generally subordinated to all other creditors, then four creditors (C, and C,) obtain one-fourth of $375, or $93.75. C, the victim, is not entirely paid, and the neutral creditors unharmed by X's action obtain a windfall. They would have obtained $75 from the distribution in the absence of equitable subordination. Now they receive $93.75. Meanwhile, X's chance for a surplus becomes more remote as a result of general subordination. If X is generally subordinated, X obtains a surplus only if the estate exceeds $400. Where X is specifically subordinated to C, only, X receives a dividend when the estate exceeds $250.

If, however, X is specifically subordinated to C, only, the matter changes. Suppose that equitable subordination achieves the assignment of X's claim to C, (but not to C,). In this conception, C, first obtains $75 in her own right. C, also obtain $75. X's claim is allocated $75, but this dividend is dedicated to C, until C, is paid. C, therefore obtains $25 of X's dividend, so that C, receives $100 in total. X receives the surplus of $50. The neutral creditors are neither helped nor harmed by the suggested allocation.

The precise result was also achieved when X's claim was deemed a fraudulent conveyance. Specific subordination, then, is the fraudulent transfer remedy where only C, is entitled to recover. When X is subordinated to C, alone (and not to all the other creditors), C, obtains a security interest on X's claim. So conceived, equitable subordination is a theory under which X's property is transferred from X to C,.

b. Under Bankruptcy Code § 509

Specific subordination under § 510(c) is no doubt rare, but it is routinely invoked by Bankruptcy Code § 509, which governs suretyship claims.162 Suppose instead of receiving a fraudulent transfer from D or visiting wicked havoc on C, so as to justify equitable subordination, X instead guarantees C,'s claim for $100.

Suppose further, as so often happens, D and X are both bankrupt. C₁ has already obtained $75 of its $100 claim from X's bankruptcy. In order to obtain reimbursement, X files a proof of claim in D's bankruptcy.¹⁶³ X is in part a contingent creditor of D. That is, D does not owe X until X actually pays C₁ and becomes subrogated to her claim. The Bankruptcy Code, however, disallows the contingent portion of the claim ($25).¹⁶⁴ The non-contingent portion—the subrogation right based on paying C₁ $75—is fully allowable,¹⁶⁵ but it is subject to the distributional rule of § 509(c), which provides:

The court shall subordinate to the claim of a creditor and for the benefit of such creditor an allowed claim, by way of subrogation under this section, or for reimbursement of contribution, or an entity that is liable with the debtor on, or that has secured, such creditor's claim, until such creditor's claim is paid in full, either through payments under this title or otherwise.¹⁶⁶

The emphasized language makes clear that only C₁ (not C₂₄) is to benefit from X's subordination.

Suppose now that C₂₄ have allowed claims of $100 against D. C₁'s $100 claim has been reduced to $25, and X has an allowed claim of $75, because X is subrogated to C₁'s right to a dividend in D's bankruptcy.

Just as C₂₄ should receive nothing from the equitable subordination of X, so they should receive nothing extra because X is surety to C₁. Rather, the $75 dividend allocable to X should be allocated to C₁ (for $25). This allocation is more complex than it seems. Both C₁ and X are entitled to dividends in their own right. Since C₁ claims $25 and X claims $75, their own dividends are $18.75 and $56.75 respectively. C₁'s dividend reduces her claim to $6.25. X, however, is subordinated to C₁. Since subordination means assignment of X's claim, C₁ receives $6.25 of X's dividend. X retains $50. As with fraudulent transfer law and equitable subordination, X should receive the surplus, not C₂₄.

¹⁶³ For ease of exposition, I will refer to X, though X's subrogation rights are property of X's bankruptcy estate.
The above example makes it possible to conclude that fraudulent transfer law and equitable subordination make X the non-recourse surety of $C_1$, but not of $C_{2.4}$. Fraudulent transfer liability and equitable subordination are therefore in the nature of non-contractual suretyships, imposed on X by operation of law.

2. General Subordination

When X's dark malice harms $C_{1.4}$ equally, it suffices to say that X is demoted in priority. But it equally suffices to say that X's claim is assigned to $C_{1.4}$ as security for their claims. In short, general subordination is simply a special case of specific subordination. When X is subordinated to $C_1$ (but not to $C_{2.4}$), $C_1$ receives double dividends—her own and (to the extent necessary) X's dividend. Beyond the amount needed to pay $C_1$, X has a surplus interest in X's original dividend. This same regime works perfectly well to describe the phenomenon of general subordination to all creditors. Where X's crime is general, not specific, all the creditors receive X's dividend.

