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CIVIL REMEDIES IN BANKRUPTCY FOR CORPORATE FRAUD

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INTRODUCTION

When a corporation's economic fate turns from "in the black" to bleak, its owners have "powerful incentives to extract whatever value they can." [1] And cases of corporate insiders [2] using various devices to effectuate transfers of corporate assets to themselves prior to their corporations filing bankruptcy are legion. [3] If bankruptcy of a corporation is initiated when some assets remain, creditors who are fraud victims have various theories that might allow them to make special claims to those assets. [4] However, if corporate insiders have fraudulently removed or concealed the corporation's assets prior to bankruptcy, civil law provisions must provide for the recovery of these assets if creditors are to be treated fairly.

No doubt the criminal laws that are discussed in this article deter fraud in bankruptcy generally, including in cases of corporate bankruptcies. However, as the United States Court of Appeals for the Seventh Circuit has recently observed, for insolvent companies "the difference between civil and criminal law is small. Corporations cannot be imprisoned." [5] And, of course, an insolvent corporate debtor cannot be made to pay criminal fines or civil liabilities. It simply disappears and its creditors remain unpaid.

Like the criminal laws on bankruptcy, the Code has its own provisions that are designed to deter serious debtor misconduct. Debts and other liabilities created by debtors' fraudulent pre−bankruptcy conduct are nondischargeable. [6] Moreover, debtors who fraudulently transfer assets within one year of their bankruptcies are generally denied the benefits of a discharge. [7] Similarly, debtors are denied discharge unless they are generally honest [8] and cooperative [9] during their bankruptcy proceedings. However, while these provisions might be important and effective incentives for individuals, they are either meaningless or significantly attenuated in the corporate context. No discharge is given to liquidating corporate debtors [10] and the incentives created by the discharge provisions accordingly have little or no influence in corporate bankruptcies. [11] Additionally, the civil recovery remedies discussed in Part I of this article offer minimal deterrence against corporate fraud. Even if fraud is discovered and a successful civil remedy action is brought, the wrongdoers are usually [12] only required to restore to the estate the property they acquired by their fraud. Hence, it is often virtually costless for insiders to engage in fraudulent conduct when corporate insolvency looms.

Because these civil provisions, at most, provide weak incentives against corporate fraud, vigilant enforcement of the criminal laws in corporate bankruptcies is especially important. Even if the corporation cannot be imprisoned or made to pay a fine because of insolvency, [13] its insiders who are responsible for various fraudulent acts can be held criminally responsible. [14] And, interestingly, the types of conduct that lead to criminal liability of insiders are generally the same as the grounds for denying individual debtors discharge of their debts. [15]

In addition to the use of criminal law to deter fraud by corporate insiders, civil laws should allow for the recovery of improperly transferred assets. This article discusses those civil laws. Part I presents a broad overview of the bankruptcy and related corporate law theories that allow for recoveries when corporate assets have been improperly transferred before filing bankruptcy. Part II examines three other consequences of

corporate fraud that can improve the likelihood of creditor recovery: piercing the corporate veil, equitable subordination and successor liability. Lastly, Part III proposes reforms of the Bankruptcy Code that would expand trustees' power slightly and clarify creditors' right to exercise the trustee's powers when a debtor−in−possession refuses to do so.

I. AN OVERVIEW OF RECOVERY THEORIES FOR THE FRAUDULENT TRANSFER OF CORPORATE ASSETS

Fraudulent corporate conduct can give rise to different civil legal consequences. When corporate assets are transferred, fraudulent conveyance law can be invoked to recover the assets from the transferees. [16] In addition, the corporate insiders who are responsible for the corporation's fraudulent acts might be held personally liable to the corporation or its creditors under various corporate law theories.

Obviously, the most important tool for the recovery of fraudulently transferred assets is fraudulent conveyance law. Available to trustees and debtors−in−possession are both 11 U.S.C. § 548 [17] and, through section 544(b), state fraudulent conveyance law. [18] For many types of transfers, provisions of state corporation law offer additional theories of recovery. [19]

In many cases, corporate owners brazenly transfer corporate assets for their own personal benefit. [20] Transfers of corporate funds to pay owners' debts, [21] transfers to purchase assets for an owner's other businesses, [22] transfers for no consideration to reduce related companies' debts, [23] transfers to third parties who in turn provide insiders with significant gains, [24] and cash transfers directly to owners for no legitimate business purpose [25] are examples of rather obvious fraudulent transfers. In all of these examples, the corporate debtor receives nothing in consideration for the transfers of corporate assets. Rather clearly, these facts justify a finding that the transfers were made with an intent to defraud the corporations' creditors. [26] Indeed, both the common law's traditional "badges of fraud" [27] and the Uniform Fraudulent Transfer Act [28] indicate that the main characteristics of these kinds of transfers − to or for the benefit of corporate insiders, for no consideration and when the corporation is insolvent − justify the inference that the transfers were made with fraudulent intent.

Even when actual intent cannot be established, a transfer for less than a "reasonably equivalent value" [29] can nevertheless be set aside if the corporation is "insolvent," [30] if the corporate property remaining after the transfer represents "an unreasonably small capital," [31] or if the corporation is likely to incur debts that it will not be able to repay. [32]

If a fraudulent transfer is established, the trustee may recover the property transferred from "initial transferees" [33] regardless of their good faith. [34] Recovery is denied against subsequent transferees who take for value, in good faith, and without knowledge of the voidability of the transfer. [35]

Because the cases for voidability are strongest when transfers are for no or less than fair consideration, transfers to corporate owners are often disguised as routine and proper business transactions. Transfers are commonly alleged to be justified as part of the salary or bonus for an insider's services or in redemption of stock owned by an insider. [36] And some transfers are alleged to be routine payments of corporate dividends. The discussion of these transfers focuses primarily on the reasonable equivalency criterion and assumes that the corporation is insolvent or has unreasonably small capital.

A. Payment of Dividends

The payment of a dividend [37] to corporate owners is one possible means for removing corporate assets during a corporation's decline. However, state corporation laws and fraudulent conveyance law generally protect creditor interests by prohibiting dividend payments that would render a corporation insolvent. [38] Furthermore, fraudulent transfer law and some states' corporations laws might offer even greater protection.

State corporation laws on the regulation of dividends afford creditors various levels of protection. The Model Business Corporations Act and other state laws prohibit a distribution to shareholders if the distribution renders the corporation insolvent in either the equity [39] or bankruptcy [40] sense. Moreover, some corporation laws go further and require that an additional layer of protection exist after dividends have been paid. [41]

If dividends are paid in violation of these proscriptive levels of creditor protection, the directors who declared the dividend can be held liable if their violation is "willful," [42] "negligent," [43] or in bad faith. [44] In our context, which assumes fraudulent conduct, the directors would be liable in all jurisdictions.

Generally, on both legal and practical grounds, shareholder liability for illegally paid dividends is more difficult to establish than is director liability. Most state corporation laws do not impose liability on shareholders unless they received the illegal dividends "with knowledge of facts indicating the impropriety." [45] Moreover, collection against shareholders of large corporations might be logistically impracticable. [46] In the context of our discussion of bankruptcy fraud, if insiders are or should be aware of their company's insolvency and effectuate dividend transfers to themselves, recovery should be both legally and practically possible. Whether the insiders are directors [47] or only shareholders, [48] given their awareness of the insolvency, liability should be clear.

Payments of dividends might also be attacked under fraudulent transfer law if the corporation is insolvent or left with unreasonably small capital after the payments. [49] Dividend transfers of money or other corporate property to shareholders are not properly characterized as gifts of corporate assets. [50] On the other hand, they clearly are "without consideration." [51] Unlike a payment to satisfy an indebtedness, which reduces both assets and liabilities and is accordingly considered a transfer for "value," [52] a dividend reduces assets alone.

Fraudulent conveyance law offers three possible advantages over state corporation law. First, fraudulent conveyance law defines "insolvency" more narrowly than some corporate dividend laws. The former values corporate property "at a fair valuation." [53] In contrast, some corporation laws use a "going concern" value standard. [54] More generally, in the corporation laws that, like fraudulent conveyance law, use the balance sheet test, valuation standards are purposely vague. The Official Comment to the Model Business Corporation Act's balance sheet insolvency test explains,

> Section 6.40 does not utilize particular accounting terminology . . . or specify accounting concepts. In making determinations . . ., the board of directors may make judgments about accounting matters, giving full effect to its right to rely upon professional or expert opinion. [55]

Second, fraudulent transfer law's unreasonably small capital standard for business debtors has the potential to "go a significant step further" than the insolvency standards of corporate restrictions on dividend payments. [56] However, the practical significance of this has been questioned. [57] Third, and possibly most important, whereas corporate law generally denies recovery of improperly paid dividends from innocent shareholders, [58] fraudulent transfer law is not as limited. Because, as analyzed above, the shareholders do not give value in exchange for dividends and the shareholders are clearly "immediate transferees" of the dividends, their innocence would not protect them. [59]

Some have suggested that fraudulent conveyance law should not apply in the context of dividend payments because corporate law's dividend statutes are very specific whereas fraudulent conveyance law is general. [60] However, this suggestion has not been followed. [61] Moreover, the creditor protection policies embodied in state corporation laws should not preempt federal creditor protection policies in the bankruptcy laws' fraudulent conveyance provisions. [62]

B. Compensation for Services

Paying a corporate owner a salary that exceeds the value of his services is, of course, one way to attempt to disguise an improper transfer of corporate assets to him. [63] Another explanation of the excessive salary is that the "salary" is in reality a disguised dividend. [64] Corporations might characterize corporate distributions as

salaries rather than dividends because the former is tax deductible while the latter is not. [65] In either case, an amount by which the compensation exceeds the reasonable value of the services should be recoverable under both fraudulent conveyance and corporate law.

Fraudulent conveyance law's reasonably equivalent value criterion as well as corporate law's proscription against waste [66] demand that "'salaries of officers in an efficiently managed corporation must bear a reasonable relation not only to the services rendered but to the income of the business, both gross and net.'" [67] Compensation must be in proportion to ability, services rendered and time devoted to the corporation's affairs. [68] Moreover, the corporation's financial condition must be considered in establishing salaries. [69] Finally, because the insiders themselves determined their compensation, they bear the burden of proving the fairness and good faith of that compensation. [70]

Insiders often take extreme measures when financial collapse is imminent. [71] They have a special incentive to provide retroactive raises, [72] award themselves bonuses, or take substantial payment as part of employment termination agreements. [73] Retroactive raises and bonuses in these circumstances [74] are almost certainly voidable as fraudulent conveyances because the past services have already been compensated and the corporation receives no consideration. [75] And under corporate law, such raises and bonuses are recoverable as gifts of corporate assets. [76] Similarly, moneys paid a retiring officer as part of severance packages and other termination agreements entered shortly before bankruptcy will generally be voidable. The corporations' insolvency prevent them from continuing in business and hence the corporation receives little or no value in being relieved of its future financial obligations to retiring officers. [77]

C. Redemption of Shares

Redemption of a failing firm's stock is another strategy for some corporate owners in their quest to garner whatever they can from their investment. Like a dividend payment, stock redemption is a form of distribution to a corporation's owners. [78] When stock is redeemed, the corporation receives the stock in exchange for a payment to a shareholder, whereas when a dividend is paid, nothing is received in return. Nonetheless, from the perspective of corporate creditors, the economic effects of dividend payments and stock redemptions are identical: Payments to redeem stock reduce assets while the amount of outstanding debt remains the same. [79] For this reason, corporation laws place restrictions on redemptions that are similar to or identical [80] to the restrictions on dividend payments. And the liability of directors who vote for an improper redemption and of shareholders whose shares are redeemed is generally the same as the liability for improper dividend payments. [81]

As with dividends, stock redemptions can also be attacked with fraudulent conveyance law. Because corporations receive nothing of value when they redeem stock, [82] redemption payments to shareholders are voidable if they leave a corporation insolvent [83] or with unreasonably small capital. [84]

Authority is divided on a rather common redemption issue: If a solvent [85] corporation redeems stock by issuing its promissory note to a shareholder, rather than cash, should the debt owed the shareholder on the note be equitably subordinated to creditors' claims if the corporation lands in bankruptcy? One theory holds that "to give the redemption claim parity with the claims of other creditors is opposed to the priority which creditors enjoy over stockholders in bankruptcy" [86] and accordingly equitably subordinates the redemption debt. [87] Others rely on the usual and traditional prerequisites for equitable subordination [88] and subordinate only when the shareholder has engaged in some inequitable conduct. [89]

II. OTHER CONSEQUENCES OF INSIDER FRAUD

Insiders' fraud can give corporate creditors additional opportunities for improving their collection rights. Fraudulent transfers of corporate assets and other fraudulent conduct by insiders for their own gain are clear manifestations of disregard of the corporate form and are often bases for "piercing the corporate veil" and, thus, permitting creditors to hold the insiders personally liable for the corporations' debts. Further, fraudulent conduct by insiders is a traditional ground for subordinating their claims to other creditors' claims. Finally, the

fraudulent transfer of a debtor corporation's assets to a new corporation for the purpose of escaping liability to the debtor's creditors is grounds for imposing upon the successor corporation liability for those creditors' claims.

A. Insider Fraud & "Piercing the Corporate Veil"

If creditors are able to pierce a corporation's veil, they are able to hold the corporate insiders with whom they dealt or who injured them generally liable for their claims. [90] Recovery is not limited to property that was transferred to the insiders. Insiders' fraudulent transfers of corporate assets and other fraudulent conduct are often considered as important factors in favor of piercing the corporate veil.

