

BANKRUPTCY'S ORGANIZING PRINCIPLE

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I. INTRODUCTION

Does bankruptcy law have an organizing principle—a spirit that unifies and animates it? Of course it does. The very invocation of the phrase “bankruptcy” evokes a domain in the mind of every lawyer and judge. Intersubjectively, bankruptcy enjoys a “rule of recognition” that makes it an intelligible concept to an interpretive community. If this spirit could be identified, our knowledge of bankruptcy law would be enriched. Then hard cases could be solved by reason rather than intuition. Law would become more rational and hence more objective.

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The organizing principle of bankruptcy I wish to identify here has to do with the creation of the bankruptcy estate. In particular, the principle must identify the mode by which property is transferred by the debtor and other entities to the trustee. This organizing principle is a myth of origin: how does bankruptcy commence, and what is the constitution of the estate?

The dominant paradigm put forth at present is that the bankruptcy estate is created by the fiat of 11 U.S.C. § 541(a). Most relevantly, section 541(a) provides:

The commencement of a case under section 301, 302, or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held:

(1) Except as provided in subsections (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case.

....

(3) Any interest in property that the trustee recovers under section 329(b), 363(n), 543, 550, 553, or 723 of this title.

(4) Any interest in property preserved for the benefit of or ordered transferred to the estate under section 510(c) or 551 of this title.¹

The orthodox view looks to section 541(a) as bankruptcy's organizing principle. As such, section 541(a) is an ad hoc compilation of theories that cannot be unified except by the fact that the theories are listed in section 541(a).

The above subsections in section 541(a) describe three different, irreconcilable ideas. Subsection 1 describes successorship: the trustee is the sorry heir to the debtor's property as it existed on the day of the bankruptcy. This is the most important organizing principle in the orthodox view. Section 541(a)(3) is more mysterious because it contains nothing but cross-references to other bankruptcy sections.²

1. 11 U.S.C. § 541(a) (1994). I have left out the other provisions as less important theoretically to the constitution of the bankruptcy estate. Subsection 2 deals with community property, such as exists in western states. Subsection 5 deals with property inherited within 180 days of a bankruptcy petition. This ad hoc addition to the estate is designed to prevent deathbed bankruptcy petitions attempting to protect an inheritance from the creditors of the impecunious heir. Subsections 6 and 7 include proceeds of estate property—a principle that might have been deduced from the other sections. Subsection 6 also strives uncertainly to exclude from the estate the post-petition earnings of an individual debtor.

2. The other cross-references in section 541(a)(3) are as follows: Section 329(b) refers to retainer recovered by trustees from lawyers whose fees were unreasonably high. Section 363(n) refers to the trustee's recovery from a buyer at a bankruptcy sale who colluded to keep bid prices low. Section 543 refers to the recovery of property possessed by "custodians"—creditor representatives under nonbankruptcy law who have taken control of the debtor's estate. Section 553 refers to setoffs. Specifically, section 553(b) allows the recovery of setoffs actually manifested within 90 days of bankruptcy where the creditor setting off improved its position over the 90-day period. Section 553(a) is not really an avoidance provision so much as it is a defense of setoffs against other avoidance theories. Section 723

What unifies these cross-references is that they all refer to property in which the debtor has no interest as of the commencement of the bankruptcy proceeding. Rather, these cross-references encompass property the debtor alienated prior to bankruptcy, but in which the trustee has an *avoidance power*, or more simply, an *in personam* cause of action created in the Bankruptcy Code. Of particular concern is the cross-reference to section 550, which provides:

[T]o the extent that a transfer is avoided under section 544, 545, 547, 548, 549, 553(b), or 724(a) of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from—

- (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or
- (2) any immediate or mediate transferee of such initial transferee.³

Again, we face a blizzard of cross-references. Most of these cross-references refer to avoidance theories—voidable preferences, fraudulent conveyances, and the like. Thus, the orthodox view of estate creation holds that property the debtor voidably conveyed enters the estate by the doubly portcullised means of section 550(a) and section 541(a)(3).

Subsection 4 in section 541(a) also communicates through the encrypted hieroglyphics of cross-reference. Of principal concern is property *preserved* (or transferred) under section 551.⁴ That provision states:

Any transfer avoided under section 522, 544, 545, 547, 548, 549, or 724(a) of this title, or any lien void under section 506(d) of this title, is preserved for the benefit of the estate but only with respect to property of the estate.⁵

Subsection 4 is usually passed over or forgotten, for reasons that are not entirely clear. Formulation of the orthodox theory usually asserts that property which the trustee might recover from third parties enters the estate via sections 550(a) and 541(a)(3), working in tandem. Nevertheless, avoided property could likewise enter into the estate courtesy of sections 541(a)(4) and 551.

In summary, the ordinary view of the bankruptcy estate is that it is created mainly by the principle of succession. Under section 541(a)(1), the trustee inherits from the debtor whatever property the

authorizes the trustee to recover from general partners of the debtor where the debtor is a partnership. Thus, the most important cross-reference for bankruptcy practice is to section 550, which provides for transferee liability for avoidable transfers.

3. 11 U.S.C. § 550 (1994).

4. Subsection 3 also mentions property preserved or transferred under section 510(c), which refers to equitable subordination.

5. *Id.* § 551.

debtor had at the time of bankruptcy. Avoided transfers by the debtor enter the estate through sections 550(a) and 541(a)(3) or through sections 551 and 541(a)(4).

I will show that there is a competing organizing principle of the bankruptcy estate that is superior to the view just expressed. According to this second theory, the trustee's strong-arm power under section 544(a)⁶ is the true soul of the Bankruptcy Code. The strong-arm power is the bankruptcy trustee's status as a hypothetical judicial lien creditor on the day of the bankruptcy petition.⁷ This status describes estate creation *and* avoidance of debtor transfers in a unified way. All other avoidance powers flow from this one. At best, the other avoidance theories—voidable preference, fraudulent conveyance, and so forth—have the effect of rendering the property of transferees susceptible to the trustee's judicial lien. According to this view, neither section 547(b) (voidable preference) nor section 548(a) (fraudulent transfer) suffices to "avoid" a transfer. Avoidance merely nullifies only so much of the transfer as is necessary to gratify the trustee's judicial lien.

Under the strong-arm theory of the bankruptcy estate, section 541(a) is not the origin of the estate, and successorship is not the operative theory. Rather, section 541(a)(1) is merely an *example* of the trustee's judicial lien at work. If the trustee has the powers of a judicial lien creditor on the day of bankruptcy, the trustee's judicial lien attaches to all the debtor's property as of the commencement of the bankruptcy proceeding. Hence, the strong-arm power describes the mode by which the debtor's property is conveyed to the bankruptcy trustee. Thus, under the strong-arm theory, bankruptcy's organizing principle is lien creation, not successorship.

6. According to section 544(a):

The trustee shall have, as of the commencement of the case, and without regard to any knowledge of the trustee or of any creditor, the rights and powers of, or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by—

(1) a creditor that extends credit to the debtor at the time of the commencement of the case, and that obtains, at such time and with respect to such credit, a judicial lien on all property on which a creditor on a simple contract could have obtained such a judicial lien, whether or not such a creditor exists;

(2) a creditor that extends credit to the debtor at the time of the commencement of the case, and obtains, at such time and with respect to such credit, an execution against the debtor that is returned unsatisfied at such time, whether or not such a creditor exists; or

(3) a bona fide purchaser of real property, other than fixtures, from the debtor, against whom applicable law permits such transfer to be perfected, that obtains the status of a bona fide purchaser and has perfected such transfer at the time of the commencement of the case, whether or not such a purchaser exists.

Id. § 544(a).

7. Since the Bankruptcy Code became effective in 1978, the trustee is also a bona fide purchaser, but only of real estate. See *infra* text accompanying notes 9-11.

Under the strong-arm theory, section 550(a) is not the postern gate through which all avoidance must pass. Rather, section 550(a) is much more limited. It establishes the *in personam* liability of third parties who received no transfers but who merely *benefited* when other third parties received transfers. In short, section 550(a) is completely superfluous to avoidance as such and exists to establish the *in personam* liability of persons who never received transfers.

This second theory solves many intractable problems in bankruptcy doctrine. Unfortunately, it is not perfect. It also creates problems in areas that the orthodox theory explains perfectly. As a result, we must conclude that two opposing kings still encamp within the Bankruptcy Code's sad domain. One king is a successorship theory based on section 541(a), which in turn must be joined with section 550(a) to organize the otherwise unruly avoiding powers. The other is a unified theory based on section 544(a), which describes both estate creation and avoidance power. Neither theory can win a decisive victory over the other. The strong-arm theory, however, is descriptively better because it generates fewer anomalies. The anomalies that cannot be eliminated are drafting errors by congressional scribes who did not fully understand bankruptcy's organizing principle.

This Article will set forth the evidence of these two competing views. First, I present a very brief history of estate formation theory, which will show that, until the passage of the Bankruptcy Code in 1978, bankruptcy tended to evolve over time away from successorship theory and toward the strong-arm theory. The Bankruptcy Code, however, places the organizing principle in new doubt. Thereafter, I discuss the nature of avoidance actions in general, dwelling on specifics with regard to fraudulent conveyances and voidable preferences. The point of this discussion is to show that avoidance does not depend on passing through the portcullis of section 550(a). Such a demonstration will subvert the orthodox notion that the bankruptcy estate is created by fiat of section 541(a). The last part of the Article discusses whether section 550(a)'s claim to imperial dominance is well clothed. The evidence ends up being somewhat mixed, mainly because of concepts involving exempt property and bona fide purchaser defenses against avoidance. In the main, however, the strong-arm theory is more descriptive of bankruptcy law and solves intractable problems that the orthodox theory cannot solve.

II. A SHORT HISTORY OF ESTATE CREATION

In its essence, bankruptcy is a transfer from the debtor to the bankruptcy trustee. Orthodoxy views this transfer as mere successorship. Under this view, the trustee simply "inherits" the debtor's property as it existed at the very moment of the bankruptcy petition. This theory suggests that there are no inherent avoiding powers. Any

such powers must be added legislatively in ad hoc fashion, which under current law occurs under sections 541(a)(3) and 550.

This is not a necessary view of the matter. The trustee might view estate creation as a "purchase." Purchases are voluntary conveyances.⁸ Overwhelmingly, most bankruptcies are commenced by a voluntary petition. Thus, a debtor usually parts amicably with her assets for the benefit of creditors. Furthermore, it is not hard to view the transfer as a purchase *for value*. The trustee receives the transfer, but only on the condition that the trustee accepts the obligation to make distributions to the creditors. So conceived, estate creation is a purchase for value.

If we view estate creation as a purchase for value, then estate creation is also capable of investing in the trustee *more* property than the debtor had at the time the estate was created. For example, if the debtor holds property in trust for A, successorship makes the trustee the owner of the debtor's legal title, but this legal title would be subject to A's beneficial interest in the trust. Under nonbankruptcy rules governing A's property interest, bona fide purchasers for value of the legal title take free and clear of all equitable titles.⁹ If, however, we could consider the creation of the bankruptcy estate to be a good faith purchase for value, then the trustee is better than a mere successor to the debtor. Bankruptcy law has always flirted with this idea.¹⁰ Indeed, the Bankruptcy Code explicitly describes estate creation as bona fide purchase—but only of real estate.¹¹

A third view of estate creation could characterize the transfer to the bankruptcy trustee as in the nature of a judicial lien, held by the trustee for the benefit of unsecured creditors and other clients of the bankruptcy trustee. The rare involuntary petition conforms to this view. Creditors who place a debtor into involuntary bankruptcy take away the debtor's property quite against her will. The property is transferred to a court officer who works for all unsecured creditors. This theory, of course, is the strong-arm power itself.¹²

Orthodox theory holds to the first view of "successorship." It portrays the bankruptcy estate as a successorship principle, with avoidance powers added on in an ad hoc manner. Strong-arm theory in-

8. See U.C.C. § 1-201(32), (33) (1995).

9. See, e.g., *Belisle v. Plunkett (In re Plunkett)*, 877 F.2d 512, 513 (7th Cir. 1989) (recognizing that Virgin Islands real estate law imposes a constructive trust which survives bankruptcy).