In order to illustrate this principle, it is necessary to change the numerical example so as to produce a surplus for X. Suppose X and $C_{1.4}$ each claim $100 and are entitled to a 90% dividend of $90. In all, there are $500 worth of claims competing for $450 of assets. X is subordinated to all the creditors.

It is typically said X stands in line\(^\text{167}\) after $C_{1.4}$, who obtain 100% dividends, leaving $50 in the bankruptcy estate. X's subordinated claim of $100 may now receive a $50 dividend. Yet if standing in line was the theory in the case of specific subordination, neutral creditors would obtain a windfall, and X would be over-punished for her crime.

On the theory presented here, the procedure for general subordination is restated (though X still obtains $50). Because equitable subordination is simply fraudulent transfer law in the context of pro rata distributions, $C_{1.4}$ obtain a lien on X's $100 claim, which itself generates a $90 dividend. $C_{1.4}$ therefore are entitled to double dividends. Each of the four obtains $90 in her own right. The estate is now reduced by $360, leaving only $90 to distribute. This equates with the dividend allocable to, but withheld from, X. The

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four creditors need $40 of X's dividend to be made whole. They therefore “take” $44.44 of X’s claim, which is what is required to generate a $40 dividend, given the 90% dividend. The bankruptcy estate is now reduced to $50. X obtains the surplus of $50, based on her remaining unsecured claim of $55.56. This is the sole remaining claim against the $50 in the bankruptcy estate. This amount is allocated to X's $55.56 claim. In effect, X receives a 90% dividend—just as C\textsubscript{1,4} did—though X’s total claim has been reduced by the amount needed to secure the claims of C\textsubscript{1,4}. Although the result is the same (X obtains $50), under this restated theory of equitable subordination, X obtains a 90% return both before and after subordination.

This demonstration shows that general subordination is the same as specific subordination, and both are the same as what is misleadingly called annulment of a fraudulent obligation under state law.\footnote{168 For a discussion of annulment, see supra notes 84-86 and accompanying text.}

C. Contractual Subordination Compared

Equitable subordination may be compared to contractual subordination. Although the nature of contractual subordination is likewise much disputed, it can be said that contractual subordination achieves through consent what equitable subordination achieves through operation of law, with one important supplement.

Contractual subordination, as I have argued elsewhere, is the assignment of a junior claim to designated senior creditors as security for the senior claims.\footnote{169 See Carlson, supra note 4.} This is quite explicitly described in the subordination provisions of the Model Indenture,\footnote{170 See AMERICAN BAR FOUNDATION COMMENTARIES ON INDENTURES 560-64 (1971).} which provide that in case of any liquidation or reorganization of the debtor:

(a) the holders of all Senior Debt shall first be entitled to receive payment in full ... before the Holders of the Debentures ... are entitled to receive any payment ...;
(b) any payment ... to which the Holders of the [junior] Debentures ... would be entitled except for the provisions of this
Article shall be paid ... directly to the holders of Senior Debt ...; and

(c) in the event that, notwithstanding the foregoing, any payment ... shall be received by the ... [junior] Holders ... before all Senior Debt is paid in full, such payment ... shall be paid over to the holders of such Senior Debt ... for application to the payment of all Senior Debt remaining unpaid until all such Senior Debt shall have been paid in full ....

These provisions go on to require that, if senior debt is paid, the junior creditors:

shall be subrogated to the rights of the holders of Senior Debt to receive payments ... applicable to the Senior Debt until all amounts owing on the Debentures ... shall be paid in full, and, as between the Company, its creditors other than holders of Senior Debt, and the [junior creditors], no such payment ... made to the holders of the Senior Debt ... which otherwise would have been made to the [junior creditors] shall be deemed a payment by the Company on account of the Senior Debt, it being understood that the provisions of this Article are and are intended solely for the purpose of defining the relative rights of the [junior creditors] on the one hand, and holders of the Senior Debt, on the other hand.

The subrogation clause operates as follows. Suppose X voluntarily subordinates her claim to $C_1$. $C_1$ is therefore entitled to double dividends. Once $C_1$ is paid out, X becomes subrogated to $C_1$'s claim. Now it is X's turn to receive double dividends. While $C_1$ remains unpaid, X obtains nothing and falls behind the neutral creditors. But once $C_1$ is paid, X begins to catch up to the neutral creditors by receiving X's own dividend plus (by subrogation) $C_1$'s dividend.