Reported cases of creditors' efforts at "piercing the corporate veil" are legion and scholarship on the topic is vast. [91] The law is vague [92] and the states' approaches to the "piercing" issue vary considerably. [93] Moreover, in bankruptcy cases, some courts have applied state law whereas others have applied an emerging federal law of "piercing." [94] Under all approaches, however, fraudulent transfers of corporate assets to insiders has provided strong support for piercing the corporate veil. [95] Even those with conservative approaches to piercing issues agree that fraudulent conduct by insiders is per se a significant factor in favor of piercing. [96] Furthermore, when an insolvent or inadequately capitalized corporation transfers assets to insiders for inadequate or no consideration, other traditional reasons for piercing the corporate veil are present. First, since by hypothesis the corporation ends up in bankruptcy, it was almost certainly either insolvent or nearly so at the time of the fraud; and undercapitalization is an important factor in favor of disregarding the corporation. [97] Moreover, fraudulent transfers are almost never in furtherance of the corporation's business but rather are harmful to it and, of course, its creditors. [98] Finally, fraudulent transfers are commonly made without regard for corporate formalities; and this is a major factor in favor of disregarding the corporation. [99]

If a corporation has made a fraudulent transfer but has otherwise generally followed corporate laws and formalities, the creditors' recovery theory is likely limited to a fraudulent conveyance action. [100]

B. Fraud & Equitable Subordination of Insider's Claims

In bankruptcy, corporate insiders who are creditors of their corporations are treated differently than other creditors in at least two important respects. First, the preference period is one year for insiders but only 90 days for other creditors. [101] Second, insiders' claims are more likely than other creditors' claims to be equitably subordinated. [102] Moreover, insiders' fraudulent conduct arms creditors with a potent case in favor of the equitable subordination of the insider's claim. [103]

When the insider's claim is subordinated to the claims of all other creditors, the effect is less drastic than when the corporate veil has been pierced. [104] Piercing the corporate veil results in general liability for the corporation's debts. [105] Subordination only denies the insider the right to collect her debt until other creditors' claims have been satisfied. [106] Thus, subordination in effect transforms insiders' "loans" to their corporations into "contributions to capital," [107] or "equity." [108] Indeed, undercapitalization of corporations by its owners has been a major factor in decisions to subordinate insiders' claims. [109]

Most courts use a three−part test to analyze whether a claim should be equitably subordinated. [110] The creditor must have engaged in inequitable conduct, that conduct must have injured the corporation or its creditors, and equitable subordination must be consistent with Code provisions. [111] Fraud by corporate insiders will almost always meet all three of these criteria. First, fraud is invariably identified as inequitable conduct [112] and, as a practical matter, defrauding creditors is sometimes identified as one of "only three typical" causes for equitable subordination. [113] Moreover, fraudulent transfer of or concealment of corporate assets prior to bankruptcy obviously prejudices other creditors. And, finally, the fraudulent transfer [114] and discharge [115] provisions indicate that equitable subordination for insiders' fraudulent conduct is compatible with Code provisions and policy.

If a court finds that the three part test for subordination has been satisfied, it must decide the extent of subordination that is appropriate. If the insider holds an unsecured claim, it will normally be subordinated to other unsecured creditors' claims. [116] If it is possible to quantify the extent of the harm that the insider's fraud caused to creditors, the court may limit subordination to that extent. [117] Similarly, subordination might be limited only to those creditors who were prejudiced by the inequitable conduct. [118] However, usually the effects of the inequitable conduct will be diffused and difficult or impossible to quantify. In these cases, the entire claim is generally subordinated. [119] If the claim to be subordinated is a secured claim, the court will, depending on its view of the insider's culpability, subordinate the claim to all creditors' claims or merely reduce the secured claim to the status of an unsecured claim. [120]

C. Fraud & Successor Liability

Fraud by corporate insiders can give creditors an alternative theory for recovery in certain circumstances. A frequent stratagem employed by corporate insiders is to create a "new" corporation to which the insolvent debtor corporation transfers, frequently through a maze of transactions, substantially all of its assets. The insiders own the stock of the new corporation and operate it as they did the old corporation. Meanwhile, the debtor corporation files bankruptcy and its creditors are left to battle over the funds that the debtor received in exchange for its assets. [121] Of course, as discussed above, if the consideration received by an insolvent debtor is not reasonably equivalent in value to the property transferred, the transfer is avoidable and the property is recoverable under fraudulent conveyance laws. [122]

An alternative approach when one corporation's assets have been transferred to a new corporation in this manner is to attempt to impose upon the new, or "successor," corporation general liability to the old corporation's creditors. The successor is treated either as the practical or as the equitable continuation of the old corporation and the sale of the debtor's assets is in reality "merely a merger or some other type of corporate reorganization that leaves real ownership unchanged." [123]

Successor liability law is, unfortunately, complex and vague. [124] The law's abstruseness is compounded when it is applied to certain groups of creditors because policy considerations affect the formulation of the law and case outcomes. [125] However, one of four commonly accepted grounds for imposing liability on a successor [126] is that the sale of assets transaction between the debtor corporation and the successor "is entered into fraudulently, in order to escape liability for the obligations of the selling corporation." [127] "Fraudulent" in this context "characterizes or modifies not the actual means of the transfer of assets or the conduct undertaken in furtherance thereof, but rather the purpose of such transfer" [128] − to escape liability for the old corporation's debts while continuing to own and operate its business. [129] Indeed, the transfer of assets to a commonly owned, new corporation without insuring that creditors will be treated fairly appears to be the crux of the law of successor liability. [130]

If a debtor corporation receives reasonably equivalent value from the successor corporation for its assets, including intangibles such as good will, [131] presumably the debtors' creditors will receive all that they are entitled to. [132] Many courts accordingly emphasize the fairness of the consideration received in their analysis of the fraud issue in particular and the successor liability issue in general. [133] On the other hand, if a court concludes that the general effect of transfers from a debtor corporation to its successor is to defraud creditors, it may impose successor liability even when it has not determined that the consideration paid to the old corporation was less than a fair equivalence. [134]

Finally, in the long run, imposition of successor liability might generally tend to harm, rather than help, creditor interest. When a debtor−corporation's assets are sold to pay creditors, the threat of potential successor liability dissuades potential buyers, which thereby lowers demand and ultimately reduces the sales price. More generally, buying firms will reduce their prices to reflect this risk. [135] Cases reflect that, to some extent, courts have been sensitive to this potentially adverse consequence of successor liability. [136]

III. REINFORCING CREDITORS' RIGHTS AGAINST CORPORATE FRAUD

As discussed in the Introduction, the Bankruptcy Code's discharge provisions discourage fraudulent conduct before and during bankruptcy. However, these provisions are largely meaningless in corporate bankruptcies because no discharge is given to liquidating corporations [137] and because those provisions are generally inapplicable to reorganizing corporations. [138] As a result, the criminal law and civil provisions of the Code and corporate law must be the sources for deterrence against corporate bankruptcy fraud. And, when fraud occurs notwithstanding this deterrence, the civil provisions are the source of creditor redress.

The Bankruptcy Code clearly vests in the trustee and debtor−in−possession [139] the power to void and recover transfers that the Code renders voidable. [140] It further allows them to "avoid any transfer" that "is voidable under applicable law by a creditor holding an unsecured claim." [141] However, the Code is unclear on two related matters. First, may a trustee assert other rights − in particular the right to pierce the corporate veil − that creditors of the estate have against third parties? And, if a trustee or debtor−in−possession refuses to assert a voidability right, may the estate's creditors do so?

To better deter fraud and increase the rates of recovery for creditors, the Code should address these questions. It should statutorily expand the standing rights of interested parties to hold responsible all who the Code or state law provides may be held liable for fraudulent actions. The trustee's right to assert unsecured creditors' voidability rights, [142] should be expanded to allow the trustee to assert creditors' rights to pierce the corporate veil. Furthermore, if a trustee or, more likely, a debtor−in−possession, refuses to pursue a voidability action, the Code should clarify that the creditors may do so if such action would be in the best interest of the estate.

A. The Trustee's Right to Pierce the Corporate Veil

As the previous discussion of piercing the corporate veil indicated, the effect of disregarding the corporate veil is to hold the shareholders liable for the corporate debts. [143] The right to pierce is a "substantive rule of liability" [144] rather than a cause of action or property right. [145] Nonetheless, most courts base their analysis of the issue, whether a trustee may disregard the corporate entity and hold the shareholders liable for estate debts, on 11 U.S.C. § 541: Does the right to pierce the corporate veil belong to the corporation, and therefore the estate, or is it a right of creditors? [146] In answering this question, the courts rely upon the state law of veil−piercing to resolve the question, [147] at least in the absence of an overriding federal interest. [148] Because different states answer this question differently, some cases hold that it is the right of the estate and assertable by the trustee [149] while others conclude that it is the right of creditors and may not be asserted by the trustee. [150]

A few courts take a more liberal approach to the issue and recognize the trustee's right to pierce the corporate veil in his capacity as representative of creditors generally and under 11 U.S.C. § 544(b). [151] This approach has serious drawbacks, however, and most courts reject it. [152] First, 11 U.S.C. § 544(b) is hardly authority for this approach. [153] The section only allows a trustee to "avoid any transfer of an interest of the debtor in property" that is "voidable by a creditor." [154] This is, however, quite dissimilar to suing to pierce the corporate veil and to impose personal liability on shareholders for all of their corporation's liabilities. Second, this more expansive view of the trustee's power to pierce the corporate veil is arguably inconsistent with the Supreme Court's decision in *Caplin v. Marine Midland Grace Trust Company of New York* [155] and lower court decisions that deny trustees the more general right to pursue creditors' claims against third parties. [156] In *Caplin*, the Court addressed the issue of whether a corporate reorganization trustee under chapter X of the former Bankruptcy Act could pursue claims on behalf of debenture owners against the debenture trustee. The Court characterized the issue as being "difficult" [157] and held that the trustee did not have standing to represent the debenture holders. It pointed out that no provision of the bankruptcy laws "enables [a trustee] to collect money not owed to the estate." [158] As indicated above, 11 U.S.C. § 544(b) of the Code does not grant such authority. [159] Moreover, the debtor corporation itself had no claim against the debenture trustee. If, as was conceivable on the facts, the debtor and debenture trustee were *in pari delicto*, then the estate would be no better off: If the reorganization trustee succeeded in recovering against the debenture trustee, the latter would be "'substituted for the debenture holders as the claimant'" under principles of subrogation. [160] Finally, the Court opined, recognition of the trustee's right to assert the creditors' rights would not necessarily "reduce litigation" but, on the contrary, litigation might "be increased." [161] This follows because a suit by the

reorganization trustee would not pre−empt suits by the individual debenture holders and various incentives would likely cause the debenture holders to sue. [162]

The Court uncharacteristically seemed to offer Congress advice and then to suggest that congressional action based upon that advice would be constitutional. The Court prefaced its opinion with the statement that the difficult issue raised by the case "is capable of resolution by explicit congressional action." [163] And after concluding that trustees do not now have standing, the Court added:

> This does not mean that it would be unwise to confer such standing on trustees in reorganization. It simply signifies that Congress has not yet indicated even a scintilla of an intention to do so, and that such a policy decision must be left to Congress and not to the judiciary.
>
> . . . Congress could determine that the trustee in a reorganization was so well situated for bringing suits against indenture trustees that he should be permitted to do so. In this event, Congress might also determine that the trustee's action was exclusive, or that it should be brought as a class action on behalf of all debenture holders, or perhaps even that the debenture holders should have the option of suing on their own or having the trustee sue on their behalf. Any number of alternatives are available. Congress would also be able to answer questions regarding subrogation or timing of law suits before these questions arise in the context of litigation. Whatever the decision, it is one that only Congress can make. [164]

A short while later, in 1973, the Commission on the Bankruptcy Laws of the United States recommended that Congress modify what is now 11 U.S.C. § 544 to enable the trustee, "when in the best interest of the estate, [to] enforce any claim which any class of creditors has against any person." [165] The Commission's proposal also addressed some of the concerns raised by the Court. [166] This recommendation was redrafted and became section 544(c) of the House of Representative's bankruptcy reform bill. [167] However, without explanation, this provision was deleted from the bill [168] and, of course, is not part of the Code. More recently, the National Bankruptcy Review Commission did not consider the issue. [169]

A general grant of power to trustees to sue third parties on behalf of creditors may be desirable [170] but it raises many collateral issues of the type raised by the Court in *Caplin*. [171] In contrast, granting all trustees the limited power to sue to pierce the corporate veil averts virtually all of the collateral concerns. As discussed above, piercing the corporate veil results in shareholder liability for all of the corporation's debts. [172] When a decision is made to pierce the corporate veil, "it is a judgment that the debts of the corporation are the debts of the alter ego," [173] the corporation's owners. The fiction of the corporation is ignored and the shareholders are recognized as the true debtors and their property is appropriately subjected to creditors' claims. [174] Collateral issues of the type identified in *Caplin* do not arise. Disregard of the corporate fiction is for the benefit of all estate creditors [175] and hence "a more equitable result occurs" than if each creditor acts on its own. [176] Moreover, concerns about the corporation being *in pari delicto* with the third party are obviated since the third party is the debtor and his liability is co−extensive with the debtor's. [177] Finally, allowing the trustee to act to pierce the corporate veil in a "single effort eliminates the many wasteful and competitive suits of individual creditors." [178]

Granting all bankruptcy trustees the right to pursue alter ego actions, irrespective of state law characterizations of it as the right of the corporation or of the creditors, [179] recognizes that, once the corporate fiction is disregarded, creditors are entitled to have their claims satisfied from the shareholders' assets. [180] This right of creditors is too fundamental to depend on state law conceptualizations about who has the right to pursue an action to disregard the corporate veil.

B. Clarifying Creditors' Rights to Exercise the Trustee's Powers

Granting creditors the statutory right to assert the trustee's rights and powers in certain circumstances would enhance creditors' recovery rights and deter fraudulent conduct by corporate insiders and debtors in

possession. Moreover, it would generally further bankruptcy policy by insuring that estate assets are recovered and preserved. [181] The Code provides that, "to the extent . . . a transfer is avoided," "the trustee" or debtor in possession [182] "may recover, for the benefit of the estate, the property transferred." [183] The Code gives a creditors' committee the right to investigate a debtor's financial matters, consult with the debtor in possession about the "administration of the estate," and request the appointment of a trustee under section 1104, [184] but it does not give the committee explicit authority to exercise the rights of a trustee. Therefore, when a trustee or debtor in possession sues to recover assets under a fraudulent conveyance law [185] or the preference provision, [186] any similar recovery action by creditors is clearly pre−empted [187] and stayed. [188]

The Code places upon the trustee a clear, statutory duty to "collect . . . the property of the estate" [189] and provides that the property recovered through the exercise of voiding powers and assertion of other claims is property of the estate. [190] Courts emphasize that this is equally a duty of a debtor−in−possession. [191] If this duty is breached, the courts generally allow the creditors' committee or individual creditors to assert the voiding power on behalf of the estate [192] if certain conditions are met. The claim that the creditors want to assert is colorable; [193] the debtor−in−possession has unjustifiably refused the creditors' demand to pursue the claim; [194] the bankruptcy court determines, "based on a cost−benefit analysis," that the estate would benefit from the creditors' action; [195] and the court has given the creditors leave to pursue the claim. [196]

In many cases, a debtor in possession's real reason for refusing to act is obvious: The voiding power or claim is against the debtors' controlling officers, directors or shareholders. These circumstances strongly suggest the likelihood that the refusal is unjustified. [197] More generally, if a debtor−in−possession offers no reason for failure to pursue a colorable claim that a creditor has shown would benefit the estate, the debtor−in−possession must then come forward with a justifiable reason or the court will allow the creditor to pursue the claim. [198] In some cases, although the debtors−in−possession will not pursue actions, they have agreed with the creditors' committees, subject to court approval, that the committees may pursue the actions on behalf of the estate. [199]

Clear and detailed statutory authorization of creditors' and creditors' committees' rights to act when a trustee or debtor−in−possession refuses to do so would obviate doubts and litigation about this issue.