10. In a notorious episode, Congress made the trustee a hypothetical bona fide purchaser of personal property. The result was that security interests on inventory might be declared dead because such security interests are no good against subsequent bona fide purchasers (in the ordinary course). Congress quickly repealed the bona fide purchaser status and substituted mere lien creditor status. See 1 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 8.6, at 272 (1965).

11. See 11 U.S.C. § 544(a)(3) (1994).

12. See *id.* § 544(a)(1).

vokes the second and third theories. Strong-arm theory would insist that the transfer is in the nature of a purchase when real estate is involved.¹³ Separately, estate creation represents the attachment of a judicial lien on all the debtor's property, both real and personal alike.¹⁴

A history of estate formation in American bankruptcy law¹⁵ reveals a struggle between the above theories. Prior to 1898, the struggle was most inconclusive. The Bankruptcy Act of 1898 eventually tilted very heavily to the strong-arm theory. Recently, the Bankruptcy Code has reinstated the spiritual confusion of the nineteenth century.

A. *The Nineteenth-Century Theory*

Although the United States Constitution authorizes bankruptcy legislation, it neglects to require it.¹⁶ Throughout the nineteenth century, America endeavored to trust to itself and live well without bankruptcy legislation. To be sure, legislation was enacted in 1800,¹⁷ 1841,¹⁸ and 1867¹⁹ in response to financial crisis, only to be repealed thereafter when better times and cooler heads prevailed. Each of these acts had avoiding powers for the trustee. In 1800 the trustee could avoid fraudulent transfers, while in the latter two acts the trustee could also avoid preferences.

The implicit theory of estate creation in these acts was controversial. It could be maintained that the bankruptcy trustee was merely the "successor in interest" to the debtor. Insofar as this part of the theory is concerned, the bankruptcy trustee is like the enfeebled heir of the debtor, a weakling with no right to avoid any conveyance. But this theory could not account for the avoidance powers. Hence, avoidance powers had to be viewed as "exceptions"—alien add-ons to the successorship soul of the bankruptcy estate.

Alternatively, these early acts could have been viewed as implicitly based on a strong-arm theory. These early acts always provided

13. See *id.* § 544(a)(3).

14. See *id.* § 544(a)(1). Some ancient English cases characterized bankruptcy as the creation of a judicial lien. See, e.g., *Ex parte Wilson*, 26 Eng. Rep. 98, 99 (Ch. 1743) ("[A] commission of bankruptcy is considered both as an action and an execution in the first instance; and after the petitioning creditor has laid hold of all the bankrupt's effects, it would be a great absurdity for the same person to be permitted to arrest him likewise."); *Twiss v. Massey*, 26 Eng. Rep. 43, 44 (Ch. 1737) ("a commission of bankrupt is an action and execution in the first instance"); 2 WILLIAM BLACKSTONE, COMMENTARIES *487.

15. The following account relies very heavily on John C. McCoid II, *Bankruptcy, the Avoiding Powers, and Unperfected Security Interests*, 59 AM. BANKR. L.J. 175 (1985).

16. See generally Thomas E. Plank, *The Constitutional Limits of Bankruptcy*, 63 TENN. L. REV. 487, 488 (1996).

17. See *id.* at 533.

18. See *id.* at 537.

19. See *id.* at 538.

that the bankruptcy trustee could avoid fraudulent transfers. This avoidance power suggests that estate creation was implicitly the creation of a judicial lien because any given creditor needed a judicial lien on A's property in order to realize value from D's fraudulent conveyance. For example, suppose D under one of these acts conveyed real estate for no consideration to A the day before a bankruptcy petition. Individual creditors could have established judicial liens on A's property because the conveyance was fraudulent as to them. In the early acts, the bankruptcy trustee succeeded to these rights of creditors.

When called upon to make explicit the theory of estate creation, courts usually expressed the ad hoc orthodox theory. In his study of the question, however, Professor John C. McCoid found that courts said one thing and did another.²⁰ What they said was that the assignee succeeded only to the debtor's property; what they usually did was to avoid unperfected security interests and fraudulent conveyances. In effect, the trustee could reach property that the debtor had already conveyed away. This suggests that the implicit theory was that the assignee succeeded not just to the debtor's property but to the creditors' avoidance rights. The estate was larger than simply the bundle of debtor rights as they existed on the day of the bankruptcy petition.

The implicit theory, however, was clearly rejected in *Stewart v. Platt*,²¹ in which Justice John Marshall Harlan ruled that an unperfected chattel mortgage was good against an assignee under the 1867 Act.²² The meaning of the case for estate creation would seem to be that the assignee might have an ad hoc statutory right to pursue fraudulent conveyances and preferences, but estate creation as such was mere successorship. Estate creation did not constitute the creation of a judicial lien superior to the unperfected chattel mortgage.²³

20. See McCoid, *supra* note 15, at 177-80.

21. 101 U.S. 731 (1879).

22. See *id.* at 744.

23. In *Stewart*, D conveyed a chattel mortgage to A. See *id.* at 735. A filed a public notice under the New York chattel mortgage statute but filed where the property was located. See *id.* at 736. Justice Harlan ruled that New York law required a filing where D resided. See *id.* at 737. Nevertheless, the unperfected security interest was perfectly good in bankruptcy:

[It is] an established rule that, "except in cases of attachments against the property of the bankrupt within a prescribed time preceding the commencement of proceedings in bankruptcy, and except in cases where the disposition of property by the bankrupt is declared by law to be fraudulent and void, the assignee takes the title subject to all equities, liens, or incumbrances, whether created by operation of law or by act of the bankrupt, which existed against the property in the hands of the bankrupt. He takes the property in the same 'plight and condition' that the bankrupt held it."

Id. at 738-39 (citations omitted).

After *Stewart*, it could not be said that the strong-arm power was the soul of bankruptcy. Rather, estate creation was an ad hoc affair in the nineteenth century. The trustee was a mere successor in interest, but this was supplemented by enumerated specific avoidance powers.

B. The 1898 Act

In 1898 the United States passed legislation that would endure until 1978.²⁴ This legislation manifested more clearly what could be called the strong-arm theory. Section 70e provided that the bankruptcy trustee could “avoid any transfer by the bankrupt of his property which any creditor of such bankrupt might have avoided.”²⁵ The implication of this provision is that the analogous rights of creditors were transferred over to the bankruptcy trustee, who would then use the power for the benefit of all creditors. No longer was the operative theory mere successorship (with ad hoc avoidance powers).

The Bankruptcy Act added a new avoidance power in order to overrule *Stewart*. Section 67a of the Bankruptcy Act allowed for the invalidation of “[c]laims which for want of record or for other reasons would not have been valid liens as against the claims of the creditors of the bankrupt.”²⁶ Thus, the successorship theory in *Stewart* was corroded by statutory reform.

Additional avoidance rights were also created in 1898. In particular, the trustee could avoid judicial liens established against debtor property within 120 days before bankruptcy.²⁷ Creditors could not have done this on their own under state law, unless the judicial liens were fraudulent transfers. In addition, the trustee could avoid preferences—payments and other transfers to creditors shortly before bankruptcy.²⁸ These, too, generally could not be avoided by creditors.

Taken together, the 1898 Bankruptcy Act, as it initially existed, created a bankruptcy estate that consisted of debtor rights and also creditor rights under state law. On top of that theory of estate creation, purely federal avoidance law was added in an ad hoc manner. The operative theory began to evolve toward the view that the commencement of a bankruptcy proceeding constituted a transfer to the trustee in the nature of a judicial lien.

One thing missing from this picture is the strong-arm power as such. Implicit at first, the express strong-arm power dates only to 1910. The 1910 amendment was a congressional reaction to *York*

24. See Bankruptcy Act of 1898, ch. 541, 30 Stat. 544 (1898) (repealed 1978).

25. *Id.* § 70(e), 30 Stat. at 566.

26. *Id.* § 67(a), 30 Stat. at 564.

27. See *id.* § 67(c), 30 Stat. at 564.

28. See *id.*

Manufacturing Co. v. Cassell,²⁹ in which the ever stubborn Supreme Court upheld an unperfected chattel mortgage from Ohio against which unsecured creditors had no rights. Rather, only judicial lien creditors had rights.³⁰ In other words, general creditors had the same (lack of) rights they have under the Uniform Commercial Code today.³¹ Justice Rufus Peckham reasoned that section 67a struck down liens that would not have been valid liens as against creditors' claims.³² The unperfected chattel mortgage was perfectly good against creditors. It was only voidable by judicial lien creditors. In short, as in *Stewart*, the Supreme Court contumaciously refused to let bankruptcy's true spirit come forth.

In 1910 Congress reacted to *Cassell* with what we now call the strong-arm power. In this legislation, the trustee was apotheosized as an ideal lien creditor:

[S]uch trustees, as to all property in the custody or coming into the custody of the bankruptcy court, shall be deemed vested with all the rights, remedies, and powers of a creditor holding a lien by legal or equitable proceedings thereon; and also, as to all property not in the custody of the bankruptcy court, shall be deemed vested with all the rights, remedies, and powers of a judgment creditor holding an execution duly returned unsatisfied.³³

It is possible to interpret this 1910 legislation as not so much changing the theory of estate creation but actualizing what was implicit all along in bankruptcy law.³⁴ As representative of creditors, the trustee succeeds to creditor power as well as to debtor property.

C. The Bankruptcy Code

In 1977 Congress substantially rewrote the federal bankruptcy law. We are now only beginning to discover that the Bankruptcy Code was, in many ways, quite a radical reconception. For our purposes, the Bankruptcy Code represents an imperfect retreat from strong-arm power. The orthodox successorship theory seems to explain much of the Bankruptcy Code. It overlaps, however, with the

29. 201 U.S. 344 (1906).

30. See *id.* at 348 ("The word 'creditors' in the Ohio conditional sales law includes only judgment creditors.").

31. See U.C.C. § 9-301(1)(b) (1995).

32. See *Cassell*, 201 U.S. at 351-52; Bankruptcy Act of 1898, ch. 541, § 67(a), 30 Stat. 544, 564 (1898).

33. Act of June 25, 1910, ch. 412, § 8, 36 Stat. 838, 840 (1910) (repealed 1978). This provision came to be codified as section 70(c) of the Bankruptcy Act.

34. Actualization of the implicit is what Hegel called the "ought." GEORG W.F. HEGEL, HEGEL'S SCIENCE OF LOGIC 132 (A.V. Miller trans., Humanities Press 1967). In short, in claiming that the 1910 legislation makes actual what was formerly implicit, I am making a *normative* argument. The supersensible spirit already present in the object-world of bankruptcy law should render itself explicit.

strong-arm theory. At the margins, the strong-arm theory is more descriptive. Occasionally, the successorship theory is superior. As a result, it must be concluded that *two* organizing principles are struggling for supremacy in the Bankruptcy Code.³⁵

Section 541(a) defines the bankruptcy estate as comprised of *debtor* property and, separately, that which the trustee recovers under section 550.³⁶ This provision could be taken to suggest that estate creation is not a function of the strong-arm power; rather, it is a function of section 541(a), which incorporates section 550 by reference.³⁷ Section 550(a), in turn, invokes the strong-arm power as one of many equally efficacious avoidance powers. Such an implication would support the orthodox notion that section 550(a) is the fount of avoidance wisdom.

In spite of the ostensible structure of section 541(a), the orthodox view fails to describe the law in many instances. In these instances, the strong-arm theory appears to be the better choice as bankruptcy's organizing principle. This is especially true with regard to the avoidance powers.

What follows is an analysis of the two organizing principles of bankruptcy law, as applied to avoidance powers.