The subrogation idea, however, falls out of the equitable subordination equation. It is usually said of intentional tortfeasors such as X that they have no right to contribution or indemnity. If this instinct is applied to equitable subordination, then X, who is

171. Id. at 561-62.
172. Id. at 562.
173. Carlson, supra note 4, at 987-89.
174. See, e.g., Levit v. Ingersoll Rand Fin. Corp., 874 F.2d 1186, 1192 (7th Cir. 1989).
subordinated to $C_1$ but not to the neutral creditors, will never receive double dividends once $C_1$ is paid out. $C_{2,4}$, however, benefit from the dividends that $C_1$ no longer needs. A refusal to subrogate $X$ to $C_1$ (after $C_1$ is paid) implies a windfall for $C_{2,4}$, though less of a windfall than total demotion would have implied.

Nevertheless, even without a right of subrogation for $X$, $X$'s remaining claim, after assignment to $C_1$, will always exceed the amount in the bankruptcy estate after $C_{1,4}$ are paid out. It is mathematically impossible for $D$ ever to get a surplus, so that loss of the subrogation right can never inhere to $D$'s advantage. It does, however, mean that $C_{2,4}$ benefit, because if $X$ has no subrogation right, $X$ never has occasion to obtain double dividends once $C_1$ is paid out.

D. The Origin of Equitable Subordination

1. Implications of Pepper v. Litton

I have shown that equitable subordination and fraudulent transfer law engender the same remedy. This point is bolstered by a study of the origin of equitable subordination. Pepper v. Litton\textsuperscript{175} was the earliest case to invoke the phrase. In Pepper, the Supreme Court perhaps implied that the doctrine existed as part of Virginia law.\textsuperscript{176} If this can be shown, then it should be clear that cases that hold equitable subordination to be strictly federal are erroneous.

In Pepper, a coal company ($D$) owed back royalties to $C_1$.\textsuperscript{177} $D$ was controlled by $X$.\textsuperscript{178} $X$ brought suit against $D$,\textsuperscript{179} and during the lawsuit, $D$ confessed judgment to $X$ and other insiders for salary.\textsuperscript{180} $X$ then bought up all other insider claims, so that $C_1$ and $X$ were the only creditors of $D$.\textsuperscript{181}

\begin{itemize}
  \item \textsuperscript{175} 308 U.S. 295 (1939).
  \item \textsuperscript{176} Id. at 302-03.
  \item \textsuperscript{177} Pepper v. Dixie Splint Coal Co., 181 S.E. 406, 408 (Va. 1935).
  \item \textsuperscript{178} Id.
  \item \textsuperscript{179} Id. at 407.
  \item \textsuperscript{180} See Smith v. Litton, 188 S.E. 214 (Va. 1936).
  \item \textsuperscript{181} Litton v. Pepper (In re Dixie Splint Coal Co.), 100 F.2d 830, 831 (4th Cir. 1939), rev'd 308 U.S. 295 (1939).
\end{itemize}
As a judgment creditor, X caused the sheriff to levy D's assets. While this was occurring, C, (now also a judgment creditor of D) sought a declaration from the trial court that X's judgment was void, because it had been confessed for D by a corporate officer with no authority to do so. Just prior to the sheriff's sale, C, intervened to ask that the sheriff allocate no funds to X. Perhaps in light of this dispute, X was made to pay cash for D's assets, instead of bidding in his claims, as he otherwise might have done. Faced with competing claims to the cash he held, the sheriff interpleaded X and C,. Soon thereafter, D filed for voluntary bankruptcy, and both X and C, consented to the bankruptcy trustee taking jurisdiction over the interpleaded funds. C, also vacated her motion challenging the confessed judgment in state court.

Now in possession of the interpleaded fund, the bankruptcy trustee sought a declaration from the Virginia state court that X's judgment was procedurally defective. The Virginia court, however, held the trustee to be estopped from challenging the judgment because the only creditor of D (other than X) was C, and C, herself was estopped from challenging X's judgment; she had earlier intervened with the sheriff to obtain proceeds from the sheriff's execution sale. Such an intervention constituted C, 's admission that X's judgment was valid. Since C, was estopped, so was the bankruptcy trustee. This holding was affirmed by the Supreme Court of Appeals in Virginia. In short, so far as the Virginia courts were concerned, D validly confessed judgment to X.