CONCLUSION

This article has reviewed most of the diverse remedies for corporate fraud that are available to trustees and creditors. Fraudulent conveyance law is the primary tool. Its general policy against transfers for unfair consideration while insolvent is reflected in state corporation statutes' limitations on dividends and stock redemptions and the more general corporate law prohibition against waste. These remedies generally result in recoveries for improper transfers of corporate assets. Usually the transferees are liable but corporate directors can also be held liable for improper distributions to others.

Other equitable theories are available to improve the likelihood of creditor recovery when corporate insiders' actions towards them have been fraudulent. Corporate liability can be imposed upon corporate insiders individually if they have failed to respect the separate corporate entity and have dealt with corporate assets and business as if it were their private property. Alternatively, if insiders continue ownership of the debtor corporation's business in a new corporate form, the successor corporation can be held liable to the debtor's creditors. Finally, insiders' claims against a debtor can be subordinated to the claims of other creditors.

Although these rights and remedies are important to protect creditor interest, it would be a mistake to assume that they, even with other Bankruptcy Code provisions, provide effective deterrence against fraud by insiders when their corporations are threatened with insolvency. As discussed, the Code's use of the discharge provision to deter objectionable debtor conduct prior to and during bankruptcy is ineffective in the corporate setting because those provisions are largely irrelevant. Moreover, the recovery theories discussed in this article provide little discouragement to insider fraud. When successful, the most important of these theories do no more than require that the insiders return the property that has been improperly transferred to them. Hence, without other possible consequences, engaging in the fraudulent conduct might be viewed by some as being

costless. True, under some theories, insiders face risks of having greater liability imposed upon them. But the threat of greater liability is greatly attenuated by at least two factors: First, often the fraudulent conduct will not be discovered. And, second, even if it is, trustees and creditors might not succeed given difficulties of proof, uncertainties about the law and facts, and costs of litigation. Consequently, especially in corporate bankruptcies where bankruptcy law's deterrent provisions are inapposite, bankruptcy and corporation laws must be complemented by effective criminal law enforcement.

FOOTNOTES:

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[1] Bernard Black & Reinier Kraakman, *A Self−Enforcing Model of Corporate Law*, 109 Harv. L. Rev. 1911, 1968 (1996). *See In re* Lifschultz Fast Freight, 132 F.3d 339, 354 (7th Cir. 1997) ("[C]lassic form of . . . misconduct is boosting the owner−employee's salary as the firm is drifting into financial collapse."); Ramesh K.S. Rao et al., *Fiduciary Duty a la Lyonnais: An Economic Perspective on Corporate Governance in a Financially−Distressed Firm*, 22 J. Corp. L. 53, 74 (1996) (noting that some corporate laws prevent shareholder withdrawals "when firm is at or near insolvency"). In *Max Sugarman Funeral Home, Inc. v. A.B.D. Investors*, 926 F.2d 1248 (1st Cir. 1991), the court, with colorful metaphor, illustrates insiders' conduct during one corporation's slow slide into bankruptcy. The case presents a

> complex factual setting involving a moribund funeral home whose inevitable financial demise was lucratively delayed for years by insiders who financed its life support system at the expense of unsuspecting debenture holders who were left holding the bag when the plug was pulled by the onset of these involuntary bankruptcy proceedings.

Id. at 1249. Back To Text

[2] "Insider" in this article means a person with a sufficiently close relationship with a corporation so that he can influence its actions and includes major shareholders, directors, officers, affiliated corporations, and persons in control. *See In re* Krehl, 86 F.3d 737, 741−43 (7th Cir. 1996) (holding that insider relationship survived debtor's resignation as president and director); *cf.* 11 U.S.C. § 101(31)(B) (1994 & Supp. 1998); Unif. Fraudulent Transfer Act § 1(7), 7A U.L.A. 644−45 (1985).Back To Text

[3] *See* cases cited *infra* notes 20−25.Back To Text

[4] *See generally* William T. Vukowich, *Consumer & Fraud Victims' Claims in Bankruptcy: Constructive Trusts & the Consumer Priority*, 1988 Annual Survey of Bankruptcy Law 129 (verified by and on file with author).Back To Text

[5] United States v. Vitek Supply Corp., 151 F.3d 580, 585 (7th Cir. 1998). *See also* State *ex rel*. Van Nguyen v. Berger, 483 S.E.2d 71, 75 (W. Va. 1996) (observing that because corporations cannot be imprisoned statute imposed personal liability on corporate officers); People v. Duncan, 2 N.E.2d 705, 706 (Ill. 1936) (recognizing that corporation may be criminally prosecuted for violation of penal statute, but corporation cannot commit certain crimes and corporations can never face some penalties, such as imprisonment).Back To Text

[6] *See* 11 U.S.C. § 523 (a)(2), (a)(4) (1994) (liabilities for fraud nondischargeable).Back To Text

[7] *See* 11 U.S.C. § 727(a)(2) (no discharge of any debt if assets fraudulently transferred within one year of bankruptcy); *see also* Martin v. Bajgar (*In re* Bajgar), 104 F.3d 495, 497 (1st Cir. 1997) (discussing policy of § 727(a)(2) where debtor returned asset to estate upon creditor objection); Bernard v. Sheaffer (*In re* Bernard), 96 F.3d 1279,1281 (9th Cir. 1996) (discussing policy where debtors removed assets from bank account to avoid judgment creditor's attachment).Back To Text

[8] *See* 11 U.S.C. § 727(a)(3), (a)(4) (no discharge of any debts if records not produced or falsified, or if false oath made); § 523(a)(2), (4) (no discharge of liabilities for fraud or false representation); Desmond v. Varrasso (*In re* Varrasso), 37 F.3d 760, 764 (1st Cir. 1994) (discussing omission of assets from schedules, but unclear whether "knowingly and fraudulently" is required under § 727(a)(4)).Back To Text

[9] *See* 11 U.S.C. § 727(a)(3), (a)(5), (a)(6) (denying discharge of any debts if debtor falsifies or conceals records, cannot explain loss of assets or refuses to follow court orders).Back To Text

[10] *See* 11 U.S.C. § 727(a)(1) (denying discharge if debtor is "not an individual"); *see also* § 1141(d) (providing that discharge in chapter 11 unaffected by §§ 523(a) and 727(a) unless liquidating substantially all assets).Back To Text

[11] Section 727(a)(7) might deter corporate insiders somewhat from engaging in fraudulent behavior before a corporation files bankruptcy and encourage their cooperation during the corporation's bankruptcy proceedings. It denies a discharge to an insider who, during a bankruptcy "concerning an insider," has engaged in conduct identified in parts (2) through (6) of the section. And a corporation is an "insider" vis−à−vis a director, officer or person in control. *See* § 101(31)(A)(iv). However, the provision is quite limited because it only applies if the insider herself files bankruptcy within one year of the corporation's bankruptcy. *See In re* Krehl, 86 F.3d 737, 741 (7th Cir. 1996) ("[S]ection 727(a)(7) applies only if the debtor in the earlier case was an insider of the present debtor when the relevant conduct occurred.") (footnote omitted). Back To Text

[12] In some instances, liability can extend beyond the value of property received. *See infra* Parts II−A (discussing general shareholder liability for corporation's debts when veil pierced), Part II−C (discussing successor corporation's general liability for former corporation's debts). Back To Text

[13] *See supra* note 5 and accompanying text. Back To Text

[14] *See* 18 U.S.C. § 152(1) (1994) (fraudulent concealment of property of estate of debtor), § 152(5) (fraudulent receipt of estate property), § 152(7) (fraudulent transfer or concealment of corporate property in personal capacity or as corporate agent or officer), § 152(8) (before or after debtor files, fraudulently concealing or falsifying debtor's records), § 152(9) (after case has been filed, fraudulently withholding records relating to property or financial affairs of debtor); *see also* 18 U.S.C. § 3057 (1994) (providing that all facts relating to violations of bankruptcy crimes must be reported to U.S. Attorney).Back To Text

[15] *Compare* grounds in *supra* notes 7−11, *with* grounds in *supra* note 14. Back To Text

[16] *See* 11 U.S.C. §§ 548, 550(a) (1994)**;** Unif. Fraudulent Transfer Act §§ 4, 5, 7, 7A U.L.A. 652−53, 657, 660 (1985) (defining what constitutes fraudulent transfers); *In re* Lifschultz Fast Freight, 132 F.3d 339, 354 (7th Cir. 1997) (observing bankruptcy law's preference and fraudulent transfer provisions empower "trustees with potent tools to avoid insiders' last−minute attempts to strip a debtor of capital").Back To Text

[17] *See* 11 U.S.C. § 548.Back To Text

[18] For convenience, when discussing state fraudulent conveyance law, reference will be made to the Uniform Fraudulent Transfer Act. Back To Text

[19] Unlike the provisions of corporate law to be discussed, fraudulent conveyance law allows recovery of the property transferred but does not result in liability on the part of those making the transfer. *See* American Nat'l Bank of Austin v. MortgageAmerica Corp. (*In re* MortgageAmerica Corp.), 714 F.2d 1266, 1272 (5th Cir. 1983) (explaining that remedy for fraudulent transfer is limited to property recovery and entails no liability on part of those responsible for transfer); Smith v. Moody, Jr. (*In re* Moody, Jr.), 77 B.R. 566, 573 (S.D. Tex. 1987) (relating that, under Texas fraudulent conveyance law, liability attaches to property and no personal liability exists for those responsible for transfer).Back To Text

[20] *See, e.g.*, Acequia, Inc. v. Clinton (*In re* Acequia, Inc.), 34 F.3d 800, 806 (9th Cir. 1994) ("no documentation, other than ambiguous check memo−line notes, to confirm [insider's] 'innocent' explanations for the transactions"); Max Sugarman Funeral Home, Inc. v. A.D.B. Investors, 926 F.2d 1248, 1253, 1255 (1st Cir. 1991) (transfers from corporation "a sham," for "no legitimate . . . purpose"); Lunsford v. Haynie, 175 F.2d 603, 606 (5th Cir. 1949) ("bare faced and inexcusable appropriation to [shareholder's] own personal use"); Bartle v. Markson, 299 F. Supp. 958, 963−64 (N.D.N.Y. 1969) ("overall plan . . . to transfer assets of the corporation . . . causing [its] assets . . . to be depleted"); *see also* Pepper v. Litton, 308 U.S. 295, 296, 301 (1939) ("scheme to defraud . . . reminiscent of some of the evils with which" original fraudulent conveyance laws were designed to cope; salary claim not honest debt).Back To Text

[21] *See* Schafer v. Las Vegas Hilton Corp. (*In re* Video Depot, Ltd.), 127 F.3d 1195, 1196 (9th Cir. 1997) (payment of owner's gambling debt to casino); Rupp v. Markgraf, 95 F.3d 936, 941 (10th Cir. 1996) (payment in partial satisfaction of owner's personal liability on judgment). Back To Text

[22] *See* Stoebner v. Lingenfelter, 115 F.3d 576, 578 (8th Cir. 1997) (debtor−corporation's assets used to purchase rare documents for another of owner's corporations). Back To Text

[23] *See In re* FBN Food Servs., Inc., 82 F.3d 1387, 1393 (7th Cir. 1996) (holding claim settlement owed to debtor transferred for benefit of related company); *see also* Bowers v. Atlanta Motor Speedway, Inc. (*In re* Southeast Hotel Properties Ltd. Partnership), 99 F.3d 151, 152 (4th Cir. 1996) (stating debtor corporation's post−bankruptcy payments of controlling corporation's bills recoverable).Back To Text

[24] *See* Geyer v. Ingersoll Publications Co., 621 A.2d 784, 786 (Del. Ch. 1992) (insider received favorable business deals from third parties after insider caused debtor−corporation to surrender valuable rights against third parties).Back To Text

[25] *See Acequia*, 34 F.3d at 803 (corporate funds transferred to owner and "'used for personal expenses'").Back To Text

[26] *See* 11 U.S.C. § 548(a)(1)(A) (1994); Unif. Fraudulent Transfer Act § 4(a)(1), 7A U.L.A. 652 (1985); *Stoebner*, 115 F.3d at 576 (holding of actual fraudulent intent based upon jury's special verdict); *Acequia*, 34 F.3d at 800; Monzack v. ADB Investors (*In re* EMB Assocs., Inc.), 100 B.R. 629 (Bankr. D. R.I. 1989) (relying in part on "badges of fraud"); *Max Sugarman Funeral Home*, 926 F.2d at 1254.Back To Text

[27] *See Acequia*, 34 F.3d at 806 (observing that debtor−corporation's bankruptcy was "imminent," "lawsuits were pending," recipient of transfers "maintained total control over the corporation's finances"); *Max Sugarman Funeral Home*, 926 F.2d at 1248 (citing "insolvency or other unmanageable indebtedness," "special relationship between the debtor and the transferee"); *EMB Assocs.*, 100 B.R. at 633 (listing transfer of all assets of value, in contemplation of bankruptcy, while insolvent, and not in ordinary course).Back To Text

[28] *See* Unif. Fraudulent Transfer Act §§ 4(b)(1) (8), (9), 7A U.L.A. 653 (providing that transfer to "insider," relative "value of consideration" received by debtor for transfer, and debtor's solvency all relevant to finding of "actual intent" to defraud); Taylor v. Rupp (*In re* Taylor), 133 F.3d 1336, 1338 (10th Cir. 1998) (stating that UFTA includes nonexclusive list of badges of fraud that may be considered as evidence of debtors' fraudulent intent).Back To Text