III. AVOIDANCE IN GENERAL

In debtor-creditor jurisprudence, courts have been misled by a misnomer—"avoidance." In common parlance, "avoidance" implies negation or ceasing-to-be—in short, complete obliteration. But, as Hegel emphasized, nothing is, after all, something.³⁸ And so it is in the Bankruptcy Code. If the Bankruptcy Code avoids, it simultaneously preserves.³⁹

35. This is not to suggest that the struggle identified here is the only struggle going on. For example, the Bankruptcy Code struggles between the view that time exists (and hence secured creditors are entitled to benefit from appreciation value) or time does not exist (in which case lien strip down is possible). See generally Mary Josephine Newborn, *Undersecured Creditors in Bankruptcy*; Dewsnap, Nobelman, and the *Decline of Priority*, 25 ARIZ. ST. L.J. 547 (1993). Many other struggles undoubtedly exist, such as the conflict between utilitarian and libertarian ethics. See, e.g., David Gray Carlson, *Philosophy in Bankruptcy*, 85 MICH. L. REV. 1341 (1987).

36. See 11 U.S.C. § 541(a)(3) (1994).

37. See *id.*

38. "Something preserves itself in the negative of its determinate being [*Nichtdasein*]; it is essentially *one* with it and essentially *not one* with it. It stands . . . in a *relation* to its otherness. . . . The otherness is at once contained in it and also still *separate* from it; it is *being-for-other*." HEGEL, *supra* note 34, at 119; see also *id.* at 102 (stating that "but a negative nothing is an affirmative something").

39. This can be seen most vividly in Bankruptcy Code section 551, which states: "Any transfer avoided under section . . . 547 . . . is preserved for the benefit of the estate but only with respect to property of the estate." 11 U.S.C. § 551 (1994). This provision will later be portrayed as merely illustrating an aspect of the strong-arm theory. See *infra* Part IV.B.3.

To illustrate this basic point, let us take the simplest of strong-arm cases. Suppose *D* grants an unperfected security interest on a thing to *A*. *D* files for bankruptcy. The trustee “avoids” the transfer of the security interest under section 544(a). Orthodox theory holds avoidance to mean that *D* still owns the thing that *D* conveyed to *A*. *A* is left with no property because the conveyance has been “avoided.”⁴⁰

Avoidance thus conceived is a purely *qualitative* phenomenon. Prior to bankruptcy, *A* had a security interest. As a result of avoidance in bankruptcy, *A* has no property interest in the thing. The strong-arm theory, however, insists upon a *quantitative* limit on the trustee’s qualitative right to *A*’s property. In speculative terms, the trustee’s hypothetical judicial lien must have both a qualitative and quantitative aspect.⁴¹ The qualitative aspect is the moment of “avoidance.” The quantitative aspect is the moment of “subordination.” The one must not be emphasized at the expense of the other. Rather, these two moments exist in a dialectic tension.

This point can be seen clearly from the text of section 544, which states:

(a) The trustee shall have, as of the commencement of the case, and without regard to any knowledge of the trustee or of any creditor, the *rights and powers* of, or *may avoid* any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by—

(1) a creditor that extends credit to the debtor at the time of the commencement of the case, and that obtains, at such time and with respect to such credit, a judicial lien on all property on which a creditor on a simple contract could have obtained such a judicial lien, whether or not such a creditor exists⁴²

Notice first that the text of section 544(a)(1) describes the strong-arm power as *either* avoidance or rights and powers, as these may exist in nonbankruptcy law. Avoidance must be located in *nonbankruptcy* law if the trustee is to “avoid” a transfer straight out under the strong-arm power. If avoidance cannot be located in nonbankruptcy law, then the trustee can avoid nothing under section 544(a). Yet even if nonbankruptcy law does not refer to avoidance, the trustee still would have the “rights and powers” of a judicial lien creditor.

40. See, e.g., *Hunter v. Snap-On Credit Corp.* (*In re Fox*), 229 B.R. 160, 165 (Bankr. N.D. Ohio 1999) (“However, unlike state rules of priority which simply subordinate the unperfected security interest against the judicial lien, the Bankruptcy Code completely eliminates the unperfected security interest, leaving the secured creditor with only an unsecured claim against the debtor’s bankruptcy estate.”).

41. See GEORG W.F. HEGEL, HEGEL’S LOGIC § 85, at 124 (William Wallace trans., 3d ed. 1975).

42. 11 U.S.C. § 544(a)(1) (1994) (emphasis added).

In the problem given above, in which *A* has an unperfected security interest from *D*, the trustee does have “rights and powers” over *A*. According to the U.C.C., “Except as otherwise provided in subsection (2), an unperfected security interest is subordinated to the rights of . . . a person who becomes a lien creditor before the security interest is perfected.”⁴³ Notice that *A*’s unperfected security interest is “subordinated” to the rights of a lien creditor. It is not “avoided.” As its etymology suggests, subordination is a quantitative idea. Subordination reflects the fact that the senior judicial lien is measured by the amount of the lien creditor’s judgment. Beyond this quantitative limit, *A*’s lien is still perfectly good. Thus, it would appear that the strong-arm power is *not* an avoidance power. Rather, it is merely a *subordinating* power.

Subordination, however, is but one side of the matter. It is equally true that *A*’s lien is “avoided”—in the sense of being obliterated. Avoidance manifests itself when the senior lien creditor exercises her power of sale. By virtue of her senior lien, the lien creditor has the power to sell free and clear of *A*’s unperfected security interest. In this sale, *A*’s security interest in the thing disappears and *A* tastes the bitter fruit of oblivion. Avoidance is the qualitative moment of the lien creditor’s senior property right; quality reveals itself when, by selling, the lien creditor obliterates *A*’s security interest,⁴⁴ leaving *A* with no relations to the collateral. At this moment, *A*’s property right has been “a-lienated.” Thus, subordination is avoidance, and avoidance is subordination.⁴⁵

43. U.C.C. § 9-301 (1995).

44. Hegel defines “quality” as “the character identical with being; so identical that a thing ceases to be what it is, if it loses its quality.” HEGEL, *supra* note 41, § 85, at 124; see also Jeanne L. Schroeder, *Never Jam To-Day: On the Impossibility of Takings Jurisprudence*, 84 GEO. L.J. 1531, 1556 (1996) (“But a quality can only be defined in terms of what it is not—it is defined by its own negation in the sense of ‘this is not that.’”).

45. Article 9 can be taken to imply the opposite—that *B* cannot sell free and clear of *A*’s lien. According to U.C.C. section 9-201, “Except as otherwise provided by this Act a security agreement is effective according to its terms between the parties, against purchasers of the collateral and against creditors.” U.C.C. § 9-201 (1995). Section 9-301(1) is such a provision overcoming the effect of section 9-201, but where in the U.C.C., however, does it say that a senior lien creditor has the power to sell collateral free and clear of the junior security interest? The answer is in the word “subordinate,” which appears in section 9-301(1). “Subordinate” includes the qualitative moment of total avoidance. Thus, section 9-301(1) itself is the provision that allows the senior judicial lien creditor to destroy the junior security interest through sale. See David Gray Carlson, *Death and Subordination Under Article 9 of the Uniform Commercial Code: Senior Buyers and Senior Lien Creditors*, 5 CARDOZO L. REV. 547, 558-63 (1984) [hereinafter Carlson, *Death and Subordination*]; David Gray Carlson, *Simultaneous Attachment of Liens on After-Acquired Property*, 6 CARDOZO L. REV. 505, 512-13 n.38 (1985); see also *Vintero Corp. v. Corporacion Venezolana de Fomento (In re Vintero Corp.)*, 735 F.2d 740, 742 (2d Cir. 1984) (concluding that the bankruptcy trustee, as a senior lien creditor, has a senior right of sale over an unperfected security interest). For a notorious case holding that sale to a bona fide purchaser does not obliterate but only subordinates an unperfected security interest, see *Aircraft Trading and Services, Inc. v. Braniff, Inc.*, 819 F.2d 1227 (2d Cir. 1987).

The U.C.C., then, proves that the trustee has a judicial lien that both avoids and subordinates. Avoidance refers to the trustee's superior power of sale.⁴⁶ Mere attachment of the trustee's judicial lien does not "avoid" A's property interest in the collateral. A's security interest is not obliterated until the trustee actually sells the property free and clear. Given mere attachment of the trustee's judicial lien, A's unperfected security interest continues to exist. This continued, admittedly mediocre existence we may call "subordination." It implies the following: (1) a continued existence of the lien; (2) a right to cash proceeds in case of a surplus following a sale; and (3) a quantitative limit to the trustee's ownership right to cash proceeds. Subordination insists that A owns the surplus once the senior judicial lien exhausts itself.⁴⁷

In bankruptcy, an important circularity usually exists to disguise the difference (and unity) between avoidance and subordination. Suppose a debtor conveys an unperfected security interest to A. The unperfected security interest is void and/or subordinate under the trustee's strong-arm power. The amount of avoidance or subordination to which the trustee is entitled is defined by the amount of debt the trustee represents. Yet, if A has recourse against D personally, A typically owns one of the claims represented by the trustee.⁴⁸ Since the trustee represents A as well as other creditors, the trustee will "subordinate" A to A's own claim as an unsecured creditor. This recursive relation between A and A's representative implies that A will have been paid off from the bankruptcy estate before any surplus appears to which A's unperfected security interest might attach. A

46. See 11 U.S.C. § 363(f) (1994) (stating that "[t]he trustee may sell . . . free and clear . . . only if— (1) applicable nonbankruptcy law permits sale of such property free and clear of such interest").

47. In elaboration of the strong-arm theory, a special note must be added about the trustee's status as a bona fide purchaser of real estate. This, too, constitutes part of the strong-arm power.

A "purchase" connotes a voluntary conveyance by the debtor to the trustee. See 11 U.S.C. § 101(43) (1994). A purchase of real estate might comprehend a purchase of fee simple absolute or a mortgage. If the trustee is deemed to be the owner of a fee simple interest, the trustee has a complete avoidance power on the day of the bankruptcy petition. This implication should be "avoided." The trustee is a creditor representative, and the trustee's ownership should only extend as far as the representative capacity does. For this reason, the type of purchase a trustee makes should be deemed to be a mortgage. This allows for the trustee to return any surplus to the third party against whom the bona fide purchaser status was invoked, instead of the debtor.

For a case wrongly denying that the trustee can hypothesize herself to be a mortgagee, see *United States v. Farrell (In re Fluge)*, 57 B.R. 451, 456 (Bankr. D.N.D. 1985).

48. If the unperfected lien implies that A has property that the trustee must "recover," A's claim is not allowable unless A has "turned over any such property." 11 U.S.C. § 502(d) (1994). Once the property is returned, A's claim "shall be determined, and shall be allowed . . . the same as if such claim had arisen before the date of the filing of the petition," but only if the "claim aris[es] from the recovery of property under section . . . 550." *Id.* § 502(h).

therefore lacks the occasion to claim the surplus. Because of this short-circuit, avoidance (the qualitative moment) falsely appears to dominate the analysis to the exclusion of the quantitative moment of subordination. In most cases, the distinction between quality and quantity is invisible and might be ignored safely.⁴⁹

The dialectic between avoidance and subordination fully reveals itself in two situations: (1) when *A* (a noncreditor) has received a fraudulent conveyance from a debtor rendered insolvent by the fraudulent transfer that is challenged; and (2) when *A* (a nonrecourse creditor) has received an unperfected security interest in *D*'s assets and where avoidance renders the bankruptcy estate insolvent. In both of these circumstances, the strong-arm theory reserves the surplus to *A*. The orthodox theory cannot do so.