Back in the bankruptcy court, the district court judge still disallowed X's claim, characterizing the state court ruling as governing only the procedural aspect of the judgment, not the substance of the claim underlying the judgment. The judge held

182. Id. at 831.
184. Id. at 214.
185. In re Dixie Splint, 100 F.2d at 831.
186. Id.
187. Id.
188. Smith, 188 S.E. at 214.
189. See id. at 215 (discussing findings of trial court); In re Dixie Splint, 100 F.2d at 830-31.
190. Smith, 188 S.E. at 214.
191. In re Dixie Splint, 100 F.2d at 832.
that the substance could be revisited afresh. Upon review, the district court judge determined that X's claim was fraudulent and disallowed it entirely. X appealed, and the Fourth Circuit Court of Appeals sided with X; it held that res judicata prevented any attack on the judgment.

On further appeal, the Supreme Court directly confronted the issue of res judicata, and found it no impediment to disallowance of X's claim under the name of equitable subordination:

In the first place, res judicata did not prevent the District Court from examining into [X's] judgment and disallowing or subordinating it as a claim. When that claim was attacked in the bankruptcy court [X] did not show that the proceeding in the state court was anything more than a proceeding under Virginia practice to set aside the judgment in his favor on the ground that it was irregular or void upon its face. He failed to show that the judgment in the state court was conclusive in his favor on the validity or priority of the underlying claim, as respects the other creditors of the bankrupt corporation—a duty which was incumbent on him. On the pleadings in the state court the validity of the underlying claim was not in issue. Nor was there presented to the state court the question of whether or not [X's] judgment might be subordinated to the claims of other creditors upon equitable principles. The motion on which that proceeding was based challenged [X's] judgment on one ground only, viz., that it was void ab initio because it was not confessed by [D] in the manner required by the Virginia statute and because [the corporate secretary] did not have either an implied or express power to confess it. In other words, in the state court under the pleadings and practice, the only decree which was asked or could be given in the plaintiff's favor was for cancellation of the judgment as a record obligation of the bankrupt. It is therefore plain that the issue which the bankruptcy court later considered was not an issue in the trial of the cause in the state court and could not be adjudicated there. Hence, the failure on the part of [X] to establish that the state judgment was res judicata plus his submission of his judgment to the bankruptcy court for allowance (as a preferred claim to the extent that it was secured

192. Id.
193. Id.
194. Id.
by the alleged lien and as a common claim as respects the deficiency) plainly left the bankruptcy court with full authority to follow the course it took and to determine the validity of [X’s] alleged secured claim and the priority which should be accorded it in the distribution of the bankrupt estate. 195

I contend that the above passage indicates that the state courts could have ordered the equitable subordination of X’s claim to that of C. This would tend to prove that the new doctrine of equitable subordination was, in effect, simply what the Virginia courts would have called a fraudulent transfer.

The first emphasized passage indicates that the bankruptcy challenge to the subordinated claim was not barred by res judicata precisely because the trustee could have brought the equitable subordination theory before the Virginia court but did not. If he had, res judicata would have indeed prevented revisitation of those same issues in bankruptcy court.

The second emphasized passage, however, is more confusing. It could be taken to mean that the Virginia courts could not have given a remedy subordinating X’s judgment to the trustee’s rights. 196 In that case, the trustee, of course, was free to litigate the equitable subordination in bankruptcy court. But this same passage can equally be read to mean that the Virginia court could not equitably subordinate because the trustee did not ask for it.

I think the fairer implication is the latter. The bankruptcy trustee could have claimed in Virginia state court that X’s judgment was a fraudulent transfer. If he had, res judicata would have prevented revisiting those same issues in bankruptcy court. This can be seen from the Supreme Court’s other great statement on res judicata in the bankruptcy courts, Heiser v. Woodruff. 197

In Heiser, X successfully sued D for the tort of conversion in California state court. 198 Later, D filed for bankruptcy. 199 The bankruptcy trustee left the bankruptcy court and moved the California

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196. The bankruptcy trustee, under the Bankruptcy Act of 1898, was (and still is) a hypothetical judicial lien creditor representing all the creditors of the debtor. Bankruptcy Act of 1898 § 70(e) (repealed 1978).
197. 327 U.S. 726 (1946).
198. Id. at 729.
199. Id.
trial court to overturn the judgment on the basis of fraud. The court denied the motion.

Back in bankruptcy court, the trustee attempted to object to X's claim because of X's alleged fraud on the court. A divided Supreme Court held that res judicata barred any further examination of the merits. According to the Heiser Court, since the issues concerning fraud had been argued by the bankruptcy trustee to the trial court in California, X was entitled to res judicata against the trustee in bankruptcy court on the issue of fraud.