[29] Unif. Fraudulent Transfer Act § 5(a), 7A U.L.A. 657; 11 U.S.C. § 548(a)(1)(B). *See, e.g.*, Leibowitz v. Parkway Bank & Trust Co. (*In re* Image Worldwide Ltd.) 139 F.3d 574, 581 (7th Cir. 1998) (holding that debtor−corporation did not receive reasonably equivalent indirect benefits in guaranteeing loan to affiliate); Texas Truck Ins. Agency, Inc. v. Cure (*In re* Dunham), 110 F.3d 286, 286 (5th Cir. 1997) (holding that business assets' appraised value of $200,000 clearly not reasonably equivalent to approximately $40,000 paid to debtor−corporation); Scholes v. Lehman, 56 F.3d 750, 756−58 (7th Cir. 1995) (explaining that payments to Ponzi investor not reasonably equivalent to extent they exceed his investment). The Courts of Appeals generally review findings regarding reasonable equivalency under the clearly erroneous standard. *See*

Dunham, 56 F.3d at 286; *see also* Jacoway v. Anderson (*In re* Ozark Restaurant Equip. Co.), 850 F.2d 342, 344 (8th Cir. 1988).Back To Text

[30] Unif. Fraudulent Transfer Act § 5(a), 7A U.L.A. 657; 11 U.S.C. § 548(a)(1)(B)(i). *See, e.g.*, Joshua Slocum, Ltd. v. Boyle (*In re* Joshua Slocum, Ltd.) 103 B.R. 610, 620−24 (Bankr. E.D. Pa. 1989) (analyzing, in detail, whether transfer rendered debtor−corporation insolvent).Back To Text

[31] 11 U.S.C. § 548(a)(1)(B)(ii)(II); *accord* Unif. Fraudulent Transfer Act § 4(a)(2)(i), 7A U.L.A. 653. *See In re* Lifschultz Fast Freight, 132 F.3d 339, 343 (7th Cir. 1997); Stoebner v. Lingenfelter, 115 F.3d 576, 576 (8th Cir. 1997); *Joshua Slocum*, 103 B.R. at 625; Robert Charles Clark, *The Duties of the Corporate Debtor to its Creditors*, 90 Harv. L. Rev. 505, 555−57 (1977); Bruce A. Markell, *Toward True and Plain Dealing: A Theory of Fraudulent Transfers Involving Unreasonably Small Capital*, 21 Ind. L. Rev. 469 (1988). Adequacy of capital is also relevant when the issues are whether debt owed to corporate owners should be subordinated and whether the corporate veil should be pierced. *See infra* Parts II−A, II−B.Back To Text

[32] *See* 11 U.S.C. § 548(a)(1)(B)(ii)(III); Unif. Fraudulent Transfer Act § 4(a)(2)(ii) 7A U.L.A. 653.Back To Text

[33] 11 U.S.C. § 550(a)(1). The section also allows for recovery against "the entity for whose benefit such transfer was made." *Id*. Courts of Appeals generally hold that an initial transferee must, at a minimum, have dominion and control over the property transferred, including the right to use the property for the transferee's own purposes. *See* Schafer v. Las Vegas Hilton Corp. (*In re* Video Depot, Ltd.) 127 F.3d 1195, 1198−1200 (9th Cir. 1997) (reviewing cases); Bowers v. Atlanta Motor Speedway, Inc. (*In re* Southeast Hotel Properties Ltd. Partnership), 99 F.3d 151, 154−55 (4th Cir. 1996); Rupp v. Markgraf, 95 F.3d 936, 938−41 (10th Cir. 1996) (reviewing cases). *See generally* Kenneth P. Coleman, *Conduits, Good Faith, & the Recovery of Preferences & Fraudulent Transfers Under Bankruptcy Code Section 550*, 114 Banking L.J. 375 (1997); John E. Theuman, Annotation, *What Constitutes "Initial Transferee" Under § 550(A) of Bankruptcy Code, Which Permits Recovery of Property, or Value Thereof, From Initial Transferee of Property to Extent Transfer is Avoided*, 92 A.L.R. Fed. 631 (1989).Back To Text

[34] *See Southeast Hotel Properties*, 99 F.3d at 157 (same); *Rupp*, 95 F.3d at 938, 944 (stating that Congress has balanced equitable considerations under § 550 by setting strict liability standard for initial transferees and non−strict liability standard for subsequent transferees). In some cases, the initial transferees are arguably "in the best position to monitor fraudulent transfers from the debtor." *Id.* at 938, 944 (initial transferees received check paid for by debtor−corporation in payment of debt owed to transferees by insider); *see also Southeast Hotel Properties*, 99 F.3d at 157−58 (check given to initial transferee indicated debtor, which was in bankruptcy, as remitter and hence initial transferee on notice).Back To Text

[35] *See* 11 U.S.C. § 550(b)(1); *Max Sugarman Funeral Home*, 926 F.2d at 1256−57, n.14 (finding transferee neither good faith transferee nor was it without knowledge of voidability of transfer under Code). One is also protected if he took from one who gave value, in good faith, and without knowledge of the voidability of the transfer. *See* 11 U.S.C. § 550(b)(2).Back To Text

[36] Other items, often of little or no value, have also been transferred to corporations to disguise the corporations' transfers to insiders. *See, e.g.*, Lunsford v. Haynie, 175 F.2d 603, 605 (5th Cir. 1949) ("money exacted from the corporation as pretended royalties on trade names" licensed by insider to corporation); Bartle v. Markson, 299 F. Supp. 958, 962 (N.D.N.Y. 1969) ("worthless debentures").Back To Text

[37] The discussion focuses on distributions of money or property and excludes stock or share dividends.Back To Text

[38] *See* Rao, *supra* note 1, at 73−74 (observing that corporate statutes ensure that "adequate capital level is available to meet the claims of creditors").Back To Text

[39] *See* Model Bus. Corp. Act § 6.40(c)(1) (amended 1987) (prohibiting distributions if corporation would be unable to pay debts as they become due); Cal. Corp. Code § 501 (Deering 1977) (same). Back To Text

[40] *See* Model Bus. Corp. Act § 6.40(c)(2) (prohibiting distributions if assets would be less than total liabilities); Del. Code Ann. tit. 8, § 244(b) (1991) (same).Back To Text

[41] *See* Cal. Corp. Code §§ 500(b)(1), (2) (assets at least 1 1/4 times liabilities); title 8, § 170(a) (value of capital at least in amount of aggregate amount of capital represented by issued preference shares); Model Bus. Corp. Act § 6.40(c)(2) & cmt. 5 (unless articles permit otherwise, assets must at least equal liabilities plus amount needed to satisfy rights of shareholders with preference rights superior to those receiving dividend); Del. Code Ann. tit. 8, § 170(a) (same).Back To Text

[42] Del. Code Ann. tit. 8, § 174(a).Back To Text

[43] *Id. See* Cal. Corp. Code §§ 316(a)(1), 309(a) ("such care, including reasonable inquiry, as an ordinarily prudent person . . . would use"); Model Bus. Corp. Act § 8.33(a), 8.30(a)(2) (similar).Back To Text

[44] *See* Cal. Corp. Code §§ 316(a)(1), 309(a) (setting standard of "good faith"); Model Bus. Corp. Act §§ 8.33(a), 8.30(a)(1) (same); *see also* Curley v. Dahlgren Chrysler−Plymouth, Dodge, Inc., 429 S.E.2d 221, 224 (Va. 1993) (holding shareholders, who assumed role of directors, though never elected, liable under corporate law for improper distributions). *See generally* Richard O. Kummert, *State Statutory Restrictions on Financial Distributions By Corporations to Shareholders*, 59 Wash. L. Rev. 185, 265−66 (1984).Back To Text

[45] Cal. Corp. Code § 506; *accord* Model Bus. Corp. Act § 8.33(b)(2) (providing shareholders liable only for contribution demanded by director who is held liable and then only if shareholder "accepted knowing the distribution was made in violation" of statute); *see* Del. Code Ann. tit. 8, § 174(c); *Curley*, 429 S.E.2d at 433−34 (shareholders who assume role of directors, though never elected, held liable under corporate law for improper distribution); Harry G. Henn & John R. Alexander, Laws of Corporations § 323, at 903−04 (3d ed. 1983).Back To Text

[46] *See In re* Midatlantic Corp. Shareholder Litig., 758 F. Supp 226, 239 (D. N.J. 1990) (explaining impracticability of organizing all shareholders in multi−billion dollar corporation); Lynn M. LoPucki, *The Death of Liability*, 106 Yale L.J. 1, 27−29 (1996) (noting dividends may be paid to thousands of shareholders which would make recovery impractical).Back To Text

[47] *See supra* notes 42−44 and accompanying text.Back To Text

[48] *See supra* note 45 and accompanying text.Back To Text

[49] *See* Clark, *supra* note 31, at 555−560.Back To Text

[50] *See* Robert L. Jordan & William D. Warren, Bankruptcy 543 (4th ed. 1995) (verified by and on file with author). One has no right to a gift. On the other hand, shareholders have an expectation that dividends will be paid and, under certain circumstances, have the right to compel a distribution of dividends. *See* Henn & Alexander, *supra* note 45, §§ 327−28, at 913−18 (explaining shareholder rights to compel payment of mandatory dividends and of discretionary dividends when nonpayment amounts to abuse of discretion). Back To Text

[51] Cal. Corp. Code § 166.Back To Text

[52] 11 U.S.C. § 548(d)(2)(A) (1994); Unif. Fraudulent Transfer Act § 3(a), 7A U.L.A. 650 (1985).Back To Text

[53] 11 U.S.C. § 101(32); Unif. Fraudulent Transfer Act § 2(a), 7A U.L.A. 648.Back To Text

[54] *See* Report of the Task Force on the Corporate Law & Accounting Comm. of the ABA Section of Corporation, Banking & Business Law, *"Current Issues on Legality of Dividends from Law & Accounting Perspective"*, at 27−28 (Master Draft 12/8/82) (verified by and on file with author).Back To Text

[55] Model Bus. Corp. Act § 6.40 cmt. 4 (amended 1987). *See also* Henn & Alexander, *supra* note 45, § 320 at 890 n.4 (noting variety among definitions of insolvency).Back To Text

[56] *See* Clark, *supra* note 31, at 555.Back To Text

[57] *See* Kummert, *supra* note 44, at 287 n.388 (noting that no case found in which typical corporate law standards would not have produced same result as unreasonably small capital standard).Back To Text

[58] *See supra* note 45 and accompanying text.Back To Text

[59] *See* 11 U.S.C. § 550(a)(1), (b)(1) (protecting only transferee who "takes for value"); Unif. Fraudulent Transfer Act §§ 7(a)(1), 8(a), 7A U.L.A. 660, 662 (voidable unless "reasonably equivalent value" given); 8(d), at 662 (certain rights accorded good faith transferee only "to the extent of the value given the debtor"); Jordan & Warren, *supra* note 50, at 546.Back To Text

[60] See authorities cited in Mark J. Roe, *Corporate Strategic Reaction to Mass Tort*, 72 Va. L. Rev. 1, 32, 33 (1986). *See* Clark, *supra* note 31, at 558−60.Back To Text

[61] *See* authorities in Roe, *supra* note 60, at 20; Clark, *supra* note 31, at 558−59, n.154.Back To Text

[62] *See* Clark, *supra* note 31, at 558.Back To Text

[63] This discussion concerns pre−bankruptcy compensation paid to insiders. A related issue concerns the appropriateness of the level of salaries paid to officers during a debtor's bankruptcy proceedings. *See In re* Regensteiner Printing Co., 122 B.R. 323 (N.D. Ill. 1990); *In re* Lyon & Reboli, Inc., 24 B.R. 152 (Bankr. E.D.N.Y. 1982); *In re* Schatz Fed. Bearings Co., 17 B.R. 780 (Bankr. S.D.N.Y. 1982). Back To Text

[64] *See* Jacob Mertens, Jr., Law of Federal Income Taxation, § 25E.28 (1997) (discussing how and when court will scrutinize compensation to determine whether it is dividend in disguise); Daniel M. Schneider, *Characterization and Assignment of Corporate and Shareholder Income*, 14 N. Ill. U. L. Rev. 133, 158 (1993) (describing when excessive compensation will be treated as dividend); Consuelo Lauda Kertz, *Executive Compensation Dilemmas in Tax Exempt Organizations: Reasonableness, Comparability, and Disclosure*, 71 Tul. L. Rev. 819, 834−35 (1997) (discussing tax considerations which motivate mischaracterization of dividends as executive compensation).Back To Text

[65] *See* Henn & Alexander, *supra* note 45, § 245, at 668−69 nn.16−17; *see also* Rutter v. Commissioner, 853 F.2d 1267, 1271 (5th Cir. 1988) (listing factors considered when determining whether compensation is excessive for tax purposes); Mertens, *supra* note 64 at § 25E.28 (describing methods used to distinguish between compensation and dividend). If a "salary" payment is deemed to be a dividend, its propriety would be evaluated as discussed in Part I−A *supra*.Back To Text

[66] *See* Henn & Alexander, *supra* note 45, § 245, at 668 n.16 (indicating that reasonableness of compensation is relevant to "negative waste or gift of corporate assets"); *id.* § 255, at 690 (stating that directors and officers are liable for waste if they improperly expend corporate funds when they are recipients and sometimes when they are not recipients). Back To Text

[67] Glenmore Distilleries Co. v. Seideman, 267 F. Supp. 915, 919 (E.D.N.Y. 1967); *accord* Lunsford v. Haynie, 175 F.2d 603, 606 (5th Cir. 1949) (holding salary "wholly disproportionate to his services" and therefore recoverable by trustee); Heise v. Earnshaw Publications, Inc., 130 F. Supp. 38, 40 (D. Mass. 1955) (stating that salaries should not be raised beyond fair value of services).Back To Text

[68] *See Glenmore Distilleries*, 267 F. Supp. at 919 (asserting compensation of corporate officers must bear reasonable relation to value of services rendered).Back To Text

[69] *See id*. (stating officer compensation must be in proportion to corporation's earnings).Back To Text

[70] *See In re* Lifschultz Fast Freight, 132 F.3d 339, 354−55 (7th Cir. 1997) (burden to show "fairness and good faith" of raise and retroactive raise shifts to insiders once substantial factual basis of impropriety established; equitable subordination context); *Lunsford*, 175 F.2d at 606 (The "burden lies heavily on [insider] to show that the exacted salary was reasonable"); *Heise*, 138 F. Supp. at 38. Back To Text

[71] *See* 136 Cong. Rec. H432−05 (Feb. 26, 1990) (statement of Congressman Mazzoli):

> We had another wild west adventure the other day, Mr. Speaker. Only this time the bad guys did not wear red bandanas [sic] and buckskin vests. They wore Hermes ties and Saville row suits. This time they didn't ride out of town on horses but on [sic] BMW's and Rolls Royces.
>
> I am talking about the $350 million in bonuses the brokerage firm, Drexel Burnham Lambert, Inc., paid to executives and insiders just days before its parent corporation declared bankruptcy owing — you guessed it — $350 million to employees, creditors, and investors.