A. Fraudulent Conveyances

1. Ownership of the Surplus

An example from state fraudulent conveyance law illustrates the point that avoidance must have a quantitative limit. Suppose *D* gives *A* a thing worth \$100 in order to prevent the creditors from getting it. This gift is a fraudulent conveyance.⁵⁰ *C*, a judgment creditor of *D* for \$50, wishes to levy on *D*'s assets but can find none. The Uniform Fraudulent Conveyance Act authorizes *C* to set aside the conveyance.⁵¹ The result of doing so is that *C* may establish a \$50 judicial lien on *A*'s thing. *C* can force a sale of the entire thing in order to satisfy the \$50 claim. If *C* sells for \$100, *C* recovers the \$50 and holds the surplus—but for whom? In state law, the surplus clearly belongs to *A*. By no means does *D* get the surplus back because the conveyance was a fraud against *C*.⁵² Insofar as *D* is concerned, the gift was

49. As a numerical illustration, suppose *D* has only one creditor (*A*) who claims \$100 and only one asset worth some unknown amount. *A* has an unperfected security interest on the asset. The trustee's hypothetical judicial lien is senior to the unperfected security interest. The quantitative limit to the strong-arm power is \$100. The trustee accordingly subordinates *A*, repossesses the asset, and manages to sell it for \$120. Because the trustee is limited to her representative capacity, she can only take \$100 of the proceeds. The trustee distributes this \$100 to *A*, but now *A*'s claim is utterly satisfied. *A* has no cause to seek the surplus, which now must be paid to *D*. See *id.* § 726(a)(6).

50. See UNIF. FRAUDULENT CONVEYANCE ACT § 4, 7A U.L.A. 67 (1999).

51. See *id.* § 9(a), U.L.A. 1305 (1997); see also *Sosne v. Reinert & Duree (In re Just Brakes Corporate Sys., Inc.)*, 108 F.3d 881, 883 (8th Cir. 1997) (allowing a creditor to obtain a court order authorizing the sale of a fraudulently conveyed trademark).

52. As the Massachusetts Supreme Court wrote:

The final decree declared the assignment void and the mortgage cancelled and discharged. A fraudulent conveyance though voidable is not a void conveyance. Where creditors seek directly to reach and apply property fraudulently conveyed the conveyance may be set aside only to the extent necessary to satisfy the debts of creditors. Where, as here, a creditor plaintiff seeks merely the freedom to collect his debt through the methods provided in a court of law, the relief to which he is entitled is the opportunity to proceed unhampered by the

final as soon as *D* delivered it to *A*. *D* absolutely alienated the thing to *A* and (thanks to fraudulent conveyance law) to *D*'s creditors.⁵³

If this demonstration is transposed to bankruptcy, a similar result should occur. A bankruptcy trustee is a judicial lien creditor representing all the unsecured creditors of *D*.⁵⁴ The quantity of those claims describes the extent of *A*'s liability to the bankruptcy trustee. Suppose creditors have \$50 in unsecured claims against *D*. The trustee does not take back the \$100 transfer altogether. Otherwise, if the bankruptcy estate ends up being solvent, *D* takes the surplus, not *A*.

According to the orthodox theory, some specific avoidance provision obliterates—avoids—the conveyance from *D* to *A*. Recovery supposedly must be achieved, if at all, under section 550(a). Thus, in the above example, the orthodox view easily finds that the conveyance is *completely void* under section 548(a).⁵⁵ Such a conclusion then sets the stage for “recovery” under section 550(a). According to that provision:

[T]o the extent that a transfer is avoided under section 544, 545, 547, 548, 549, 553(b), or 724(a) of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from—

(1) the initial transferee of such transfer or the entity for whose benefit such transfer was made⁵⁶

In the example given above, *D* fraudulently conveyed a thing worth \$100 to *A* when *D* had \$50 of unsecured claims against her. *D* then filed for bankruptcy. Under the orthodox theory, which exalts section 550(a) as the source of avoidance power, the whole thing can be recovered from *A* under section 550(a)(1) because *A* is the initial trans-

obstacles of the mortgage and the assignment. The decree should not have declared the assignment void. A decree is to be entered providing in substance that the mortgage and the assignment do not constitute a lien on the premises as against the plaintiff or any person or persons claiming under or through the plaintiff and that the defendant Milton Welton and all persons claiming under or through him are perpetually enjoined from setting up or claiming any right under the mortgage or the assignment, and awarding costs to the plaintiff.

Service Mortgage Corp. v. Welton, 200 N.E. 278, 280 (Mass. 1936) (citations omitted).

53. See David Gray Carlson, *Voidable Preferences and Proceeds: A Reconceptualization*, 71 AM. BANKR. L.J. 517, 520-23 (1997).

54. See 11 U.S.C. § 544(a)(1) (1994).

55. In the case of a fraudulent transfer, three different avoidance provisions could have avoided *D*'s transfer to *A*. First, the strong-arm power under section 544(a)(1) suggests that the trustee may “avoid” the transfer because any simple judicial lien creditor could do so. Second, the trustee is subrogated to the right of an unsecured creditor to avoid the conveyance. The trustee, however, must find a real, flesh-and-blood creditor who could have avoided the transfer. Third, without regard to state law or to the rights of flesh-and-blood creditors, the trustee can avoid fraudulent transfer directly as a matter of pure federal law under Bankruptcy Code section 548(a).

56. *Id.* § 550(a).

feree of the conveyance. At this point, A's thing belongs completely to the bankruptcy trustee. A has no further interest in it.

But who owns the \$50 surplus? If it honestly applied itself, orthodox theory would have to conclude that the surplus belongs to *D*, even though *D* completely alienated the thing before bankruptcy—to *A* and to *D*'s creditors. *D*'s ownership of the surplus is established in section 726(a)—the all-important provision that governs the distribution of the bankruptcy estate. Section 726(a) indicates the priority between various classes of creditors. Under section 726(a)(6), *D* has the residual claim to the surplus once the creditors are paid.⁵⁷ *A* nowhere appears in section 726(a), because *A* is not a creditor of *D*. This is the consequence of holding section 550(a) to be the central organizing principle of bankruptcy avoidance.

The strong-arm theory could achieve a \$50 recovery for the trustee, while preserving the surplus for *A*. On the strong-arm theory, the trustee only has a \$50 lien on *A*'s thing. *A* still owns the surplus. By virtue of this judicial lien, the trustee can sell the thing and raise cash proceeds. The cash surplus, however, belongs to *A*, not *D*. Because the estate only has a \$50 recovery from *A*, section 726(a) cannot award the surplus to *D*. In short, *A*'s interest in the thing is subordinated to the trustee but not entirely avoided. *A*'s interest in the surplus survives avoidance.⁵⁸

A major difference between the orthodox theory and the strong-arm theory is the centrality of section 550(a). The orthodox view insists that section 550(a) is the very fount of avoidance wit. On this view, the bankruptcy estate consists of the debtor's interests in prepetition property plus whatever the trustee can recover from third parties under section 550(a). In contrast, the strong-arm theory consigns to section 550(a) only a minor role in estate creation, which will be described later.⁵⁹ The strong-arm power is independently a theory of recovery independent from section 550(a). This power organizes all other avoidance concepts. "Avoidance" in this theory simply means that *A*'s property is susceptible to the trustee's hypothetical judicial lien.

To test whether the strong-arm theory can be sustained, independently of section 550(a), let us suppose that Congress, in an experimental mood, repeals section 550, without bothering to remove the many cross-references to 550(a) that lay scattered throughout the Bankruptcy Code.⁶⁰ In such a case, section 548(a)(2)(B)(i) provides

57. See *id.* § 726(a)(6).

58. The surplus would be awarded to *A* under section 725, before any distributions to the general creditors under section 726(a) take place.

59. This role—*in personam* liability of nontransferees—is described *infra* note 76.

60. This experiment will also include repeal of section 551 as well because section 551, in conjunction with section 541(a)(4), also serves to net avoidance recoveries for the bankruptcy estate. I shall leave this out, however, for ease of exposition.

that the trustee may “avoid” the transfer of the \$100 thing to A.⁶¹ On the strong-arm theory, “avoiding” the transfer means only that A’s property is made susceptible to the bankruptcy trustee’s judicial lien. Since the trustee represents only \$50 worth of unsecured claims, the trustee may sell the whole thing, but A owns the surplus of \$50. All of this works quite comfortably without the aid of section 550(a).

The right of recovery could be sustained under Bankruptcy Code section 542(a). According to that provision, “an entity . . . in possession . . . of property that the trustee may use, sell, or lease under section 363 . . . shall deliver to the trustee . . . such property.”⁶² Because the trustee has a judicial lien on A’s property, the trustee may sell the property under section 363(f)(1), which, in relevant part, provides that “[t]he trustee may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of an entity other than the estate only if . . . applicable nonbankruptcy law permits sale of such property free and clear of such interest.”⁶³ Since the trustee, as lien creditor, can sell A’s property free and clear of A, the trustee can “use, sell, or lease” under section 363, and hence A has the duty to turn over the property to the trustee’s custody. Therefore, section 542(a) serves as a satisfactory replacement to section 550(a).

I am compelled to confess an obstacle, however. Section 363(f)(1) states that the trustee may sell A’s property *under subsection (b)*. Section 363(b) in turn provides: “The trustee . . . may . . . sell . . . *property of the estate*.”⁶⁴ Hence, it must now be shown that A’s asset, to which the trustee’s \$50 judicial lien has attached, is “property of the estate.”

The orthodox account insists that “property of the estate” is defined by section 541(a). The challenge at this point is to show that the trustee’s judicial lien is in the estate. If so, then the trustee can sell A’s thing under section 363(f)(1).

This challenge, however, is an awkward one, if indeed I must locate some part of section 541(a) that makes the trustee’s hypothetical judicial lien on A’s thing part of the bankruptcy estate. D has no interest in A’s thing. Only A and D’s creditors (courtesy of fraudulent conveyance law) have an interest in the thing as of the time of the

61. In relevant part, this provision states:

(a) The trustee may avoid any transfer of an interest of the debtor in property . . . that was made . . . within one year before the date of the filing of the petition, if the debtor voluntarily

. . . .

(2)(A) received less than a reasonably equivalent value in exchange for such transfer . . . ; and

(B)(i) . . . became insolvent as a result of such transfer

Id. § 548.

62. *Id.* § 542(a).

63. *Id.* § 363(f)(1).

64. *Id.* § 363(b) (emphasis added).

bankruptcy petition. Properly conceived, section 541(a)(1) cannot help us because it only brings into the estate "all legal or equitable interests of the debtor in property as of the commencement of the case."⁶⁵ Meanwhile, section 541(a)(3) states that "property of the estate" includes "[a]ny interest in property that the trustee recovers under section . . . 550."⁶⁶ Of course, our goal is to minimize the role of section 550 in avoidance theory. I cannot use section 541(a)(3) to solve the problem because, *ex hypothesi*, section 550 has been repealed.

The Supreme Court confronted this awkwardness in *United States v. Whiting Pools, Inc.*⁶⁷ In this landmark case, a debtor-in-possession wished to recover over-encumbered inventory seized by the IRS so that the inventory could be used to rehabilitate the debtor. In deciding for the debtor-in-possession, Justice Harry Blackmun had to solve the following problem: where *D* has granted a valid perfected security interest on a thing to *A*, is the entire thing in the estate, or only *D*'s interest in the thing? Section 541(a)(1) makes only "legal or equitable interests of the debtor in property" part of the estate.⁶⁸ This implies that the debtor equity is *in* the estate, but *A*'s lien is *out*. If so, how can encumbered collateral ever be used for debtor rehabilitation? To solve this problem, Justice Blackmun remarked that property of the estate exceeds the narrow words of section 541 (a): "Although these statutes could be read to limit the estate to those 'interests of the debtor in property' at the time of the filing of the petition, we view them as a definition of what is included in the estate, rather than as a limitation."⁶⁹ The point of this remark is to establish that the bankruptcy estate exceeds the words of section 541(a)(1). Thus, the estate includes not only the debtor's interest in a thing, but the *whole* thing, including the IRS's rights in the thing. Under this dictum, since the trustee can use "property of the estate,"⁷⁰ the trustee can use the whole of a secured party's collateral.⁷¹

Somewhat separately and less convincingly, Justice Blackmun made clear that trustee powers come into the estate under section 541(a)(1)—*not* under 541(a)(3)—with its reference to 550(a): "Most important, in the context of this case, § 541(a)(1) is intended to include in the estate any property made available to the estate by other provisions of the Bankruptcy Code."⁷² The "other provision" Black-

65. *Id.* § 541(a)(1).