This holding of the Supreme Court can fairly be taken to mean that the bankruptcy trustee could have litigated, and indeed did litigate, the matter in a nonbankruptcy forum. True, the remedy the debtor sought was not characterized as subordination of one claim to others, but rather relief from the judgment itself. But is this not precisely the fraudulent transfer remedy? And is not the Heiser court equating fraudulent transfer remedies and equitable subordination law? Heiser, then, supplies a reasonable inference that state courts can entertain equitable subordination actions.

2. Origins in State Law of Fraudulent Transfer

A close examination of Pepper v. Litton shows that the Supreme Court relied at least in part on state law in constructing the federal doctrine of equitable subordination. This reliance on

200. Id. at 730.
201. Id. at 731.
202. Id.
203. Id. at 739-40.
204. The Heiser Court stated that res judicata was appropriate in the case before it only because:

[t]here was no equitable ground upon which his claim or the judgment upon it could be set aside or subordinated to those of other creditors in the bankruptcy proceeding, except that asserted by respondents that the judgment had been procured by a fraud perpetrated on the judgment creditor. That issue, having been twice litigated and decided in the court in which the judgment was rendered, in proceedings brought by the trustee in bankruptcy and the bankrupt, and by the bankrupt alone, may not now be relitigated in the bankruptcy court.

Id.

205. Admittedly, relief from the judgment would be annulment in the erasure sense, whereas this Article has argued that fraudulent transfer always transfers property to C1.
state law antecedents strongly suggests that the Supreme Court viewed equitable subordination as already implicit in the state law at the time.

Admittedly, some of the grounds cited in Pepper were clearly federal in nature. The Bankruptcy Act, the Court observed, granted power to bankruptcy courts over:

the allowance and disallowance of claims; the collection and distribution of the estates of bankrupts and the determination of controversies in relation thereto; the rejection in whole or in part "according to the equities of the case" of claims previously allowed; and the entering of such judgments "as may be necessary for the enforcement of the provisions" of the Act. In such respects the jurisdiction of the bankruptcy court is exclusive of all other courts.207

This passage grounds equitable subordination in the exclusive power of a bankruptcy court to decide matters of distribution of the estate. Such a remark, however, taken to its extreme, would abolish res judicata in the bankruptcy courts altogether. As Heiser established, this goes too far. Rather, the matter should be as follows: the bankruptcy courts must accept the doctrine of res judicata—unless the judgment in question is a fraudulent transfer or deserving of equitable subordination.208

At least one major purpose of equitable subordination, then, is to strike a blow against res judicata, where application of that doctrine comes at the expense of the creditors.209 Yet this is an

207. Id. at 304 (emphasis added).
209. An illustrative case in the equitable subordination vein is Societa Internazionale Turismo v. Barr (In re Lockwood), 14 B.R. 374 (Bankr. E.D.N.Y. 1981), where X filed a complaint in New York Supreme Court to recover a debt that the debtors clearly did not owe. The debtors answered, but this answer was struck from the record because the debtors did
important function of fraudulent transfer law as well. Moreover, it is possible to claim that equitable subordination itself originates in fraudulent transfer law—a principle by no means exclusive to the bankruptcy courts.

Indeed, Pepper's most direct statement against res judicata is the following: "[T]he bankruptcy trustee may collaterally attack a judgment offered as a claim against the estate for the purpose of showing that it was obtained by collusion of the parties or is founded upon no real debt." For this proposition the Court cited at least one case which is a classic fraudulent transfer case.

not provide the plaintiff with proper discovery. "Thus it is clear that the State Court action was not resolved upon the merits of the Plaintiff's claim." Id. at 376. A judgment was entered and docketed, and X claimed a judicial lien against D's real estate.

The bankruptcy court gave credence to the debtors' claim about the true merits of the judgment obtained by plaintiffs:

In the case at bar the debtors and the trustee collaterally attack the Plaintiff's judgment on the ground that it is "founded upon no real debt." It is undisputed that in this case ... the validity of the Plaintiff's claim never has been fully litigated. The state court judgment was not rendered upon the merits of the case. It was a default judgment that was entered against the debtors after their answer was stricken for failure to comply with an order of the state court requiring them to provide discovery. However, the default was not due to the lack of diligence on the part of the debtors .... It appears that the gross incompetence of the debtors' counsel, not the debtors' conduct, was the ground for the entry of the default judgment. Under these circumstances the debtors did not have "ample opportunity" to have their case heard. Moreover, the only testimony adduced at the hearing convinces the court that the Plaintiff had no valid claim against the debtors.

Id. at 379-80 (footnotes and citations omitted). This case, in the name of equitable subordination, directly authorizes a court to go behind a state court judgment to determine the true merits. As such a remedy is also precisely what fraudulent transfer law achieves, the two remedies can be seen as structurally identical. Since state courts can annul judgments under the name of fraudulent transfer law, they should likewise have the power to do the same thing under the name of equitable subordination.