See also Drexel Sues Former Top−Paid Executives Securities: The Investment Firm Is Trying To Get Back Big Bonuses It Paid Out Just Before Filing For Bankruptcy, L.A. Times, Feb. 12, 1992, at D3 (Drexel subsequently sued to recover payments).Back To Text

[72] *See Lifschultz Fast Freight*, 132 F.3d at 339 (significant retroactive and other raises just months before bankruptcy; equitable subordination context).Back To Text

[73] *See* Joshua Slocum, Ltd. v. Boyle (*In re* Joshua Slocum, Ltd.), 103 B.R. 610, 619−20 (Bankr. E.D. Pa. 1989) (holding insider's surrender of right to continued employment "with the rapidly−declining Debtors was negligible" and not reasonably equivalent value for payment to insider).Back To Text

[74] Corporation laws and cases are increasingly recognizing the validity of bonuses and similar compensation when properly adopted by the corporation. *See* Henn & Alexander, *supra* note 45, § 246, at 671−72; 2 F. Hodge O'Neal & Robert B. Thompson, O'Neal's Close Corporations § 8.11, at 54−55 (3d ed. 1996); *id.* § 8.23, at 184 (discussing use of bonus plans in close corporations). This recognition and approval generally concerns officers' rights vis−à−vis the corporation's shareholders. However, the instant discussion focuses on the rights of officers of failing or insolvent corporations vis−à−vis the corporation's creditors. *See also* Pepper v. Litton, 308 U.S. 295, 297 (1939) (discussing propriety of payment to insider for alleged accumulation of salary for five years).Back To Text

[75] *See* 11 U.S.C. § 548(a)(1)(B)(i) (1994); Unif. Fraudulent Transfer Act § 5(a), 7A U.L.A. 660 (1985).Back To Text

[76] *See* Henn & Alexander, *supra* note 45, § 245, at 669, n.18 (stating that retroactive compensation is usually without consideration).Back To Text

[77] *See Joshua Slocum*, 103 B.R. at 627−28 (noting that value of termination agreement to corporation was "negligible").Back To Text

[78] *See, e.g.*, Cal. Corp. Code § 166 (Deering 1977) (defining "distribution to shareholders" to include both dividends and redemption of shares); Model Bus. Corp. Act § 1.40(6) & cmt. 3 (1984) (same); LibcoCorp. v. Leigh (*In re* Reliable Mfg. Corp.), 703 F.2d 996, 1001 (7th Cir. 1983) (calling redemption of shares "redistributing [corporate] assets to shareholders")Back To Text

[79] *See* Cal. Corp. Code § 166 (transfer "without consideration" when for "purchase or redemption of its shares"); Stoumbos v. Kilimnik, 988 F.2d 949, 965 (9th Cir. 1993) (stating that redemption of shares is not preference since it is not payment of corporate debt). The shares that the corporation receives upon a redemption have been called "treasury shares." Henn & Alexander, *supra* note 45, § 337, at 942. The court in *Consove v. Cohen (In re Roco Corp.)*, 701 F.2d 978, 982 (5th Cir. 1983), explains the economic consequences of a stock redemption:

> Under generally accepted accounting principles this treasury stock would be reported on the balance sheet . . . as a reduction of stockholders' equity, not as an asset. See generally R. Anthony & J. Reese, Accounting Principles 215 (4th ed. 1979) ("Treasury stock is clearly not an 'economic resource' of an entity.") . . . [T]reasury stock is a form of shareholder distribution from which the corporation receives no assets.

Accord In re Main Street Brewing Co., 210 B.R. 662, 664−65 (Bankr. D. Mass. 1997). The Model Business Corporation Act eliminated the concept of "treasury shares" in 1980. *See* Model Bus. Corp. Act § 6.31 cmt.Back To Text

[80] *See* Model Bus. Corp. Act § 6.40 (amended 1987) (providing that distribution rules apply to all kinds of "distributions"); Cal. Corp. Code § 500 (same); Del. Code Ann. tit. 8, §§ 160, 244 (1991 & Supp. 1996) (providing general prohibition against reduction of capital unless assets sufficient to pay debts); Joshua Slocum, Ltd., v. Boyle (*In re* Joshua Slocum Ltd.), 103 B.R. 610, 627−28 (Bankr. E.D. Pa. 1989) (Pennsylvania law). The Delaware Code's restrictions on redemption do not provide for the preference class "cushion" that is built into its dividend restriction. *Compare* Del. Ann. Code tit. 8, § 160(a)(1), *with* title 8, § 170(a).Back To Text

[81] *See* Cal. Corp. Code §§ 316, 506 (providing that liability provisions apply to "any distribution" that is improper); Model Bus. Corp. Act § 8.33(a), (b)(2) (same); Del. Ann. Code tit. 8, § 174(a), (c) (liability provisions apply to both unlawful dividend and redemption); *see also* Kummert, *supra* note 44, at 200. For a discussion of indemnity of directors for such liability, see Marcia M. McMurray et al., Notes, *Special Project: Director and Officer Liability*, 40 Vand. L. Rev. 599, 759−761 (1987); *supra* notes 42−44 and accompanying text. Back To Text

[82] *See* Cal. Corp. Code § 166 (providing that redemption of shares is "without consideration"); *see also supra* note 79 and accompanying text.Back To Text

[83] *See, e.g.*, *Roco*, 701 F.2d at 982, 983 (finding that redemption of "virtually worthless" stock and corporation "insolvent"); *Joshua Slocum*, 103 B.R. at 619−20 (holding that stock in insolvent or nearly insolvent firm did not benefit firm and that payment for stock recoverable); Hargrave v. Boehmer (*In re* F.H.L., Inc.), 91 B.R. 288, 299−302 (Bankr. D. N.J. 1988) (ruling that payments to redeem stock by insolvent corporation were voidable as fraudulent transfers); *see also Stoumbos*, 988 F.2d at 965 (pointing out that recovery for redemption by insolvent corporation should be based upon fraudulent transfer, not preferential transfer, theory).Back To Text

[84] *See* Lunsford v. Haynie, 175 F.2d 603, 606 (5th Cir. 1949) (stating that cancellation of insider's stock for cash left corporation unreasonably vulnerable to becoming insolvent). Back To Text

[85] If a corporation is insolvent when it redeems stock, the preceding discussion in this section indicates that payments would be recoverable as fraudulent transfers or violations of state corporation laws.Back To Text

[86] *Main Street Brewing*, 210 B.R. at 665; *see also In re* Envirodyne Indus., 79 F.3d 579, 582−83 (7th Cir. 1996).Back To Text

[87] *See, e.g.*, Robinson v. Wangemann, 75 F.2d 756 (5th Cir. 1935); *In re* SPM Mfg. Corp., 163 B.R. 411, 414 (Bankr. D. Mass. 1994) (finding support for subordination in § 510(c)).Back To Text

[88] *See infra* Part II−B.Back To Text

[89] *See In re* Stern−Slegman−Prins Co., 86 B.R. 994, 1000 (Bankr. W.D. Mo. 1988); *Main Street Brewing*, 210 B.R. at 665. The Model Business Corporations Act treats debt that is issued in compliance with its redemption provisions "at parity with" debt to creditors. *See* Model Bus. Corp. Act § 6.40(f). Its rationale is, "General creditors are better off . . . than they would have been if cash . . . had been paid out for the shares . . . and no worse off than if cash had been paid or distributed and then lent back to the corporation . . . ." *Id*. cmt. 8.c.Back To Text

[90] *See* Henn & Alexander, *supra* note 45, § 146, at 349 (discussing that, although shareholders not normally liable for corporate debts, they may nonetheless be held liable if corporate entity disregarded); *id.* § 148, at 356 (stating that if one corporation is under control of another, former will be treated as agent and latter as principal); *see also* United States v. Bestfoods, 118 S. Ct. 1876, 1885 (1998) (stating that when corporate form is misused, "corporate veil may be pierced and the shareholder held liable for the corporation's conduct"); Berlin v. Boedecker, 887 P.2d 1180, 1188 (Mont. 1994) (holding 97% shareholder and corporation jointly and severally liable); Econ Marketing, Inc. v. Leisure Am. Resorts, Inc., 664 So.2d 869, 871 (Ala. 1994) (holding shareholder personally liable for corporate debts after corporate veil pierced). Usually, to be held liable, an insider must himself have acted in a manner that justifies disregard as to him; passive investors who did not engage in the objectionable conduct are not subject to liability. *See* William P. Hackney & Tracey G. Benson, *Shareholder Liability for Inadequate Capital*, 43 U. Pitt. L. Rev. 837, 876−78 (1982).Back To Text

[91] *See* Henn & Alexander, *supra* note 45, § 146, at 345 n.6; Hackney & Benson, *supra* note 90, at 838−39 nn.2−3; Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 Cornell L. Rev. 1036, 1036 (1991) (most litigated topic in corporate law).Back To Text

[92] *See, e.g.*, AMFAC Foods, Inc. v. International Sys. & Controls Corp., 654 P.2d 1092, 1096 (Or. 1982) (observing that there are no "articulated rules with the specificity typical of rules applied in actions at law"); Franklin A. Gevurtz, *Piercing Piercing: An Attempt to Lift the Veil of Confusion Surrounding the Doctrine of Piercing the Corporate Veil*, 76 Or. L. Rev. 853, 853 (1997); Dale A. Oesterle, *Subcurrents in LLC Statutes: Limiting the Discretion of State Courts to Restructure the Internal Affairs of Small Business*, 66 U. Colo. L. Rev. 881, 898 (1995) (noting confusion causes lawyers to be "frustrated"); *see also* Thompson, *supra* note 91, at 1036−37 (quoting Cardozo who "described this corner of the law as 'enveloped in the mists of metaphor'"). Back To Text

[93] *See* Henn & Alexander, *supra* note 45, § 146, at 346 n.10 (noting variations from state to state). Moreover, some state laws and courts resolve piercing issues more conservatively when the plaintiff is a contract creditor than when the plaintiff is a tort creditor. *See* Western Horizontal Drilling, Inc. v. Jonnet Energy Corp., 11 F.3d 65, 68 (5th Cir. 1994) (noting that under Texas statutory and case law, fewer grounds for piercing corporate veil are available to contract creditors); Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. Chi. L. Rev. 89, 107−12 (1985) (stating that "[c]ourts are more willing to disregard the corporate veil in tort than in contract cases"). Back To Text

[94] *See* United States v. Bestfoods, 118 S. Ct. 1876, 1879 n.9 (1998) (context of federal environmental liability); United States v. Vitek Supply Corp., 151 F.3d 580, 585 (7th Cir. 1998); Note, *Piercing the Corporate Veil: The Alter Ego Doctrine Under Federal Common Law*, 95 Harv. L. Rev. 853, 860−61 (1982) [hereinafter *Piercing Veil*]. *See also* Subway Equip. Leasing Corp. v. Sims (*In re* Sims), 994 F.2d 210, 218 n.11 (5th Cir. 1993) (stating not necessary to determine one of two state standards for piercing or "federal common law" standard applies since standards comparable given issues in case). *Compare, e.g.*, Gough v. Titus (*In re* Christian & Porter Aluminum Co.), 584 F.2d 326, 337 (9th Cir. 1978) (state law controls), *with, e.g., In re* Pittsburgh Rys., 155 F.2d 477, 483 (3d Cir. 1946) (holding federal standard applies).Back To Text

[95] *See, e.g., Vitek Supply*, 151 F.3d at 585 (stating insiders "cannot escape . . . obligations . . . by playing a shell game with assets"; transfers to owner, lawyers and affiliated companies); Benson v. Richardson, 537

N.W.2d 748, 761 (Iowa 1995) (cannot use corporation as conduit for fraudulently transferring assets from one spouse to another); Berlin v. Boedecker, 887 P.2d 1180, 1189 (Mont. 1994) (owners' transfer of corporate assets to themselves for no consideration was evidence that owners were alter egos); *see also Bestfoods*, 118 S. Ct. at 1885 (corporate veil may be pierced to hold shareholder liable for corporation's acts when corporate form would otherwise be "misused to accomplish certain wrongful purposes, most notably fraud, on the shareholder's behalf").Back To Text

[96] *See, e.g.*, Carte Blanche (Singapore) Pte., Ltd. v. Diners Club Int'l, Inc., 2 F.3d 24, 26 (2d Cir. 1993) (noting that although New York "reluctant to pierce corporate veils," exceptions include "to prevent fraud"); Easterbrook & Fischel, *supra* note 93, at 112 (stating fraud or misrepresentation should be required to pierce when plaintiff is contract creditor). Back To Text

[97] *See* Packer v. TDI Sys., Inc., 959 F. Supp. 192, 201−02 (S.D.N.Y. 1997) (stating "inadequate capitalization" relevant to piercing determination); State v. McKinney, 508 N.E.2d 1319, 1321 (Ind. Ct. App. 1987) (stating that "the entire initial capitalization of the corporation came from items he transferred to it: 'a typewriter, couple of desks, and a copy machine, files, storage cabinets, that's about it.'"); Gevurtz, *supra* note 92, at 886−87 (stating that proof of inadequate capitalization may prove that defendant's self−dealing was abusive); Hackney & Benson, *supra* note 90, at 854−60 (discussing judicial reliance upon inadequate capital as grounds for imposition of shareholder liability); Thompson, *supra* note 91, at 1063 tbl.11 (showing that where undercapitalization was factor, veil was pierced more than 73% of time).Back To Text

[98] *See* Geyer v. Ingersoll Publications Co., 621 A.2d 784, 787 (Del. Ch. 1992) (declaring that upon insolvency directors owe fiduciary duties to creditors); Hackney & Benson, *supra* note 90, at 850−51 ("spoilation, mismanagement and faithless stewardship," "stripping corporation of assets"); Stephen R. McDonnell, Comment, *Geyer v. Ingersoll Publications Co.: Insolvency Shifts Directors' Burden From Shareholders to Creditors*, 19 Del. J. Corp. L. 177, 191−92 (1994) (stating that corporate insolvency gives rise to fiduciary duty to creditors). In addition, a minority of courts continue to recognize the "trust fund doctrine" which holds that corporation's "'assets constitute a trust fund for the benefit of its stockholders and creditors. . . . '" American Nat'l Bank of Austin v. MortgageAmerica Corp. (*In re* MortgageAmerica Corp.), 714 F.2d 1266, 1270 (5th Cir. 1983). The doctrine allows creditors to sue for waste of corporate assets. *See id.* at 1270−72.Back To Text

[99] *See Carte Blanche*, 2 F.3d at 28 (noting that all of debtor's revenues were put into affiliates' account); K.C. Roofing Ctr. v. On Top Roofing, Inc., 807 S.W.2d 545, 547 (Mo. Ct. App. 1991) (no annual meeting, insufficient number of directors); Oesterle, *supra* note 92, at 920, n.86 (noting no case found where corporate "entity has been disregarded when corporate formalities have been respected"); Hackney & Benson, *supra* note 90, at 851 (stating that failure to maintain records or comply with formalities is basis for piercing corporate veil); Thompson, *supra* note 91, at 1063 tbl.11.