66. *Id.* § 541(a)(3).

67. 462 U.S. 198 (1983).

68. 11 U.S.C. § 541(a)(1) (1994).

69. *Whiting Pools*, 462 U.S. at 203.

70. 11 U.S.C. § 363(b)(1) (1994).

71. For an excellent and challenging analysis of *Whiting Pools*, see Thomas E. Plank, *The Outer Boundaries of the Bankruptcy Estate*, 47 EMORY L.J. 1193 (1998).

72. *Whiting Pools*, 462 U.S. at 205.

mun had in mind was the turnover provision.⁷³ This provision is not mentioned in section 550, and so section 541(a)(3) could not aid Blackmun in his quest to show that a debtor-in-possession has the right to regain possession of collateral levied by the IRS. In his demonstration, Blackmun went on to make clear that all avoidance provisions are included within the terms of section 541(a)(1), just like the turnover provision:

Indeed, if this were not the effect, § 542(a) would be largely superfluous in light of § 541(a)(1). Interests in the seized property that could have been exercised by the debtor—in this case, the rights to notice and the surplus from a tax sale—are already part of the estate by virtue of § 541(a)(1). No coercive power is needed for this inclusion. The fact that § 542(a) grants the trustee greater rights than those held by the debtor prior to the filing of the petition is consistent with other provisions of the Bankruptcy Code that address the scope of the estate.⁷⁴

Thus, section 541(a)(1) brings the strong-arm power—and other avoidance powers—into the estate.

This view of the bankruptcy estate, however, must be criticized as inexact. First, the idea that the *debtor* owns property fraudulently conveyed cannot be sustained. What drives Blackmun's analysis is probably metaphoric confusion with regard to "avoidance." The term implies a counterfactual world in which the debtor never transferred property to A. Thus, D might be taken to own the property still, even after deeding it over to A. This seems to be the thrust of Blackmun's view that avoidance powers come into the estate under section 541(a)(1). Second, the above passage assumes that provisions such as sections 545 and 549 are *separate* avoidance theories from section 544. Such a view obliterates the quantitative side of avoidance theory and, indeed, is no better than the orthodox theory that views section 550(a) as heliocentric. Rather, it should be recognized that the function of sections 545 and 549 is to render A's property susceptible to the bankruptcy trustee's judicial lien under section 544(a).⁷⁵

Be that as it may, the implication of *Whiting Pools* for the current argument is that "property of the estate" exceeds the definition of section 541(a). Therefore, property encumbered by the strong-arm

73. See 11 U.S.C. § 542(a) (1994).

74. *Whiting Pools*, 462 U.S. at 207 n.15 (citations omitted).

75. More precisely, if the trustee already has encumbered all the debtor's property with a judicial lien, then section 549 (postpetition transfers by the debtor) is largely superfluous because a debtor cannot generally convey free and clear of a judicial lien (unless a statute directly so empowers the debtor). As section 549 does so empower the debtor to make certain transfers free and clear, the real significance of section 549 is in these exceptions or in the special statute of limitations under section 549(d), not in the general proposition that the debtor is disempowered to convey property. The strong-arm principle disempowers the debtor by its very nature.

power could be part of the estate, separate and apart from section 541(a). The strong-arm power implies the trustee's ability to sell free and clear of A. A's equity surplus, however, is not part of the estate.

Indeed, it is possible to confirm that the estate *is* the strong-arm power. Of course, a judicial lien *will* attach to the legal and equitable interests of the debtor. Section 541(a)(1) therefore simply repeats what is already implicit in section 544(a). Likewise, section 541(a)(3)'s reference to section 550(a) merely repeats what 544(a) is capable of establishing on its own.⁷⁶

Hence, for the strong-arm theory to succeed, the reader must agree that, without the aid of section 541(a)(3), the trustee's judicial lien rights under section 544(a) are part of the estate. This should not be a difficult concession. Not only does *Whiting Pools* so hold,⁷⁷ but section 544(a) directly declares that the trustee owns the "rights and powers" of a hypothetical judicial lien creditor.⁷⁸ Section 544(a) describes the bankruptcy estate just as much as section 541(a) does.⁷⁹

Much labor has now been expended in order to achieve this result: A must surrender custody of the thing that is encumbered by the trustee's hypothetical judicial lien—without any reference to the rights mentioned in section 550(a). A must turn over the thing under section 542(a). Thus, section 550(a) is not strictly necessary to the result. Of course, section 550(a) *is* part of the Bankruptcy Code, and a

76. Have I now rendered section 541(a)(3) meaningless? Absolute superfluity of statutory language is quite an achievement. Rarely is it true that *no* utility can be thought up with regard to any portion of a statute. Section 541(a)(3) is still useful because it covers *in personam* liabilities to the trustee separate and apart from "transfers" of debtor property made or suffered by the debtor. The following is the exact text of section 541(a)(3): "Any interest in property that the trustee recovers under section 329(b), 363(n), 543, 550, 553, or 723 of this title." 11 U.S.C. § 541(a)(3) (1994). Some of these cross-references clearly entail *in personam* liabilities to the bankruptcy trustee. Thus, section 363(n) covers at least some purely *in personam* liabilities imposed upon persons who buy at collusive bankruptcy sales. Section 723 involves liability of general partners to a bankruptcy trustee for a partnership. Such liability does not grow out of any transfers. Other cross-references problematically refer to *in rem* interests. Section 329(b) covers the return of excessive attorneys' fees paid by the debtor. Section 543 provides for the turnover of property obtained by a "custodian" for creditors (such as a receiver). Section 553 provides for the negation of certain illegal set-offs. Setoff rights are deemed liens in section 506(a). In any case, section 550(a)'s chief utility is to provide *in personam* liability of beneficiaries who never received any transfers of property. See 11 U.S.C. § 550(a)(1) (1994). Hence, section 541(a)(3) includes in the estate debts owed to the estate. Accordingly, I have not erased section 541(a)(3) from the table of memory. This commandment still lives within the book and volume of the brain.

77. See *supra* text accompanying notes 69-71.

78. 11 U.S.C. § 544(a) (1994).

79. Admittedly, section 541(a) states that "[s]uch estate is comprised of all the following property, wherever located and by whomever held." *Id.* § 541(a). If this phrase as read to mean that the estate is comprised of the designated property *and no other*, the argument for the strong-arm power must fail. See *id.* § 102(3) ("includes' and 'including' are not limiting"). This last provision arguably suggests that "comprised" *is* intended to be limiting.

citation to it provides a short cut to justify the result I have just established.

A's thing is now part of the estate. The trustee can sell it under section 363(f)(1). Suppose this is done, and the trustee sells for \$100. The trustee takes \$50 of this amount as representative of the unsecured creditors. The other \$50 constitutes A's cash collateral.⁸⁰

This cash collateral is not subject to the distribution rule of section 726(a). Rather, it is subject to the rule of section 725:

After the commencement of a case under this chapter, but before final distribution of property of the estate under section 726 of this title, the trustee, after notice and a hearing, shall dispose of any property in which an entity other than the estate has an interest, such as a lien, and that has not been disposed of under another section of this title.⁸¹

A is "an entity other than the estate" with an interest in the \$50 surplus. Thanks to section 725, A must receive this surplus "before final distribution . . . under section 726."⁸² A thus retains any surplus after the strong-arm power is exhausted. D does not get it.

Where section 550(a) is held to be the soul of avoidance wit and section 548(a) the tedious outward limbs and flourishes, it is hard to justify the conclusion that A owns the \$50 surplus. After all, section 548(a)(2)(B)(i) indicates that the trustee may avoid the *entire* conveyance of the thing to A. If, as the orthodox theory holds, A's interest in the thing is entirely destroyed (i.e., loss of quality), A is not an "entity other than the estate [that] has an interest"⁸³ in the proceeds generated from the sale of the thing within the meaning of section 725. Section 725 has no application to the case; only section 726(a) applies. Once the unsecured creditors receive \$50 under section 726(a)(1) to (5), the debtor (not A) is entitled to any surplus from the bankruptcy estate.⁸⁴

80. It may seem odd that A should have "cash collateral" when A is not a secured creditor. Rather, A is the owner of the equity after the judicial lien is satisfied. Nevertheless, the definition of cash collateral does not require A to be a secured creditor. "Cash collateral" is defined to mean cash and the like in which the estate and an entity other than the estate have a joint interest. According to section 363(a), cash collateral means the following:

cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property . . . subject to a security interest as provided in section 552(b) of this title, whether existing before or after the commencement of a case under this title.

Id. § 363(a).

81. *Id.* § 725 (1994).

82. *Id.*

83. *Id.*

84. *See id.* § 726(a)(6).

The way section 550(a) theorists explain why *D* does not get the \$50 surplus is to focus on the fact that, according to section 550(a), “the trustee may recover, for the benefit of the estate,”⁸⁵ not for the benefit of the debtor personally.⁸⁶ This formulation, however, does not work. It presupposes that only *creditors* have an interest in the bankruptcy estate. But this is not so. Claims to debtor equity (which the Bankruptcy Code calls “interests”)⁸⁷ are just as much entitled to estate distributions as are creditor interests.⁸⁸

A premier expositor of section 550(a) supremacy is Judge Frank Easterbrook.⁸⁹ Judge Easterbrook, however, could not quite sustain this supremacy when faced with a fraudulent conveyance by a solvent debtor. His opinion is a good illustration of how the orthodox theory implodes upon itself when pushed to extremes.

In *In re FBN Food Services, Inc.*,⁹⁰ a debtor transferred property to A. For simplicity, I will say hypothetically that the property transferred was worth \$100 and the timely filed claims against the debtor were \$50. The trustee sued A for \$100, but A claimed his liability was limited to \$50, on the principles just enunciated. Judge Easterbrook held fast the mortal sword of his section 550(a) theory and attempted to use that weapon to solve the problem of A's surplus. According to Easterbrook: “Section 550(a) says that the trustee recovers ‘the property transferred’—here [\$100]. Once the whole transfer has been pulled into the estate, the money is distributed according to the pri-

85. *Id.* § 550(a).

86. See, e.g., *Acequia, Inc. v. Clinton (In re Acequia, Inc.)*, 34 F.3d 800, 811 (9th Cir. 1994); *Wellman v. Wellman*, 933 F.2d 215, 217-18 (4th Cir. 1991); *Dunes Hotel Assocs. v. Hyatt Corp. (In re Dunes Hotel Assocs.)*, 194 B.R. 967, 984-86 (Bankr. D.S.C. 1995).

87. See 11 U.S.C. §§ 501, 510(b), 1122(a), 1129(b)(2)(C) (1994).

88. See *id.* §§ 726(a)(6), 1129(b)(2)(C). In *Trans World Airlines, Inc. v. Travellers International AG (In re Trans World Airlines, Inc.)*, 163 B.R. 964 (Bankr. D. Del. 1994), Judge Peter Walsh remarked:

Section 550(a) requires a benefit to the “estate,” not to creditors. . . . There is no requirement that an avoidance action recovery be distributed (or “committed”) in whole or in part to creditors. Indeed, the Code clearly contemplates otherwise. Pursuant to § 541(a) an estate is created by the petition filing, and under § 541(a)(3) property of the estate includes property recovered in avoidance actions. Pursuant to § 363, the DIP [Debtor-in-Possession] may use property of the estate either in the ordinary course of business, or, with the court's approval, outside the ordinary course of business. Thus, the Code clearly contemplates the use of avoidance action recoveries in the operation of the business in a manner which only indirectly benefits creditors.

Id. at 972 (citation omitted); see also *id.* at 973 (stating that “the estate is the focus of § 550(a), not individual creditors”). Some of these remarks are inconsistent with strong-arm theory, but Judge Walsh clearly saw through the specious “benefit” argument based on section 550(a). *Accord* *Rooster, Inc. v. Raphael Roy, S.R.L. (In re Rooster, Inc.)*, 127 B.R. 560, 573 n.15 (Bankr. E.D. Pa. 1991).