210. See supra notes 152-54 and accompanying text.

211. Pepper, 308 U.S. at 306.

212. Id. at 308 n.13 (citing Chandler v. Thompson, 120 F. 940 (7th Cir. 1902)). In Chandler, X allegedly obtained a judgment against D on a fictional debt. C, (or perhaps the bankruptcy trustee) objected to X's proof of claim because "said confessions were designed to hinder, delay and defraud C and the owners of said mortgages, and that the same are fraudulent, and should be disallowed and discharged by this Honorable Court." Chandler, 120 F. at 940. The court ruled that C could have the remedy of disallowance of X's claim:

The averments, in the petition, of fraud and collusion are inartistically drawn. They show in substance, however, that no real debt underlay the judgments, but that the judgments were entered in pursuance of a scheme (to which both judgment creditor and judgment debtor were parties) to hinder, delay,
In *Pepper*, the Court also looked to other aspects of state law as grounds for the equitable subordination doctrine. Thus, it emphasized that state courts have equitable power to examine transfers to directors or stockholders from the corporation to which they owe a fiduciary duty.\textsuperscript{213} This principle was drawn from diversity actions to set aside mortgage foreclosures by fiduciaries\textsuperscript{214} or asset sales to other corporations,\textsuperscript{215} or to declare constructive trusts with regard to fiduciary property.\textsuperscript{216} The Court noted that, because corporate officers are fiduciaries, equity would set aside the claims of officers when they are in violation of state fiduciary law:

While normally that fiduciary obligation is enforceable directly by the corporation, or through a stockholder's derivative action, it is, in the event of bankruptcy of the corporation, enforceable by the trustee. For that standard of fiduciary obligation is

defraud certain claimants, in the collection of claims .... The case, thus presented, is not that of an attack collaterally upon the judgments by the parties thereto, or their privies. It is the case of an attack by the trustee of third persons, strangers to the judgment, whose rights and interests would be injuriously affected, if the judgments were allowed to stand proved as claims. As to such persons, a judgment procured through the collusion of the parties thereto, and founded upon no real debt, is to be treated as void, and open to collateral attack whenever, and wherever it may come in conflict with their rights or interests. A judgment not founded on an actual debt or other legal liability, due or enforceable at the time of its entry, will not be upheld against creditors of the judgment debtor. 

\textit{Id.} (citations omitted). This case could fairly be interpreted as a fraudulent transfer case.

The two other cases cited by Justice Douglas seem less clearly fraudulent transfer cases. In *In re Continental Engine Co.*, 234 F. 58 (7th Cir. 1916), the court permitted disallowance of a default judgment, when the merits had never been litigated. This is not so much a fraudulent transfer case as a simple failure of res judicata. \textit{But see} Kelleran v. Andrejevic, 825 F.2d 692, 696 (2d Cir. 1987) (holding that default judgment entitled to res judicata, where debtor was denied default relief in state court, but bankruptcy court could nevertheless revisit the amount of damages).

In the second case cited, *In re Thompson*, 276 F. 313, 315-16 (W.D. Pa. 1921), \textit{aff'd}, 284 F. 65 (3d Cir. 1922), \(X\) had obtained a judgment that a mortgage debt was due. Nevertheless, the bankruptcy trustee was permitted to show that the mortgage debt had been paid by setoff. This case is probably not a fraudulent transfer. Rather, it is simply one in which the trustee asserted \(D\)'s right to prove that a judgment had been paid in a separate transaction.\textsuperscript{213} *Pepper*, 308 U.S. at 306.

\textsuperscript{214} \textit{See} Twin-Lick Oil Co. v. Marbury, 91 U.S. 587, 588 (1875) (applying West Virginia law); Jackson v. Ludeling, 88 U.S. 616, 618 (1874) (applying Louisiana law).


\textsuperscript{216} \textit{See} S. Pac. Corp. v. Bogert, 250 U.S. 483, 492 (1914) (applying New York law).
designed for the protection of the entire community of interests in the corporation—creditors as well as stockholders.\textsuperscript{217}

The Court went on to emphasize that equitable subordination was simply the ordinary exercise of equity powers.\textsuperscript{218} Equity is not limited to bankruptcy proceedings and so the Court conceived that it was simply adapting nonbankruptcy law to the context of bankruptcy liquidations.