Failure to follow corporate law formalities might also be an independent basis for holding shareholders liable. *See, e.g.*, Minich v. Gem State Developers, Inc., 591 P.2d 1078,1082 (Idaho 1979) (failure to file articles of incorporation); Truces Oil Co. v. Keeney, 455 P.2d 954 (Wash. 1969); Mountain States Supply, Inc. v. Mountain States Feed & Livestock Co., 425 P.2d 75, 77 (Mont. 1967) (failure to file annual report); *see also* Henn & Alexander, *supra* note 45, §§ 138−45, at 326−44 (discussing defective incorporation and potential liability of individuals who attempt to form corporation).Back To Text

[100] *See* Oesterle, *supra* note 92, at 920 n.86 (noting no case found where corporate "entity has been disregarded when corporate formalities have been respected").Back To Text

[101] *See* 11 U.S.C. § 547(b)(4)(B) (1994); Hargrave v. Boehmer (*In re* F.H.L), 91 B.R. 288, 294 (Bankr. D. N.J. 1988) ("However, the presumption of insolvency [under § 547(f)] applies only during the ninety days immediately preceding the date of the filing of the petition.").Back To Text

[102] *See* Pepper v. Litton, 308 U.S. 295, 303−310 (1939) (discussing claims of insiders); Summit Coffee Co. v. Herby's Foods, Inc. (*In re* Herby's Foods, Inc.), 2 F.3d 128, 131 (5th Cir. 1993) (stating less egregious conduct needed to subordinate when claimant is insider); Fabricators, Inc. v. Technical Fabricators, Inc. (*In re* Fabricators, Inc.), 926 F.2d 1458, 1465−66 (5th Cir. 1991) (stating that claims between debtor and insider "rigorously scrutinized"; standard of scrutiny higher for insiders); Wilson v. Huffman (*In re* Missionary Baptist Found. of Am.), 818 F.2d 1135, 1145−47 n.5 (5th Cir. 1987). *See, e.g.*, *In re* Lifschultz Fast Freight, 132 F.3d 339, 343−44 (7th Cir. 1997) ("Equitable subordination typically involves closely−held corporations and their insiders."); Official Comm. of Unsecured Creditors v. Cajun Elec. Power Coop., Inc. (*In re* Cajun Elec. Power Coop., Inc.), 119 F.3d 349, 357 (5th Cir. 1997) (same); Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351, 1356 (7th Cir. 1990) (same).Back To Text

[103] *See Pepper*, 308 U.S. at 304−05 (stating that equitable powers of bankruptcy courts invoked "to the end that fraud will not prevail"); *id*. at 312 (observing that it is proper to exercise equitable powers and subordinate secured claim of insider to all creditors' claims when insider's actions taken pursuant to "'planned and fraudulent scheme'"); *Fabricators*, 926 F.2d at 1465 (stating that fraud may be basis for equitable subordination even as to one who is not insider); *Missionary Baptist Found.*, 818 F.2d at 1142 (stating that fraud is sufficient ground for equitable subordination). Back To Text

[104] *See* Hackney & Benson, *supra* note 90, at 882. Back To Text

[105] *See supra* note 90 and accompanying text.Back To Text

[106] *See infra* notes 116−20 and accompanying text.Back To Text

[107] *See Pepper*, 308 U.S. at 309−10 (when "so−called loans" are subordinated they are "treated in effect as capital contributions"); *Fabricators*, 926 F.2d at 1469; *see also* Hackney & Benson, *supra* note 90, at 879−83. Whereas "piercing the corporate veil" in effect converts

> an investor into a guarantor, ... [t]he doctrine of equitable subordination, . . . operates on the assumption that the amount loaned by the shareholder is roughly equal to the amount of the capital inadequacy, and yields a result which in effect requires the shareholder to make such amount available for other creditors . . . .

Id. at 888. The quotation refers to piercing the corporate veil and subordination because of undercapitalization. However, the ultimate effect on insider and creditor alike is the same when fraud or other inequitable conduct is found.Back To Text

[108] *See Lifschultz Fast Freight*, 132 F.3d at 344 ("court will strip her of her debt claim and recharacterize it as what it truly is — equity").Back To Text

[109] *See, e.g.*, *Fabricators*, 926 F.2d at 1469 (declaring that insider loan to undercapitalized corporation is factor in favor of recasting "loans as contributions to capital"); Hackney & Benson, *supra* note 90, at 883−90 (discussing undercapitalization as sole factor in piercing and subordination). However, undercapitalization alone is generally not viewed as a sufficient ground for equitable subordination. *See Lifschultz Fast Freight*, 132 F.3d at 349 (stating that undercapitalization alone insufficient without other inequitable conduct; "extraordinary circumstances" possible exception); *Herby's Foods*, 2 F.3d at 131−33 (stating that subordination requires undercapitalization plus other inequitable insider actions).Back To Text

[110] Most courts are guided by the analysis in *Benjamin v. Diamond* (*In re Mobile Steel Co.*), 563 F.2d 692 (5th Cir. 1977). *See Lifschultz Fast Freight*, 132 F.3d at 344 (characterizing *Mobile Steel* as "magisterial" and "most influential"); First Nat'l Bank of Barnesville v. Rafoth (*In re* Baker & Getty Fin. Servs., Inc.), 974 F.2d 712, 717−18 (6th Cir. 1992). *See generally Fabricators*, 926 F.2d at 1464−67 (discussing *Mobile* test).Back To Text

[111] *See Lifschultz Fast Freight*, 132 F.3d at 344; *Cajun Elec. Power Coop.*, 119 F.3d at 357; EEE Comm. Corp. v. Holmes (*In re* ASI Reactivation, Inc.), 934 F.2d 1315, 1321 (4th Cir. 1991) (listing "fraudulent conduct" in place of more traditional "inequitable conduct"); *Mobile Steel*, 563 F.2d at 699−700; *accord* Stoumbos v. Kilimnik, 988 F.2d 949, 958 (9th Cir. 1993); Andres DeNatale & Prudence B. Abram, *The Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors*, 40 Bus. Law. 417, 423 (1985). Courts have equitably subordinated claims without requiring inequitable conduct on the part of the creditor. *See In re* Envirodyne Indus. Inc., 79 F.3d 579, 581−584 (7th Cir. 1996); *see also supra* notes 85−89 and accompanying text (notes given to shareholders to redeem shares subordinated to creditors' claims). Back To Text

[112] *See, e.g.*, *Herby's Foods*, 2 F.3d at 131, 134 (stating inequitable conduct includes "fraud, illegality, breach of fiduciary duties"; insiders' secured claims relegated to equity where debtor undercapitalized and insiders' "deceptive practices" concealed debtor's financial condition); *ASI Reactivation*, 934 F.2d at 1321 (denying subordination because insider's conduct not shown to be "fraudulent").Back To Text

[113] *Cajun Elec. Power Coop.*, 119 F.3d at 357; United States Abatement Corp. v. Mobil Exploration & Producing U.S., Inc. (*In re* United States Abatement Corp.), 39 F.3d 556, 561 (5th Cir. 1994). The other two causes are when fiduciaries misuse position to the disadvantage of creditors and when parties control debtors to the prejudice of creditors. *Id*.

Although the inequitable conduct often relates to the claim asserted by the insider, it need not do so. *See Herby's Foods*, 2 F.3d at 131 (stating inequitable conduct by claimant may be sufficient to warrant subordination whether or not misconduct related to acquisition or assertion of claim); *Mobile Steel*, 563 F.2d at 700−01 (stating improper acts unconnected with acquisition or assertion of particular claim frequently formed at least part of basis for subordination); Bostian v. Schapiro (*In re* Kansas City Journal−Post Co.), 144 F.2d 791, 803−04 (8th Cir. 1944). Thus an insider who was involved in the debtor's fraudulent transfer — as an officer or transferee — might nonetheless have an unrelated claim subordinated for such fraudulent conduct. Back To Text

[114] *See* 11 U.S.C. § 548 (1994).Back To Text

[115] *See id.* § 523(a)(2), (4); § 727(a)(2), (3), (5).Back To Text

[116] *See* Pepper v. Litton, 308 U.S. 295, 309−10 (1939) (explaining that effect of subordination is transformation of insider's debt to capital contribution); *Lifschultz Fast Freight*, 132 F.3d at 344 (stating that creditor loses debt claim and debt treated like equity); *Fabricators*, 926 F.2d at 1469 (same). Back To Text

[117] *See* Wilson v. Huffman *(In re* Missionary Baptist Found. of Am.), 818 F.2d 1135, 1147−48 (5th Cir. 1987) (discussing creditor's attempt to quantify precisely amount of harm); *Mobile Steel*, 563 F.2d at 701 (noting subordination should only be to extent necessary to offset harm). *But see* Clark, *supra* note 31, at 518−25 (stating that partial subordination is uncommon).Back To Text

[118] *See* Stoumbos v. Kilimnik, 988 F.2d 949, 960−61 (9th Cir. 1993) (stating claim subordinated only to claims of creditors disadvantaged by inequitable conduct).Back To Text

[119] *See* DeNatale & Abram, *supra* note 111, at 427 (stating where injury difficult to quantify, court may subordinate entire claim).Back To Text

[120] *Compare Pepper*, 308 U.S. at 311−13 (holding judgment lien for dubious salary claims subordinated to all creditors' claims) *and* Summit Coffee Co. v. Herby's Foods, Inc. (*In re* Herby's Foods, Inc.), 2 F.3d 128, 131, 134 (5th Cir. 1993) (holding that, because security interests given to insiders while debtor was undercapitalized and loan records irregular, appropriate to subordinate to all creditors' claims) *with Fabricators*, 926 F.2d at 1470 (considering both that creditor unfairly obtained security for loan and that some aspects of creditor's conduct also "positive," therefore proper to subordinate secured claim to status of

unsecured claim). Back To Text

[121] This discussion assumes that the transfers occur prior to bankruptcy. Different policy issues arise when creditors attempt to impose successor liability on an entity that purchases a debtor's assets at a bankruptcy sale. *See* Chicago Truck Drivers, Helpers & Warehouse Workers Union (Independent) Pension Fund v. Tasemkin, Inc., 59 F.3d 48, 50 (7th Cir. 1995) (stating fear that successor liability would "chill" sales in bankruptcy and harm debtors' creditors); Hon. William T. Bodoh & Michelle M. Morgan, *Inequality Among Creditors: The Unconstitutional Use of Successor Liability to Create a New Class of Priority Claimants*, 4 Am. Bankr. Inst. L. Rev. 325 (1996); Michael H. Reed, *Successor Liability and Bankruptcy* Sales, 51 Bus. Law. 653 (1996).Back To Text

[122] *See Stoumbos*, 988 F.2d at 963−64 (holding that transfer of old corporation's good will to new corporation was fraudulent); 15 Stephen M. Flanagan et al., Fletcher Cyclopedia of the Law of Private Corporations, § 7122, at 232 (1990); § 7125, at 297 (discussing fraudulent transfer of assets from old corporation to successor); *supra* notes 29−30. Back To Text

[123] *Chicago Truck Drivers*, 59 F.3d at 49.Back To Text

[124] *See* Howard Johnson Co. v. Detroit Local Joint Executive Bd., 417 U.S. 249, 256 (1974) (referring to "the difficulty of the successorship question" and "absence of congressional guidance as to its resolution"); Atchison, Topeka & Santa Fe Ry. v. Brown & Bryant, Inc., 1997 WL 1047644, at *7 n.5 (9th Cir. Dec. 30, 1997) (noting "conflicts and uncertainties" in federal decisions in attempts to fashion a federal law of successor liability); Steinbach v. Hubbard, 51 F.3d 843, 846 (9th Cir. 1995) (noting differences in approaches to resolving successor liability issues); Nathan F. Coco, Note, *An Examination of Successor Liability in the Post−Bankruptcy Context*, 22 J. Corp. L. 345, 347 (1997) (no "common framework with which to analyze" successor liability issues); *see also* 15 Flanagan et al., *supra* note 122, § 7122, at 231−32 (citations omitted) ("Before a decision can be made as to liability, the many facts and policy factors must be weighed in the balance, and the policy protecting corporate creditors must be weighed against the equally important policy respecting separate corporate entities.").Back To Text

[125] *See Chicago Truck Drivers*, 59 F.3d at 49 (observing that when "federal rights" or "federal policies" involved, federal common law of successor liability is "broader still" than state law); *Steinbach*, 51 F.3d at 845 (listing various federal employment law policies); City Management Corp. v. U.S. Chemical Co., 43 F.3d 244, 251−52 (6th Cir. 1994) (discussing Michigan product liability law and federal environmental law); 15 Flanagan et al., *supra* note 122, § 7122.40, at 259 (collective bargaining agreements), *id.* § 7123, at 262 (torts); *id.* § 7122, at 233 & supp. at 43. Doubt exists about when a recently fashioned federal law of successor liability should apply. *See Atchison*, 1997 WL 1047644, at *3 (concluding that recent Supreme Court decisions indicate that state law is appropriately applied under CERCLA).Back To Text

[126] The other grounds are that "(1) . . . the purchasing corporation expressly or impliedly agrees to assume the selling corporation's liabilities; (2) . . . the transaction amounts to a consolidation or merger of the two corporations; [and] (3) . . . the purchasing corporation is a mere continuation of the selling corporation . . . ." *City Management*, 43 F.3d at 251; *Atchison*, 1997 WL 1047644, at *2; *accord Chicago Truck Drivers*, 59 F.3d at 49; Nachazel v. Mira Co., 466 N.W.2d 248, 254 (Iowa 1991); 15 Flanagan et al., *supra* note 122, § 7122, at 232; Coco, *supra* note 124, at 347−48 (discussing four grounds in which asset purchasing corporation may be liable for claims against its predecessor). Back To Text