89. Easterbrook memorably espoused the theory in the famous *Deprizio* case—a voidable preference landmark to be discussed *infra* Part IV.A. See *Levit v. Ingersoll Rand Fin. Corp. (In re V.N. Deprizio Constr. Co.)*, 874 F.2d 1186, 1194 (7th Cir. 1989).

90. 82 F.3d 1387 (7th Cir. 1996).

orities established by the Code”⁹¹ The reference to the “priorities established by the Code” must point to section 726(a)(6), which would give *D*, not *A*, the surplus.

Easterbrook, however, overlooked section 726(a)(6) in his analysis. Instead, citing sections 548(c) and 550(b)(1)—sections establishing *A*’s defense to liability—he noted that *these* sections (and a great many others that could have been cited) said nothing about ownership of the surplus:

To answer that question—for example, do the equity holders have a contractual (but non-debt) commitment?—the court must turn elsewhere. Once the rules established by the Code have been exhausted, remaining entitlements come from outside bankruptcy, which is to say from state law. No surprise, then, that courts regularly have looked to state law (under both the Bankruptcy Act of 1898 and the Bankruptcy Code of 1978) to determine how much the recipient of a fraudulent conveyance can claim in the bankruptcy.⁹²

Thus, Judge Easterbrook suggests that the Bankruptcy Code has no rule about the surplus. Rather, state law must supply the answer. But such an analysis overlooks section 726(a)(6), which awards the surplus to the debtor.⁹³

In contrast, the strong-arm thesis holds that section 550(a) does not establish the extent of the trustee’s fraudulent transfer recovery. Rather, the trustee’s representative capacity decides the matter—as a matter of federal law. The trustee’s right of recovery is limited to \$50. This theory leaves *A* as the owner of the \$50 surplus.

One final aspect of the *FBN* case is worthy of comment. In the case, the trustee claimed the right to avoid the entire \$100 conveyance, because, in addition to the \$50 in unsecured claims the trustee represented, the trustee also represented an additional \$75 in claims that had not been filed by the time of the bar date.⁹⁴ Very questionably, Judge Easterbrook ruled that late-filed claims are not claims at

91. *Id.* at 1396. Easterbrook adds that distributions might also be made according to “the debtor’s own commitments.” *Id.* I cannot discern what Judge Easterbrook had in mind by this phrase and so I omit discussion of it.

92. *Id.* (citations omitted).

93. Easterbrook toys with the theory that if *A* must surrender a fraudulent conveyance, *A* has a credit claim against the estate for the loss of property. *See id.* at 1392 (“A defendant in a fraudulent conveyance action therefore is a contingent creditor of the estate, potentially interested in the value of competing claims.”). In a solvent case, if we could say *A* is a creditor for the loss of property in a fraudulent conveyance case, *A* will obtain the surplus. But in the typical insolvent case, *A*’s claim would dilute the distributions to all the other creditors.

There is no justification for holding that a donee has a cause of action against the donor if the gift turns out to be a fraudulent conveyance. Warranties of title exist in the case of a purchase for value but not in the case of gift. *See* U.C.C. § 2-312 (1995).

94. Of course, I am making these numbers up for the purpose of simple exposition. The real numbers in *FBN* had many more zeroes after them than I have implied here.

all. This proposition cannot be sustained, because late claims are expressly entitled to distributions under section 726(a)(4).⁹⁵

Whether Judge Easterbrook is right or wrong with regard to late claims, the strong-arm theory can accommodate either view. Under the strong-arm theory, the entire \$100 conveyance is avoided, and the thing is sold. The trustee holds the proceeds to the extent of the trustee's representative capacity. These would include late-filed claims, so long as they are recognized as entitled to distributions. If not, then the trustee must distribute only so much of the loot as is necessary to satisfy genuine section 726(a) creditor claims. The surplus belongs to A under section 725. Therefore, qualitative avoidance is total, but the quantitative extent of avoidance could be deferred until a final determination of who is and who is not a creditor.

2. *Ownership of the Enforcement Right*

Strong-arm theory shows strength—and orthodox theory a weakness—with regard to the time at which A's property enters the estate. From that time forward, bankruptcy's automatic stay provision prohibits private creditors from pursuing A's property in competition with the bankruptcy trustee.⁹⁶

The strong-arm theory holds that the bankruptcy petition represents the creation of a judicial lien on all of the debtor's property, as of the bankruptcy petition. Section 541(a)(1) makes "legal or equitable interests of the debtor in property"⁹⁷ part of the estate, but this remark is not the true source of the bankruptcy estate. Rather, section 541(a)(1) is simply an *example* of the strong-arm theory at work—a mere epiphenomenon. A judicial lien on behalf of all creditors naturally would attach to any property of the debtor at the moment the bankruptcy petition is filed. It is the strong-arm power—not the successorship implicit in section 541(a)(1) taken alone—that creates the estate.

The hypothetical judicial lien perforce attaches to all the debtor's property owned at the commencement of the case. In addition, a judicial lien attaches to all property of A, provided A's transfer is "voidable." That is, voidability means the susceptibility of property to the trustee's hypothetical judicial lien. Attachment of the lien occurs on day one, even if the judicial finding of voidability is delayed. Under the strong-arm theory, the trustee has a judicial lien on A's property *ab initio*.

95. See David Gray Carlson, *Proofs of Claim in Bankruptcy: Their Relevance to Secured Creditors*, 4 J. BANKR. L. & PRAC. 555, 565-69 (1995).

96. Thus, according to section 362(a)(3), a private creditor (C) is precluded from "any act to obtain possession of property of the estate . . . or to exercise control over property of the estate." 11 U.S.C. § 362(a)(3) (1994).

97. *Id.* § 541(a)(1).

The strong-arm theory adequately permits the trustee to take control of A's property *ab initio*, when D fraudulently conveyed property to A prior to bankruptcy. When D files for bankruptcy, the trustee's hypothetical judicial lien encumbers A's property to the extent of the trustee's representative capacity. A's property instantly becomes property of the estate. Thus, if a private creditor (C) were to bring a private action against A's property after the bankruptcy petition, C would violate the automatic stay. Only the trustee can pursue A's property—for the benefit of all creditors.

Orthodox theory holds that section 541(a) describes the estate. The theory of the estate is fundamentally *ad hoc*. Thus, section 541(a)(1) brings the debtor's prepetition property into the estate on a successorship theory. As to timing, successorship occurs as soon as the bankruptcy petition is filed. That is, any property that the debtor owned prior to bankruptcy is *immediately* property of the estate. Quite separately, orthodox theory goes on to claim that the avoidance powers are added in section 541(a)(3), which brings the following into the bankruptcy estate: "[a]ny interest in property that the trustee recovers under section 329(b), 363(n), 543, 550, 553, or 723."⁹⁸ Notice that avoidance actions brought under section 550—supposedly the fount of avoidance—does not come into the estate *ab initio*. It comes in when the trustee "recovers" it. Hence, there is a gap between the bankruptcy petition and recovery of A's property. Pending recovery, A's property is not in the estate. Accordingly, the automatic stay cannot prevent C from pursuing A's property privately during the gap period.

Courts agree that C may not pursue A's property in competition with the trustee, but the theorizing to reach this result is inadequate. In effect, some courts have attempted to show that the bankruptcy trustee succeeds to all avoiding powers *ab initio* under section 541(a)(1). Such a showing, however, must fail. If D fraudulently conveys a thing to A before bankruptcy, D has completely alienated that thing. Only A and the creditors of D plausibly have a right to the thing. Other courts think that avoidance powers come into the estate only under section 541(a)(3). Hence, a gap exists between the bankruptcy petition and actual recovery by the trustee. This theory should authorize C's selfish pursuit of A's property. These courts attempt to fill the gap by palpably unconvincing means.

(a) *Property Ab Initio*

In the leading case of *American National Bank v. MortgageAmerica Corp. (In re MortgageAmerica Corp.)*,⁹⁹ a private credi-

98. *Id.* § 541(a)(3).

99. 714 F.2d 1266 (5th Cir. 1983).

tor (C) attempted to expropriate property fraudulently conveyed by *D* to *A*. The bankruptcy trustee claimed that *C*'s private fraudulent conveyance action violated the automatic stay. This proposition would have been true only if the trustee could show that the voidably conveyed property was already in the bankruptcy estate, at the time *C* commenced an action against such property, even though the bankruptcy trustee had not yet recovered it.¹⁰⁰

Judge Carolyn Randall (now Carolyn Dineen King) ruled that after the debtor fraudulently conveyed property to *A*, *D* continued to own the property.¹⁰¹ Hence, such property enters the estate *ab initio* under section 541(a)(1). In short, Judge Randall tried to bring what was in effect the strong-arm theory under the aegis of successorship. By means of this logic, the automatic stay prevented *C* from pursuing fraudulent conveyance actions that the bankruptcy trustee should pursue for the common good of all.

In so ruling, Judge Randall cited the awkward phraseology of fraudulent conveyance law¹⁰²—a phraseology that speaks of conveyances being “set aside.”¹⁰³ Under such formulations, what the debtor gave away seems to remain with the debtor, so that a creditor's judicial lien might attach to it. Such language permitted Judge Randall to say that the debtor still owns property given away, when creditors can reach such property under fraudulent conveyance law:

An action under the Fraudulent Transfers Act is essentially one for property that properly belongs to the debtor and which the debtor has fraudulently transferred in an effort to put it out of the reach of creditors. The transferee may have colorable title to the property, but the equitable interest—at least as far as the creditors (but not the debtor) are concerned—is considered to remain in the debtor so that creditors may attach or execute judgment upon it as though the debtor had never transferred it. We think that when such a debtor is forced into bankruptcy, it makes the most sense to consider the debtor as continuing to have a “legal or equitable interest[]” in the property fraudulently transferred within the meaning of section 541(a)(1) of the Bankruptcy Code.¹⁰⁴

In this passage, however, Judge Randall could not help but admit that what *D* conveyed to *A* is *not* debtor property so far as the debtor is concerned. It is only debtor property in so far as individual creditors are concerned. This is tantamount to confessing that the debtor

100. See 11 U.S.C. § 362(a)(2), (3) (1982).

101. See *MortgageAmerica*, 714 F.2d at 1275.

102. See *id.* at 1273 (“The basic principle of a fraudulent transfers act, according to one court, is that ‘as to the creditors, the property continues in the debtor, and it or its proceeds are liable to the creditors’ demands.” (quoting *Hallack v. Hawkins*, 409 F.2d 627, 630 (6th Cir. 1969))).

103. UNIF. FRAUDULENT CONVEYANCE ACT § 9(1)(a), 7A U.L.A. 198 (1999).

104. *MortgageAmerica*, 714 F.2d at 1275 (citation omitted).

has no remaining property in what has been fraudulently conveyed. Rather, this property belongs solely to the transferee and to creditors, whose judicial liens might attach to the transferee's property.¹⁰⁵ The transferee has a present possessory right, and the creditors have a future right to attach judicial liens to this property, under which the initial transferee might be divested of her property.¹⁰⁶ The debtor has nothing whatever.

The better description of avoidance than that which *MortgageAmerica* supplies is that the debtor alienates all right, title and interest in the voidably conveyed property forever. In the case of fraudulent conveyance, individual creditors receive a present right to pursue the thing conveyed to A (and a future bankruptcy trustee separately obtains a future interest by virtue of section 548(a) of the Bankruptcy Code). A has the balance of the title. D has no title whatever to the thing, once D conveys it away.

Nevertheless, Judge Randall was able to rely on in *Whiting Pools*¹⁰⁷ that do indeed support her position,¹⁰⁸ however correct or incorrect, *Whiting Pools* may have been on its own. We have seen that *Whiting Pools* does indeed confirm that all avoidance powers come into the estate *ab initio* under section 541(a)(1). Therefore, under the reasoning of *Whiting Pools*, C's private fraudulent conveyance action violates the automatic stay.