In further explaining the doctrine of equitable subordination, the Pepper Court wrote: "The applicable principle is that, where a corporation is so organized and controlled as to make it a mere instrumentality or adjunct of another, and the subsidiary becomes bankrupt, the parent corporation cannot have its claim paid until all other claims are first satisfied ...."\textsuperscript{219} Immediately following this remark, Justice Douglas added: "The same result has been reached in equity receiverships."

\textsuperscript{220} At least after Erie,\textsuperscript{221} equity receiverships arise under state, not federal, law.\textsuperscript{222} Hence, the Supreme Court itself recognized that the doctrine of equitable subordination was founded in state law principles. Its extension into federal bankruptcy jurisprudence was therefore founded upon nonbankruptcy antecedents.\textsuperscript{223}

\textsuperscript{217} Pepper, 308 U.S. at 307 (footnotes omitted) (citing Converse v. United Shoe Mach. Co., 95 N.E. 929 (Mass. 1911)).
\textsuperscript{218} Id. at 307.
\textsuperscript{219} Id. at 310 n.26 (citing In re Otsego Waxed Paper Co., 14 F. Supp. 15 (W.D. Mich. 1935)).
\textsuperscript{220} Id. (emphasis added) (citing S.G.V. Co. of Del. v. S.G.V. Co. of Pa., 107 A. 721 (Pa. 1919)).
\textsuperscript{221} Erie R.R. Co. v. Tompkins, 304 U.S. 64 (1938).
\textsuperscript{222} E.g., N.Y. C.P.L.R. 5228 (McKinney 1990); Paula W. Best, Corporate Receiverships and Chapter 11 Reorganizations, 10 CARDOZo L. REV. 285 (1988). To be more precise, in pre-Erie days, federal common law might have supplied the law of equity receivership.
\textsuperscript{223} An early and prestigious article on equitable subordination also characterizes equitable subordination as the ordinary law of equity, not a unique federal bankruptcy concept. See Aza S. Herzog & Joel B. Zweibel, The Equitable Subordination of Claims in Bankruptcy, 15 VAND. L. REV. 83, 113 (1961):

It seems to us that there has been much unwarranted confusion in connection with the subordination of claims in bankruptcy. The equitable powers of the bankruptcy court in dealing with claims have not been seriously challenged; certainly not in recent years. In subordinating ethically inferior claims, no new fundamental principles have evolved, nor have they been necessary in order to cope with the problem. All that was required was the extension of cardinal principles of equitable jurisprudence, long employed to thwart fraud and
Other courts have found estoppel to be the ground of equitable subordination. Obviously, estoppel is a classic state law principle. In *In re Credit Industrial Corp.*, the Second Circuit overruled a lower court's refusal to enforce contractual subordination unless the senior creditors could prove that they relied on the subordination agreement in extending credit. The Second Circuit accused the lower court of confusing contractual subordination with equitable subordination:

Moreover, the enforcement of such agreements is not based on any theory of equitable estoppel. In our opinion, the district court erroneously relied on the doctrine of equitable estoppel as a basis for its position and failed to recognize the distinction between equitable and consensual subordination in bankruptcy. Equitable subordination, which is founded upon estoppel, is the doctrine invoked by courts to deny equal treatment to creditors based on some inequitable or unconscionable conduct in which they have engaged, or a special position which they occupy vis-a-vis the bankrupt that justifies subordination of their claims. On the other hand, consensual or contractual subordination, of which the debt subordination agreements involved here are prime examples, occurs when a creditor and the bankrupt agree to create priorities among debts. Such agreements have been uniformly enforced according to their terms by bankruptcy courts. The doctrine of equitable estoppel is clearly irrelevant to a determination of whether a lawful subordination agreement is enforceable in bankruptcy proceedings and the district court erred in invoking it to support its determination that enforcement of such agreements is conditioned on proof of reliance.

The basic and overriding consideration of equity is the prevention of fraud and injustice when the remedy at law is inadequate. Where the facts indicate that allowance of a claim on equal terms with others would constitute an injustice, subordination is the remedy afforded by equity. And, where man's ingenuity creates new situations without precise factual precedent, equity has the capacity to adapt itself. In so doing, equity will be found equal to the task, extending old principles, if necessary, to accomplish its purpose.

*Id.*

224. 366 F.2d 402 (2d Cir. 1966).