[127] *City Management*, 43 F.3d at 251. *See* Raytech Corp. v. White, 54 F.3d 187, 192 n.6 (3d Cir. 1994) (stating general rule of successor liability that purchasing corporation does not assume debts and liability of selling corporation except in situation where four grounds for liability apply, including fraudulent purpose for evading liability); *Stoumbos*, 988 F.2d at 961 (concluding that bankruptcy court should have considered successor liability in situation where purchase of corporation involved theory of fraud); *Nachazel*, 466 N.W.2d at 254 (concluding successor corporation did not meet the four independent requirements necessary to impose personal liability); 15 Flanagan et al., *supra* note 122, § 7122, at 231 (listing four exceptions to rule

that transferee corporation not liable for transferor's debts); *see also* Ed Peters Jewelry Co. v. C&J Jewelry Co., 124 F.3d 252, 266 (1st Cir. 1997) (determining fraud requirement involves transfer of assets with fraudulent intent).Back To Text

[128] *Raytech*, 54 F.3d at 192.Back To Text

[129] *See id*. at 192−93 (discussing imposition of liability when debtor had significant liabilities and transferred only profit−generating assets to successor); Eagle Pac. Ins. Co. v. Christensen Motor Yacht Corp., 959 P.2d 1052 (Wash. 1998) (holding successor liable where transfer of assets and business operations stripped transferor of source of income).Back To Text

[130] *See Chicago Truck Drivers*, 59 F.3d at 51 (stating that sale of debtor's assets had effect of "frustrating unsecured creditors while resurrecting virtually the identical enterprise"); *Raytech*, 54 F.3d at 193 ("transferring assets for the purpose . . . of escaping liability" is a fraudulent purpose); Schmoll v. Acands, Inc., 703 F. Supp. 868, 873 (D. Or. 1988) (stating that tort claimants "left with little"); *Eagle Pac. Ins.*, 959 P.2d at 1060 (finding assets were transferred "to avoid the reach of creditors"); *see also Nachazel*, 466 N.W.2d at 254−55 (finding case not appropriate for imposition of successor liability, but equitable lien imposed upon assets transferred "without making adequate provision for the payment of . . . unsecured debts").Back To Text

[131] *See Stoumbos*, 988 F.2d at 962, 963 (noting need to value good will, including employee base, customer relations, other intangible assets); Budd Tire Corp. v. Pierce Tire Co., 370 S.E.2d 267, 270 (N.C. 1988) (affirming finding that successor paid inadequate consideration for assets, including good will, of transferor**;** 15 Flanagan et al., *supra* note 122, § 7122, at 232 (observing that, if goodwill is transferred without adequate consideration, creditors have claim against successor for its value). In *Schmoll v. Acands, Inc.*, 703 F. Supp. 868, a debtor's profitable businesses were transferred to a new corporation for cash, stock and notes. The court did not compare the value of the assets transferred with this consideration. The court nonetheless imposed successor liability upon the new corporation because "creditors will no longer have access to [the transferred] valuable assets or to the potential stream of profits generated by these assets." *Id.* at 873. Although this reasoning was endorsed in a related case, *Raytech*, a better approach would have been to compare the consideration received to the value of the transferred assets, including their income producing potential. *Cf. Raytech*, 54 F.3d at 195 (court might have compared these values but did not do so).Back To Text

[132] *See* Atchison, Topeka & Santa Fe Ry. v. Brown & Bryant, Inc., 1997 WL 1047644, at *7 (9th Cir. Dec. 30, 1997) (affirming refusal to impose successor liability where debtor's assets were insufficient to pay debts before sale and where buyer "paid the appraised value" for items purchased); *Ed Peters Jewelry*, 124 F.3d at 270 (discussing that valuable consideration is considered adequate if two "corporate entities" negotiate at arms length and if creditors can continue to look to divesting corporation for satisfaction of claims); 15 Flanagan et al., *supra* note 122, § 7125, at 297 (asserting that if transfer of assets to successor is for full consideration and in good faith, successor liability will not be imposed).Back To Text

[133] *See Ed Peters Jewelry*, 124 F.3d at 269−70 (stating that "inadequate consideration" is appropriate basis for inference that "transferor harbored a fraudulent intent to evade its obligations to creditors" and is relevant to mere continuation theory of successor liability); *see also Stoumbos*, 988 F.2d at 962 (holding that sufficiency of consideration is relevant to continuation theory of successor liability); 15 Flanagan et al., *supra* note 122, § 7125, at 297 (noting relevance of consideration).Back To Text

[134] *See Raytech*, 54 F.3d at 192, 195 (having found general fraudulent intent to escape liability to creditors, no need to compare values of consideration exchanged); *Stoumbos*, 988 F.2d at 962 (stating that if fraud to creditors theory established by other evidence, no need to "decide extent and adequacy of the consideration"); *Eagle Pac.*, 959 P.2d at 1056−58 (bad faith transfer with intent to avoid creditors' claims is fraudulent and successor liability is proper without showing of inadequate consideration). Back To Text

[135] *See Chicago Truck Drivers*, 59 F.3d at 50−51 (discussing how imposition of successor liability might "chill" sales of corporation in bankruptcy and discourage market growth); Steinbach v. Hubbard, 51 F.3d 843, 846−47 (9th Cir. 1995) (noting that imposition of successor liability makes it more difficult for distressed companies to find buyer of assets); Musiki v. Essi, Inc., 760 F.2d 740, 750 (7th Cir. 1985) (determining that imposing liability upon successor corporation would severely inhibit sale of assets by failing businesses).Back To Text

[136] *See* NLRB v. Burns Int'l Sec. Servs., Inc., 406 U.S. 272, 287−88 (1972) (recognizing strong interest in free transferability of assets by failing companies is general consideration weighing against successor liability); *Chicago Truck Drivers*, 59 F.3d at 50−51 (discussing pros and cons of policies affecting imposition of successor liability); *Steinbach*, 51 F.3d at 846−47 (possible adverse effect of imposition of successor liability "does provide reason to consider" issue "in a different light"); *see also* J. Maxwell Tucker, *The Clash of Successor Liability Principle, Reorganization Law, and the Just Demand that Relief Be Afforded Unknown and Unknowable Claimants*, 12 Bankr. Dev. J. 1, 15 (1995) (discussing imposition of successor liability upon buyers and consequences creditors will have to face).Back To Text

[137] *See* 11 U.S.C. § 727(a)(1) (1994) (no discharge if debtor not individual), § 1141(d)(3) (providing that liquidating corporations subject to § 727(a)).Back To Text

[138] *See* 11 U.S.C. § 1141(d)(1) (providing discharge without reference to §§ 523, 727). If a corporation has engaged in fraudulent conduct, that might be grounds for denying confirmation for the lack of good faith under 11 U.S.C. § 1129(a)(3). *See In re* Schwarb, 150 B.R. 470, 473 (Bankr. M.D. Fla. 1992) (stating that chapters 11, 12 and 13 are not liquidation cases but still provide relief from pre−bankruptcy fraud through their good faith requirements for reorganization plans); Frederick County Nat'l Bank v. Lazerow (*In re* Lazerow), 119 B.R. 74, 77 (Bankr. D. Md. 1990) (noting if "legal fraud" will arise due to debtor's conduct, then creditor can raise good faith as ground for denying confirmation of plan and ultimately discharge); *In re* Wiggles, 7 B.R. 373, 380 (Bankr. N.D. Ga. 1980) (stating that good faith requires "honesty of purpose," "full disclosure of relevant facts"). Back To Text

[139] *See* 11 U.S.C. § 1107.Back To Text

[140] *See* 11 U.S.C. §§ 547, 548, 549, 550 (delineating voiding powers).Back To Text

[141] 11 U.S.C. § 544(b). Because property recovered is property of the estate, the automatic stay prevents creditors from pursuing their own fraudulent conveyance actions against transferees. *See* 11 U.S.C. § 541(a)(3); § 550(a); § 362(a)(3); § 362(a)(6); Flip Mortgage Corp. v. McElhone, 841 F.2d 531 (4th Cir. 1988); American Nat'l Bank of Austin v. MortgageAmerica Corp. (*In re* MortgageAmerica Corp.), 714 F.2d 1266 (5th Cir. 1983).Back To Text

[142] *See* 11 U.S.C. § 544(b).Back To Text

[143] *See supra* note 90 and accompanying text.Back To Text

[144] Thomas v. Peacock, 39 F.3d 493, 499 (4th Cir. 1994) (explaining that piercing corporate veil is not merely procedural rule but is substantive rule of liability). *See* Craig v. Lake Asbestos of Quebec, Ltd., 843 F.2d 145, 149 (3d Cir. 1988) (finding that federal court sitting in diversity must apply New Jersey substantive rule regarding piercing corporate veil).Back To Text

[145] *See Thomas*, 39 F.3d at 499 (asserting that attempt to pierce corporate veil is not in itself cause of action); 1 Flanagan et al., *supra* note 122, § 41, at 603 (stating that piercing corporate veil is not action itself but liability exists through underlying claim).Back To Text

[146] *See* Spartan Tube & Steel, Inc. v. Himmelspach (*In re* RCS Engineered Prods. Co.), 102 F.3d 223, 225−26 (6th Cir. 1996) (stating that under Michigan law, piercing corporate veil action is property of estate);

Steinberg v. Buczynski, 40 F.3d 890, 892 (7th Cir. 1994) (authorizing trustee to pursue piercing corporate veil action only for debtor−corporation's estate); Kalb, Voorhis & Co. v. American Fin. Corp., 8 F.3d 130, 132 (2d Cir. 1993) (asserting that piercing corporate veil action does not belong to creditor but is property of debtor's estate); Mixon v. Anderson (*In re* Ozark Restaurant Equip. Co.), 816 F.2d 1222, 1224 (8th Cir. 1987) (deciding that under 11 U.S.C. § 541 piercing corporate veil action belongs to debtor as property of estate and not to creditor).Back To Text

[147] *See RCS Engineered Prods.*, 102 F.3d at 226 (Michigan law states that creditor has no standing to sue on piercing corporate veil action); *Kalb, Voorhis*, 8 F.3d at 133 (applying Texas law and concluding creditor lacks standing to sue on piercing corporate veil action); Steyr−Daimler−Puch of Am. Corp. v. Pappas, 852 F.2d 132, 136 (4th Cir. 1988) (concluding that under Virginia law claim for piercing corporate veil is property of estate); Koch Refining v. Farmers Union Cent. Exch., Inc., 831 F.2d 1339, 1344−45 (7th Cir. 1987) (determining that state law where cause of action is asserted will determine whether piercing corporate veil action is property of debtor or not). Back To Text

[148] *See* American Bankers Ins. Co. of Fla. v. Maness, 101 F.3d 358, 362−63 (4th Cir. 1996) (stating that in absence of any federal controlling law, state law governs interest in estate); *Thomas*, 39 F.3d at 503−04 (finding that federal court will pierce corporate veil and apply federal law where corporation attempts to circumvent federal statute regarding ERISA liability); *Piercing Veil*, *supra* note 94, at 855−858 (recognizing that states have different laws regarding piercing corporate veil); *see also* United States v. Bestfoods, 118 S. Ct. 1876, 1885 n.9 (1998) (explaining divergence of opinion among authorities as to whether federal or state "piercing" law should apply to corporate polluters under CERCLA); Subway Equip. Leasing Corp. v. Sims (*In re* Sims), 994 F.2d 210, 218 n.11 (noting that federal standard "substantially identical" to some state laws).Back To Text

[149] *See Kalb, Voorhis*, 8 F.3d at 132 (Texas law) (finding that piercing corporate veil action under Texas law is exclusive right of trustee or debtor−in−possession); *Koch Refining*, 831 F.2d at 1345−46 (Illinois and Indiana law) (concluding that under Illinois and Indiana law, trustee can represent either debtor or creditor in piercing corporate veil action); Moore v. Kumer (*In re* Adam Furniture Indus., Inc.) 191 B.R. 249, 253−55 (Bankr. S.D. Ga. 1996) (Georgia Law) (finding state law inconclusive but holding trustee may pursue action for estate).Back To Text

[150] *See Mixon*, 816 F.2d at 1225 (Arkansas law) (concluding that under Arkansas law, right to pierce corporate veil claim belongs to creditors, not debtor, and trustee therefore may not pursue piercing action); *RCS Engineered Prods.*, 102 F.3d at 226 (Michigan law) (finding that, under Michigan law regarding piercing corporate veil, because subsidiary debtor may not bring claim against parent, claim does not belong to trustee); Morrow v. Kelson (*In re* Morgan−Staley Lumber Co.), 70 B.R. 186, 188 (Bankr. D. Or. 1986) (Oregon law) (stating that under Oregon law, piercing corporate veil action belongs to creditors and trustee has no right to pursue action).Back To Text

[151] *See Koch Refining*, 831 F.2d at 1342 (Illinois and Indiana law) (characterizing trustee as representative not only of debtor "but also [of] the interests of creditors"); *In re* Kaiser, 791 F.2d 73, 76 (7th Cir. 1986) (holding that creditors could have pierced corporate veil under misrepresentation theory and "trustee stands in their shoes").Back To Text

[152] *See* E.F. Hutton & Co. v. Hadley, 901 F.2d 979, 985−87 (11th Cir. 1990) (recognizing divergence of views on issue and ruling that trustee is not authorized statutorily to represent creditors); Steyr−Daimler−Puch of Am. Corp. v. Pappas, 852 F.2d 132, 135 (4th Cir. 1988) (listing cases where courts have concluded that § 544 did not grant trustee right to assert creditor claims); *Mixon*, 816 F.2d at 1226−30 (declining to recognize trustee's right to pursue piercing of corporate veil action on behalf of creditors under § 544 until legislative action expands trustee's rights).Back To Text

[153] *See* John D. Wilmore, Note, *The Bankruptcy Trustee: Can an Alter Ego Sue in Alter Ego?*, 65 S. Cal. L. Rev. 705, 727 (1991) (discussing why § 544(b) is "probably inapplicable" in the alter ego context).Back To

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[154] 11 U.S.C. § 544(b) (1994).Back To Text