(b) Property Only When Recovered

Orthodox theory has great difficulty with the problem at hand. It holds that debtor property comes into the estate by means of section 541(a)(1)—a successorship theory. A's property comes into the estate under section 550(a) because 550(a) is the very navel of all avoidance power. Furthermore, section 541(a)(3) brings in this property only when the trustee "recovers" it—whether recovery means filing an adversary proceeding, prevailing in that proceeding, or actually physically obtaining the property from A.

Section 541(a)(3) holds that the estate is comprised of certain designated items, including: "[a]ny interest in property that the trus-

105. Judge Randall more plausibly characterized a "trust fund" theory as property of the debtor prior to bankruptcy and reasoned that a creditor or a shareholder could bring such a cause of action, but it must be brought for both groups as a whole. Individual remedies did not exist. Since the action was one that unified both the creditors and the shareholders, and since the very personhood of the corporate debtor was this very unity, the action should be viewed as belonging to the unity—that is, to the debtor. See *id.* at 1269-72.

106. See Carlson, *supra* note 53, at 521-22, 524.

107. 462 U.S. 198 (1983).

108. See *MortgageAmerica*, 714 F.2d at 1275-76 ("The Supreme Court has, in fact, expressly noted that section '541(a)(1) is intended to include in the estate any property made available to the estate by other provisions of the Bankruptcy Code,' which would include property made available through section 544." (quoting *Whiting Pools*, 462 U.S. at 205)).

tee recovers under section 329(b), 363(n), 543, 550, 553, or 723.¹⁰⁹ The trustee *can* recover A's property under section 550(a)(1)—but has not yet done so. Perhaps, then, the fraudulently conveyed property is not part of the bankruptcy estate, prior to its actual recovery.

In support of this proposition is the fact that the trustee never avoids a transaction unless she brings an "adversary proceeding" within the meaning of Rule 7001 of the Federal Rules of Bankruptcy Procedure.¹¹⁰ So conceived, A's property is not part of the estate *ab initio*. Only the adversary proceeding (or recovery on the adversary proceeding) brings it in. Without a judgment in the adversary proceeding, A rightfully possesses the property fraudulently conveyed by D.¹¹¹

This view has been embraced by the Second Circuit in *Federal Deposit Insurance Corp. v. Hirsch (In re Colonial Realty Co.)*,¹¹² where Judge Daniel Mahoney renounced *MortgageAmerica*¹¹³ and held that voidably conveyed property enters the bankruptcy estate only by means of section 541(a)(3).¹¹⁴ On this view, the future interest of the trustee to recover is in the estate, but the present possessory right is beyond the estate.¹¹⁵

In *Colonial Realty*, the issue was the same as it was in *MortgageAmerica*: could C pursue fraudulent conveyances made by D, once the debtor was in bankruptcy? As the Fifth Circuit held in *MortgageAmerica*, the Second Circuit held that the automatic stay prevented such lawsuits, but on grounds much different from those

109. 11 U.S.C. § 541(a)(3) (1994).

110. See *Brady v. Andrew (In re Commercial W. Fin. Corp.)*, 761 F.2d 1329, 1336 (9th Cir. 1985).

111. On the other hand, the Supreme Court in *United States v. Nordic Village, Inc.*, 503 U.S. 30 (1992), wrote that "the right to recover a postpetition transfer under § 550 is clearly a 'claim' (defined in § 101(4)(A)) and is 'property of the estate' (defined in § 541(a)(3))." *Id.* at 37. This passage indicates that the Court views a mere claim not yet recovered as property of the estate.

112. 980 F.2d 125, 130-32 (2d Cir. 1992).

113. The theory of this case is discussed *supra* Part III.A.2.a.

114. See *Colonial Realty Co.*, 980 F.2d at 130-32. Actually, the right to recover fraudulent conveyances also comes in under section 541(a)(4): "Any interest in property preserved for the benefit of or ordered transferred to the estate under section 510(c) or 551 of this title." Section 551 in turn provides, "Any transfer avoided under section 522, 544, 545, 547, 548, 549, or 724(a) of this title, or any lien void under section 506(d) of this title, is preserved for the benefit of the estate but only with respect to property of the estate." 11 U.S.C. § 551 (1994). Notice that section 541(a)(4) can also be viewed as *not* bringing in the fraudulently conveyed property *ab initio* because only "avoided" property is preserved. Pending avoidance, nothing is preserved. See 1 DAVID G. EPSTEIN ET AL., *BANKRUPTCY* § 6-2, at 498-99 (1992) ("Transfers condemned through the avoiding powers are not automatically avoided in a bankruptcy case. Avoidance does not occur by operation of law. Rather, a person whom the Code empowers to avoid transfers must bring an action or proceeding to do so . . .").

115. See generally Plank, *supra* note 71, at 1222 (arguing that nonpossessory rights are beyond the reach of bankruptcy trustees).

which prevailed in *MortgageAmerica*.¹¹⁶ Specifically rejecting *MortgageAmerica's* reliance on section 541(a)(1), Judge Mahoney incorporated by reference the analysis to be found in *In re Saunders*,¹¹⁷ where Bankruptcy Judge Lewis Killian, Jr., wrote:

We think that the inclusion of property recovered by the trustee pursuant to his avoidance powers in a separate definitional subparagraph [i.e., § 541(a)(3)] clearly reflects the congressional intent that such property is not to be considered property of the estate until it is recovered. Until a judicial determination has been made that the property was, in fact, fraudulently transferred, it is not property of the estate. If it were, the trustee could simply use a turnover action under 11 U.S.C. § 542, and the two (2) year statute of limitations of § 546(a) for actions under §§ 544 and 548 could be avoided.¹¹⁸

If fraudulent conveyances do not enter the estate *ab initio*, how then can the automatic stay prevent private creditors from privately pursuing fraudulent conveyances in competition with the bankruptcy trustee? Judge Killian reasoned that creditors were barred by the automatic stay under section 362(a)(1), which prohibits:

the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title.¹¹⁹

Judge Killian figured that since a fraudulent conveyance action turned on the creditor's rights against the debtor, the pursuit of *A* was the same as the pursuit of *D*. On this analogy, *A* was protected by the automatic stay under section 362(a)(1).

The trouble with this view, however, is that it establishes that automatic stay protects all sureties of the debtor, since all such actions are founded on claims against the debtor as well. A principle that brings all sureties under the automatic stay cannot be recommended as sound. It is universally assumed that the automatic stay typically does not prohibit suits against the debtor's surety.¹²⁰

Because of the side effect on suretyship, Judge Killian's theory can hardly be accepted as sound. Orthodox theory must therefore

116. See *Colonial Realty*, 980 F.2d at 131-32.

117. 101 B.R. 303 (Bankr. N.D. Fla. 1989).

118. *Id.* at 305; see also *Colonial Realty*, 980 F.2d at 130-32; *Grossman v. Murray (In re Murray)*, 214 B.R. 271, 279 (Bankr. D. Mass. 1997). Some of these claims could be disputed. For instance, if turnover were an adjunct to actions under section 544, then turnover could last only so long as the section 544 theory lasts.

119. *In re Saunders*, 101 B.R. at 305 (quoting 11 U.S.C. § 362(a)(1)).

120. See Barry L. Zaretsky, *Co-Debtor Stays in Chapter 11 Bankruptcy*, 73 CORNELL L. REV. 213, 235-36 (1988).

admit that *C* does indeed have a present right to pursue *A*'s property selfishly. The automatic stay does not prevent these lawsuits because *A*'s property is beyond the bankruptcy estate.

Nevertheless, orthodox theory can be rehabilitated in part from its inability to make the automatic stay apply to preserve *A*'s property for the trustee's own fraudulent conveyance action. Even if, *ex hypothesi*, the trustee has no present right to *A*'s property until the trustee recovers it, the trustee still has a *future* interest in this property.¹²¹ At best, *C* could only get a judicial lien on *A*'s present possessory right, pending the trustee's future recovery. *C* would then be a transferee of a transferee under section 550(a)(2). Since *C* would have knowledge of the trustee's right, *C* is unentitled to the defense under section 550(b) and so would be liable to return any property *C* recovered from *A*. This complicated relation between *A*, *C*, and the bankruptcy trustee must be the position taken if the presently possessory rights to voidably conveyed property do not enter the estate *ab initio*, and pursuing third parties does not violate the automatic stay.

This is the best orthodox theory can do with the administration of *A*'s property prior to its actual recovery by the bankruptcy trustee. The strong-arm theory, however, has no trouble with this matter. Since the judicial lien attaches to all voidably conveyed property *ab initio*, *A*'s property is part of the estate from day one. Any attempt by *C* to interfere with this senior judicial lien is an illegal interference with estate property.

B. Moore v. Bay

The strong-arm theory insists that every avoidance power works in conjunction with the trustee's judicial lien or (in real estate cases) the trustee's mortgage.¹²² The "strong-arm" lien has a quantitative limit—the amount of unsecured claims represented by the trustee.

According to the Ninth Circuit,¹²³ such a view contradicts *Moore v. Bay*,¹²⁴ a landmark Supreme Court pronouncement upon avoidance power. The Ninth Circuit is mistaken, however. The strong-arm theory is reconcilable with *Moore*.

In *Moore*, a secured party neglected to perfect a security interest promptly, though it did perfect eventually.¹²⁵ In the gap of unperfection, a few unsecured creditors existed who, under now-repealed

121. See Carlson, *supra* note 53, at 522.

122. The status of a trustee as mortgagee to a debtor's prepetition real estate is discussed *supra* note 7.

123. See *Acequia, Inc. v. Clinton (In re Acequia, Inc.)*, 34 F.3d 800, 808-10 (9th Cir. 1994).

124. 284 U.S. 4 (1931).

125. See *Moore v. Bay (In re Sassard & Kimball, Inc.)*, 45 F.2d 449, 449 (9th Cir. 1930).

California law, could have avoided the security interest. The trustee, subrogated to the rights of these "gap" creditors,¹²⁶ sought to avoid the entire security interest (even though the quantity of gap credit was less than the amount of the security interest).¹²⁷ The Ninth Circuit Court of Appeals ruled that the bankruptcy trustee could avoid only so much of the security interest as corresponded with the gap credit.¹²⁸ The Supreme Court, however, reversed.¹²⁹ In a famously cryptic opinion, Justice Oliver Wendell Holmes wrote that the trustee "gets the title to all property which has been transferred by the bankrupt in fraud of creditors."¹³⁰

Moore is taken as establishing two propositions about the trustee's subrogation powers, now found in Bankruptcy Code section 544(b)(1): (1) If a transfer is void against even one actual creditor, it is entirely void against all creditors; and (2) all the creditors share the loot—not just the ones who held the avoidance right to which the trustee was subrogated.¹³¹

Nothing in *Moore* disrupts the strong-arm theory being described here, which states that the trustee's avoidance power is measured by the extent of her representative capacity. In other words, the trustee represents a limited amount of unsecured claims. When those claims are paid, the trustee's avoidance rights come to an end. *Moore* does not hold that there can be *no* limit to the trustee's avoidance power. It holds only that, when the trustee is subrogated to the avoidance right of a single creditor, the single creditor's claim is not the limit.¹³² The possibility of limit is not negated entirely. Hence, the limit suggested by the strong-arm theory does not contradict *Moore*.¹³³

126. This subrogation right can now be found in Bankruptcy Code section 544(b). See 11 U.S.C.S. § 544(b) (Law. Co-op 1994 & Supp. 1998).