225. *Id.* at 408-09 (citations omitted). For a pre-Pepper case using estoppel to demote a creditor, see *Miller v. Borton (In re Bowman Hardware & Elec. Co.)*, 67 F.2d 792 (7th Cir. 1933).
In truth, the invocation of estoppel inadequately describes equitable subordination. It supports the notion of disallowing a claim altogether, when the more precise definition of equitable subordination involves the transfer of the subordinated claim to the creditors harmed by wrongful conduct. Nevertheless, the identification of estoppel, a state law principle, as the ground of equitable subordination tends to discredit the notion that state courts are unable to construct a doctrine of equitable subordination. It at least supports the notion that equitable subordination has a state law ground, though the position I have maintained here is that fraudulent transfer, not estoppel, is the correct ground.

E. Examples of Equitable Subordination Under Nonbankruptcy Law

In *HBE Leasing Corp. v. Frank*, the Second Circuit ruled there was no cause of action under New York law for equitable subordination. *HBE Leasing* was therefore a diversity case, and, as such, a mere “Erie guess” as to what New York law really was.

There is evidence, however, that equitable subordination is directly part of the law of New York. In *Shultis v. Woodstock Land Development Associates*, a New York court subordinated a senior mortgagee to the extent a newly executed mortgage agreement prejudiced a junior mortgagee. This theory has been expressly labeled by courts as a theory of equitable subordination. Like examples can be located in the law of other states.

A recent bank liquidation case shows a nonbankruptcy court borrowing the doctrine of equitable subordination from the United States Bankruptcy Code and applying it as a matter of federal

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226. 48 F.3d 623 (2d Cir. 1995).
common law. *Gaff v. FDIC*\(^{231}\) involved the liquidation of a nationally chartered bank. For historic reasons, banks have always been exempt from bankruptcy laws in the United States.\(^{232}\) Nationally chartered banks instead are liquidated under the National Bank Act, which calls for pro rata distributions to creditors.\(^{233}\) The National Bank Act has no provision authorizing equitable subordination.

In *Gaff*, shareholders of a failed bank sought damages under Michigan law from officers and directors of the bank. The receiver for the bank asserted a derivative claim on behalf of the bank. The Sixth Circuit Court of Appeals directed that the shareholder claim be equitably subordinated to that of the receiver. This relief was granted, thereby proving that equitable subordination was not simply the province of the federal Bankruptcy Code. Rather, the court introduced equitable subordination into the common law of bank receiverships.\(^{234}\)

Subsequent cases, however, have disapproved of *Gaff*. Their objection was that Congress had considered but rejected a legislative enactment expressly subordinating shareholder actions to actions by a bank receiver. These subsequent cases therefore assumed that a rule of equitable subordination violated the intent of Congress.\(^{235}\) These cases did not dispute, however, the exportability in general of the doctrine of equitable subordination from bankruptcy law to general common law. Indeed, one of the traditional three elements of equitable subordination is that the remedy must not contradict a specific congressional intent, just as equity must always honor specific statutory enactments.\(^{236}\) The cases opposing *Gaff* simply stand for the (dubious) proposition that, in the exact situation of a bank receiver competing with a shareholder for the assets of former bank officers, Congress intended the shareholders to be on a par with the bank receiver.

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231. 919 F.2d 384 (6th Cir. 1990).
233. 12 U.S.C. § 194 (2003); *see also* *Gaff*, 919 F.2d at 385 n.1.
234. *Gaff*, 919 F.2d at 387.
236. *See* Benjamin v. Diamond (*In re Mobile Steel Co.*), 563 F.2d 692, 700 (5th Cir. 1977).
CONCLUSION

This Article argued that, while the moral intuitions behind equitable subordination and fraudulent transfer differ, the remedies are structurally identical. Both aim to transfer property from some third party to a set of creditors with claims against a debtor. Properly theorized, fraudulent transfer law never rescinds, annuls, avoids, or erases. Rather, it transfers rights of third parties to those creditors with fraudulent transfer rights. Equitable subordination never demotes or rearranges priorities. It transfers bankruptcy dividends to a set of creditors who were harmed by a creditor’s inequitable conduct. Accordingly, since the fraudulent transfer remedy is a routine feature of state law, equitable subordination might likewise be invoked as a matter of state law. Cases like *HBE Leasing Corp. v. Frank*237 to the contrary should therefore be viewed as bad “Erie guesses”238 as to the content of state law.

If fraudulent transfers and equitable subordinations were recast in these terms, certain admittedly marginal cases could be solved in a way that better accords with the spirit of debtor-creditor law. Although the effect a reform of vocabulary would have on the outcome of actual cases is perhaps not large, nevertheless it is the marginal case that proves the true nature of the theory that underlies this, or any other, area of law.

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237. 48 F.3d 623 (2d Cir. 1995).
238. *See supra* notes 225-26 and accompanying text.