[155] 406 U.S. 416 (1972).Back To Text

[156] *See* Mediators, Inc. v. Manney (*In re* Mediators, Inc.), 105 F.3d 822, 826 (2d Cir. 1997) (treating creditors committee as if it were trustee for purpose of determining standing and finding committee lacked standing to assert claims against third parties properly belonging solely to individual creditors); Hirsch v. Arthur Andersen & Co., 72 F.3d 1085, 1094 (2d Cir. 1995) (holding trustee lacked standing to bring malpractice claims against third party accounting firm for allegedly assisting debtor's defrauding of investors); Shearson Lehman Hutton, Inc. v. Wagoner, 944 F.2d 114, 119−20 (2d Cir. 1991) (holding trustee lacked standing to bring claim on behalf of creditors against third party broker for allegedly defrauding debtor corporation with cooperation of debtor's management); *E.F. Hutton*, 901 F.2d at 987 (holding trustee lacked standing to bring tort action on behalf of creditors against third party brokerage firm); Lippe v. Bairnco Corp., 218 B.R. 294, 301 (S.D.N.Y. 1998) (dismissing trustee's claim against third party where claim belonged solely to creditors).Back To Text

[157] *Caplin*, 406 U.S. at 422.Back To Text

[158] *Id*. at 428. *See E.F. Hutton*, 901 F.2d at 986−87 (relying on *Caplin* to deny trustee standing to assert claims of estate creditors).Back To Text

[159] *See supra* notes 153−54 and accompanying text.Back To Text

[160] *Caplin*, 406 U.S. at 430 (quoting from opinion of Court of Appeals) Back To Text

[161] *Id*. at 434.Back To Text

[162] *See id*. at 432 (observing that suit by debenture holders are likely because, *inter alia*, trustee and all debenture holders might not agree upon theory on which to sue or on amount of damages).Back To Text

[163] *Id*. at 422.Back To Text

[164] *Id*. at 434−35.Back To Text

[165] 2 Report of the Commission on the Bankruptcy Laws of the United States, at 160 (1973) (verified by and on file with author).Back To Text

[166] *See* Bryan Hull, *A Void in Avoidance Powers? The Bankruptcy Trustee's Inability to Assert Damages Claims on Behalf of Creditors Against Third Parties*, 46 U. Miami L. Rev. 263, 274−75 (1991) (stating that trustees' actions on behalf of creditors would be binding on creditors and, therefore, creditors would be barred from asserting individual claims against third parties).Back To Text

[167] *See* H.R. 8200, 95th Cong., §§ 416−17 (1977) (containing proposed § 544(c) allowing trustee limited right to enforce any claim that creditor has against any person); *see also* Mixon v. Anderson (*In re* Ozark Restaurant Equip. Co.), 816 F.2d 1222, 1227−29 (8th Cir. 1987) (observing that § 544(c), as originally proposed by House, was intended to overrule *Caplin*); Rodolakis v. Shadduck (*In re* Shadduck), 208 B.R. 1, 3−5 (Bankr. D. Mass. 1997) (observing that § 544(c) would have expressly given trustee limited right to assert creditors' claims); Hull, *supra* note 166, at 273−309 (examining whether proposed § 544(c) provides more satisfactory balance of bankruptcy policies than *Caplin* rule forbidding trustee from asserting creditors' claims against third parties).Back To Text

[168] *See* 124 Cong. Rec. H11097 (Sept. 28, 1978) (stating simply, "The House deletes Section 544(c) of the House Bill."); *see also Mixon*, 816 F.2d at 1228 n.10 (citing Congressional Record about deletion of proposed § 544(c)); Hull, *supra* note 166, at 275 (observing that when House and Senate conferenced to finalize new Bankruptcy Code, proposed § 544(c) was omitted without explanation).Back To Text

[169] E−mail communication to author from Commission Reporter, Prof. Elizabeth Warren.Back To Text

[170] *See* H.R. Rep. No. 95−595, at 179−80 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6139−40 (stating that proposed § 544(c) permits trustee to benefit estate by enforcing causes of action against dishonest indenture trustees or corporate directors who often escape liability under current law); Hull, *supra* note 166, at 266 (stating that trustee's successful assertion of creditors claim against third party would result in significant increase in available assets to pay creditors, orderly and efficient administration of claims through their consolidation, and greater probability of asset maximization); Stephen E. Boyce, *Koch Refining and In Re Ozark: The Chapter 7 Trustee's Standing to Assert an Alter Ego Cause of Action*, 64 Am. Bankr. L.J. 315, 318 (1990) (stating that granting trustee standing obviates multiple lawsuits brought by individual creditor, eliminates race to courthouse, and results in balancing of equities and interests of all affected parties); Wilmore, *supra* note 153, at 713 (stating that allowing trustee to pursue general creditor actions would serve goal of fair and efficient settling of bankrupt's estate). Back To Text

[171] *See* Hull, *supra* note 166, at 278−82, 296−304 (raising problem of equitable distribution of proceeds among creditors after trustee's successful assertion of creditors' claims against third party); Wilmore, *supra* note 153, at 712−713 (stating that *Caplin* Court was concerned about conflict between trustee and individual creditors over how to pursue suit).Back To Text

[172] *See* Henn & Alexander, *supra* note 90, § 146, at 348−49 (stating shareholders may be held liable if corporation disregarded); § 148, at 356 (stating that if debtor− corporation's veil pierced, owner is treated as principal and debtor as its agent); *see also* United States v. Bestfoods, 118 S. Ct. 1876, 1885 (1998) (discussing ability to reach stockholders by way of piercing corporate veil); United States v. Sutton, 795 F.2d 1040, 1060 (Temp. Emer. Ct. App. 1986) (discussing liability of shareholders, once corporate veil is pierced); Econ Marketing, Inc. v. Leisure Am. Resorts, Inc., 664 So.2d 869, 871 (Ala. 1995) (stating personal liability imposed upon piercing corporate veil); Berlin v. Boedecker, 887 P.2d 1180, 1188 (Mont. 1994) (holding 97% shareholder and corporation jointly and severally liable). Usually, to be held liable, an insider must himself have acted in a manner that justifies disregard as to him; passive investors who did not engage in the objectionable conduct are not necessarily subject to liability. *See* Hackney & Benson, *supra* note 90, at 876−78 (discussing imposition of personal liability upon investors past corporate veil piercing).Back To Text

[173] Boyce, *supra* note 170, at 325, n.68.Back To Text

[174] This rationale supports the argument that "the alter ego's assets are either section 541 property or money owed to the estate." *Id.* at 325, n.69.Back To Text

[175] *See* Kalb, Voorhis & Co. v. American Fin. Corp., 8 F.3d 130, 133 (2d Cir. 1993); Koch Refining v. Farmers Union Cent. Exch., Inc. 831 F.2d 1339, 1342 (7th Cir. 1987); Wilmore, *supra* note 153, at 713.Back To Text

[176] Hull, *supra* note 166, at 295 (surmising that sophisticated creditors are likely to fare better than smaller creditors if creditors are left to pursue their own actions). Back To Text

[177] *See* Wilmore, *supra* note 153, at 723−24 (analyzing alter ego actions as "unique" and concluding that *in pari delicto* is not present in such actions).Back To Text

[178] *Koch Refining*, 831 F.2d at 1342−43.Back To Text

[179] However, the substantive state law should be applied to determine whether the corporate veil should be pierced. Until there is a clear indication that a federal standard should apply generally in bankruptcy, state law should apply because it establishes the prerequisites for corporateness that guide shareholders and creditors in their pre−bankruptcy dealings. *See generally supra* note 147 (noting that state law generally applies in bankruptcy cases).Back To Text

[180] *See supra* note 90 and accompanying text.Back To Text

[181] *See* Canadian Pac. Forest Prods. Ltd. v. J.D. Irving, Ltd. (*In re* Gibson Group, Inc.), 66 F.3d 1436, 1442 (6th Cir. 1995) (discussing furtherance of bankruptcy policies of marshaling and preservation of assets).Back To Text

[182] *See* 11 U.S.C. § 1107 (1994).Back To Text

[183] *Id.* § 550(a).Back To Text

[184] *See id.* § 1103(c)(1), (2), (4).Back To Text

[185] *See id.* §§ 548, 550; Unif. Fraudulent Transfer Act §§ 4, 5, 7, 7A U.L.A. 652−53, 657, 660 (1985). Back To Text

[186] *See* 11 U.S.C. § 547.Back To Text

[187] *See* Flip Mortgage Corp. v. McElhone, 841 F.2d 531, 539 (4th Cir. 1988) (fraudulent conveyance); *In re* Xonics Photochemical, Inc., 841 F.2d 198, 202 (7th Cir. 1988) (fraudulent transfer); Moore v. Kumer (*In re* Adam Furniture Indus., Inc.) 191 B.R. 249, 253 (Bankr. S.D. Ga. 1996) (fraudulent conveyances, preferences, post−petition transfers).Back To Text

[188] *See* 11 U.S.C. § 362(a)(2), (3), (6); § 541(a)(3); American Nat'l Bank of Austin v. MortgageAmerica Corp. (*In re* MortgageAmerica Corp.), 714 F.2d 1266, 1275 (5th Cir. 1983) (stating that individual creditor fraudulent conveyance actions are stayed).Back To Text

[189] 11 U.S.C. § 704(1). *See* CFTC v. Weintraub, 471 U.S. 343, 352 (1985) (declaring that trustee has "duty to maximize the value of the estate"); *In re* Perkins, 902 F.2d 1254, 1257 (7th Cir. 1990) (noting sole authority to collect debtor's assets is entrusted to trustee).Back To Text

[190] *See* 11 U.S.C. § 541(a)(1), (3).Back To Text

[191] *See* 11 U.S.C. § 1107. *See Weintraub*, 471 U.S. at 355; Louisiana World Exposition v. Federal Ins. Co., 858 F.2d 233, 245−46, 249−50 (5th Cir. 1988); *see also* Canadian Pac. Forest Prods. Ltd. v. J.D. Irving, Ltd. (*In re* Gibson Group, Inc.), 66 F.3d 1436, 1442 (6th Cir. 1995) (although goals of chapters 7 and 11 differ so that "maximization of value" not necessarily goal of debtor−in−possession, failure to recover assets can be abuse of discretion).Back To Text

[192] This discussion is of the creditors' committee's derivative right to sue in place of the trustee or debtor−in−possession. Obviously, the creditors' action in this derivative capacity in not maintainable if the trustee would not have had the right to sue. An interesting case highlighting the distinction between this derivative right of creditors and their rights *qua* creditors is *Mediators, Inc. v. Manney (In re Mediators, Inc.)*, 105 F.3d 822, 824 (2d Cir. 1997) (holding that action against third parties is creditors, "in their own right," but not corporate right). Back To Text

[193] *See Perkins*, 902 F.2d at 1258 (listing colorable creditor cause of action as condition allowing creditors committee to divest trustee of prosecutorial authority); Official Comm. of Unsecured Creditors of Am.'s Hobby Ctr., Inc. v. Hudson United Bank (*In re* America's Hobby Ctr., Inc.), 223 B.R. 275, 282 (Bankr.

S.D.N.Y. 1998) (explaining that test is similar to when defendant moves to dismiss complaint for failure to state claim); Crowthers McCall Pattern, Inc. v. Lewis, 114 B.R. 407, 408 (S.D.N.Y. 1990) (noting that colorable claim is *sine qua non* to approval of action maintained by creditor committee).Back To Text

[194] *See Louisiana World Exposition*, 858 F.2d at 248−54 (discussing in detail why debtor−in−possession's conduct amounted to unjustified refusal); Tennessee Valley Steel Corp. v. B.T. Commercial Corp. (*In re* Tennessee Valley Steel Corp.), 183 B.R. 795, 800 (Bankr. E.D. Tenn. 1995) (listing debtor's unjustifiable refusal to pursue claim as qualification to committee standing); *see also* Peter C. Blain & Diane Harrison O'Gawa, *Creditors' Committees Under Chapter 11 of the United States Bankruptcy Code: Creation, Composition, Powers, and Duties*, 73 Marq. L. Rev. 581, 606 (1990) (stating that most instances of committee standing to sue involve unjust refusal to act by debtor−in−possession of trustee).Back To Text

[195] *Gibson Group*, 66 F.3d at 1438; *see In re* Valley Park, Inc., 217 B.R. 864, 868 (Bankr. D. Mont. 1998) (noting that creditors agreed to underwrite litigation costs unless their avoidance action successful); *see also Louisiana World*, 858 F.2d at 247, 253 (omitting explicit discussion of cost−benefit as condition, but noting that "claim . . . could have greatly increased the value of the estate"); *America's Hobby Ctr.*, 223 B.R. at 284−88 (analyzing costs of litigation and merits of claim; concluding that committee may pursue some, but not other, claims).Back To Text

[196] *See Louisiana World*, at 247; *Valley Park*, 217 B.R. at 866; *see also Gibson Group*, 66 F.3d at 1438 (noting court may permit single creditor to initiate action instead of debtor−in−possession if creditor performs list of requirements among which creditor alleges colorable claim that benefits estate based on cost−benefit analysis); Liberty Mut. Ins. Co. v. Official Unsecured Creditors' Comm. of Spaulding Composites Co. (*In re* Spaulding Composites Co.), 207 B.R. 899, 904−05 (B.A.P. 9th Cir. 1997) (finding that committee received "retroactive authorization" from court).Back To Text

[197] *See Louisiana World*, 858 F.2d at 252−53 (stating that debtor−in−possession's refusal to pursue cause of action against officers and directors for negligent mismanagement may have been "understandable given the grave conflict of interest," but finding that refusal was unjustified).Back To Text

[198] *See Gibson Group*, 66 F.3d at 1442−43 (stating that rebuttable presumption is raised if claim likely to benefit estate based on cost−benefit analysis); *Valley Park*, 217 B.R. at 866 (noting creditor meets burden by proving first three requirements under *Gibson* where debtor fails to justify inaction); *see also* Norman C. Witte & William L. Healy, II, *Bankruptcy*, 1996 Det. C.L. Rev. 179, 204−05 (noting that burden shifts to debtor−in−possession to establish justified action).Back To Text

[199] *See Valley* Park, 217 B.R. at 866−69 (recognizing right of committee when debtor−in−possession has consented to order granting committee right to pursue fraudulent transfer actions); *Spaulding Composites*, 207 B.R. at 904 (holding that debtor−in−possession may stipulate to representation by creditor committee); *see also* Coral Petroleum, Inc. v. Banque Paribas−London, 797 F.2d 1351, 1363 (5th Cir. 1986) (asserting that debtor−in−possession's stipulation is effective to confer standing on committee).Back To Text