127. See *Moore*, 45 F.2d at 449.

128. See *id.* at 450.

129. See *Moore*, 284 U.S. at 5.

130. *Id.*

131. See generally John C. McCoid, II, *Moore v. Bay: An Exercise in Choice of Law*, 1990 ANN. SURV. BANKR. L. 157.

132. See *Moore*, 284 U.S. at 5.

133. Thomas Jackson, an opponent of *Moore*, opposes any view that harnesses *Moore* to the strong-arm power. See Thomas H. Jackson, *Avoiding Powers in Bankruptcy*, 36 STAN. L. REV. 725, 752 (1984). Instead, Jackson argues the trustee should be subrogated only to the real creditors' claims. Thus, if a belatedly recorded mortgage for \$1 million can be avoided by a real creditor who claims \$1, Jackson would say that the strong-arm power, as to this mortgage (which is perfected as of the day of bankruptcy), should be worth only \$1. See *id.* at 742-50.

Grant Gilmore thought that, consistent with *Moore*, the trustee's strong-arm power constitutes the quantitative limit to the subrogation power of a bankruptcy trustee:

Which brings us back full circle to what we assumed Justice Holmes would have said in *Moore v. Bay* if he had dotted his i's and crossed his t's: [the strong-arm power] merely supplements [the trustee's subrogation power] by conferring lien status on the trustee in his representation of existing or actual creditors if applicable state law provides that only lien creditors can avoid the challenged transaction.

The opposite view is expressed by the Ninth Circuit in *Acequia, Inc. v. Clinton (In re Acequia, Inc.)*.¹³⁴ This case, on its face, takes the wrong view of fraudulent conveyance avoidance in bankruptcy. Using our now-familiar numbers for ease of illustration, let us say that the aggregate claims of all the unsecured creditors in *Acequia* amounted to \$50, and that the debtor had fraudulently transferred a \$100 thing to A. Under section 544(b)(1), which subrogates the debtor-in-possession to the state law rights of some actual creditor, the debtor-in-possession should have been able to recover only \$50 because \$50 represents the outward limit of the strong-arm power.

Judge Cynthia Holcomb Hall, however, mistakenly ruled that the entire \$100 thing should be recovered. Judge Hall reasoned that *Acequia* was a standard application of *Moore*, which allows the trustee to avoid the whole thing if even a creditor claiming only a dollar has the right to avoid the transfer under state fraudulent transfer law.¹³⁵ This would have been adequate if the debtor were insolvent. In such a case, the trustee's hypothetical judicial lien would exceed the full \$100 transfer. But, in *Acequia*, the debtor was solvent. The trustee should have recovered a fraudulent transfer only to the extent of the trustee's representative capacity. The surplus should have belonged to A, but Judge Hall's decision allows the trustee to take back a gift that—though fraudulent as to creditors—is otherwise completely valid. The bankruptcy surplus therefore belonged to D, not to A.

In so ruling, Judge Hall was worried that, if section 544(b) recoveries were limited by the strong-arm power, allocative absurdity might result. Quoting the trustee's brief, Judge Hall wrote:

Let's assume that the president of a corporation transfers \$3 million of corporate assets to his personal account over a period of three years prior to the filing of a bankruptcy petition. The transfers are made by writing separate checks of \$1 million each year. The last \$1 million transfer was made within one (1) year before the filing of the bankruptcy petition . . . At the time the bankruptcy petition was filed, there existed ten unsecured creditors with claims totaling \$500,000.

2 GILMORE, *supra* note 10, § 45.3.2, at 1295. In truth, this passage is not precisely on point. Gilmore here referred to outmoded state law according to which gap creditors who *later* obtained liens might avoid the unperfected chattel mortgage, even though their liens post-date perfection. So conceived, such legislation declared unperfected security interests to be fraudulent conveyances—voidable by any gap creditor. Article 9, in contrast, gives no such right to gap creditors. Rather, creditors must actually obtain their liens in the gap. See U.C.C. § 9-301(1)(b) (1995). Gilmore thus thought that, when an actual gap creditor existed, and when the debtor later filed for bankruptcy, the trustee, as representative of all gap creditors, could avoid the unperfected lien under the strong-arm power. This passage nevertheless shows some consciousness that Gilmore viewed the strong-arm power as the primary organizing theme of all other avoidance powers.

134. 34 F.3d 800 (9th Cir. 1994).

135. See *id.* at 808-10.

In this scenario, under § 548(a) the trustee may avoid only the \$1 million transfer that occurred within one year before the filing of the bankruptcy petition. Under § 544(b), the trustee may clearly avoid the \$1 million transfer made two years before the filing of the bankruptcy petition . . . Under [the defendant's] analysis, the trustee may not avoid the first \$1 million transfer, even though it violated § 544(b), because that transfer exceeds the claims of the unsecured creditors. If, however, the first and second transfers occurred by the president writing one \$2 million check instead of two \$1 million checks, then [the defendant] concedes that the entire \$2 million would be voidable.¹³⁶

The mistake here, fueled by the defendant's too-generous concession, is that section 548(a) avoids the full \$1 million check or the \$2 million check, if they are cashed within the one-year period of section 548(a). Under the strong-arm theory, the trustee could avoid these transfers only to the extent of the trustee's strong-arm power. Thus, since the trustee represents \$500,000 of unsecured claims, the trustee could recover only that amount under either of the above scenarios. The balance of the recovery would belong to the third party transferee. Thus, no allocational absurdity exists.

Somewhat differently, Judge Hall raises the following concern:

[S]uppose a debtor with \$50 in unsecured claims makes avoidable transfers of \$10, \$20, and \$45. Under [the defendant's] reasoning, the *order* in which a trustee sought to recover the transfers would determine their avoidability. For example, by pursuing the \$10 and \$20 transfers first, the trustee could later avoid the \$45 transfer in full. By recovering the \$45 transfer first, however, the trustee could later avoid either the \$10 or \$20 transfers, but not both, because the final avoidance action would commence after the trustee had received an amount in excess of the unsecured claims. We refuse to interpret the Bankruptcy Code in such an arbitrary way.¹³⁷

Thus, Judge Hall fears that, by manipulating the order in which recovery is sought, the trustee might recover either \$75, \$65, or \$55 at her whim. Under the theory being defended here, the trustee could recover only \$50, no matter what chronological order the trustee chooses to follow in avoiding these fraudulent transfers. To be sure, allocational choice cannot be avoided. If the above three fraudulent conveyances are made to different people, the trustee may choose which of the persons will bear the loss. But this is simply the ordinary phenomenon of joint and several liability of intentional torts, wherein the defendants are subject to the plaintiff's caprice in pursuing one but not the other of the defendants. Such allocational ca-

136. *Id.* at 810.

137. *Id.* (emphasis added).

price cannot be avoided. It should not be used to prove that *A* has no right to a surplus when the trustee's representative capacity has been exhausted.

Of course, Judge Hall's decision guarantees that recovery would adhere to equity participants, not to the creditors, who had already been paid. Nevertheless, she reasoned that the trustee was entitled to recover whenever the "estate" would be benefited. This last phrase echoes section 550(a), which provides that "the trustee may recover, for the benefit of the estate, the property transferred" to *A*.¹³⁸ At least prior to confirmation of the plan, "the estate" does not merely comprehend sufficient property to pay off creditors. Equity participants also have claims against "the estate," and so Judge Hall was justified in finding that section 550(a) supports the notion that recoveries can outstrip the trustee's representative capacity. Her error was in assuming the centrality of section 550(a) in the first place. The strong-arm theory holds that "avoidance" merely suspends third party rights so that the trustee's judicial lien or mortgage can attach to it. Under this alternate theory, windfalls to the equity participants are avoided. The debtor may be the heir to the trustee's strong-arm power, but, if the representative capacity of the trustee has already been exhausted, the debtor inherits nothing.

C. Nonrecourse Security Interests

In the typical bankruptcy avoidance case, *D* conveys a \$100 thing to *A* and has debts of, say, \$1 million. In such a case, one need not be too fine about avoidance theory. Whether the strong-arm theory or section 550(a) reigns, *A* loses the thing entirely if the conveyance is voidable for any reason.

Suppose, however, that *D* has only \$50 of *in personam* debts and has borrowed nonrecourse from *A* for \$1 million. *D* has granted *A* a security interest on *D*'s \$100 thing. *A*, however, has not perfected the security interest. That is, *D* has no *in personam* liability to *A*, and *A*'s security interest is simultaneously subordinated and avoided in *D*'s bankruptcy.

If *A* has no recourse,¹³⁹ then avoidance of the lien means that *A* has no claim in the bankruptcy at all.¹⁴⁰ In such a case, the trustee

138. 11 U.S.C. § 550(a) (1994) (emphasis added).

139. *A* would be wise to insist, if possible, upon a warranty that the security interest is validly perfected. Breach of such a warranty would generate recourse and obviate the problems about to be discussed.

140. This conclusion is not easily reached from the text of the Bankruptcy Code. According to section 102(2), a "claim against the debtor" includes a "claim against [the] property of the debtor." *Id.* § 102(2). Nothing in section 502, however, clearly explains the extent to which a nonrecourse lender has a claim. According to section 502(b)(1), a bankruptcy court is required to disallow a claim that "is unenforceable against the debtor and property of the debtor." *Id.* § 502(b)(1). Therefore, the nonrecourse secured creditor may

can sell the collateral free and clear of A's lien. This is the qualitative moment of avoidance arising from the strong-arm power. In addition, A, not D, should own the \$50 surplus. This result reflects the quantitative limitation on the trustee's recovery. A's security interest is "subordinated," not "avoided."

These are the facts and (roughly) the result in *Vintero Corp. v. Corporacion Venezolana de Fomento (In re Vintero Corp.)*.¹⁴¹ In this case, decided under the Bankruptcy Act of 1898, a debtor gave a secured party a nonrecourse security interest in ships, which were perfected under Virginia's U.C.C.¹⁴² Prior to bankruptcy, these ships sailed lazily across the Chesapeake to Maryland, gently tacking against the soft southerly breezes that sweep benignly over those placid waters. This easy voyage must have been a delight for the happy crew; no doubt their rations of hard tack and sea biscuit were leavened with fresh oysters and Maryland blue crabs, easily garnered from the generous cornucopia of the Chesapeake. It was, however, a scurvy trip for the secured creditor, who, like a seasick landlubber, found even that easy voyage too much to stomach. The effect of this three-hour tour was eventual de-perfection of the security interest.¹⁴³ The encumbrance was scraped clean from the hull of each

not collect any deficit claim because it is "unenforceable against the debtor." *Id.* Meanwhile, the collateral itself is encumbered by the trustee's judicial lien which will, in whole or part, limit the amount of recovery the secured creditor might obtain from the collateral. The nonrecourse secured creditor who has failed to perfect obtains no value from the collateral and is precluded from obtaining any deficit from the bankruptcy estate.

141. 735 F.2d 740 (2d Cir. 1984).

142. See *id.* at 741. Presumably, the secured party, a foreign corporation taking a mortgage on foreign vessels, was ineligible to take a mortgage under the Ship Mortgage Act of 1920. See 46 U.S.C. §§ 30101(1), (3), 31322(a)(1)(c). See generally MICHAEL DOWNEY RICE, ASSET FINANCING 318-23 (1989). While the Ship Mortgage Act allows for a certain priority against other maritime liens, it is still possible to perfect a security interest under Article 9, which, while not good against maritime liens, is at least good against state-law judicial lien creditors and hence against bankruptcy trustees. See *id.* at 310-13; *In re H & S Trans. Co.*, 42 B.R. 164, 165 (Bankr. M.D. Tenn. 1984) (concluding that trustee may not hypothesize maritime lien status). But see *In re Alberto*, 66 B.R. 132, 139 (Bankr. D.N.J. 1985) (holding that Article 9 perfection is not good enough for a vessel that could be perfected under the Ship Mortgage Act of 1920), *rev'd on other grounds*, 823 F.2d 712 (3d Cir. 1987).

143. It is not clear why this should have been so. Presumably vessels are "mobile goods" within the meaning of the U.C.C., which provides:

This subsection applies to accounts . . . and general intangibles . . . and to goods which are mobile and which are of a type normally used in more than one jurisdiction, such as motor vehicles, trailers, rolling stock, airplanes, shipping containers, road building and construction machinery and commercial harvesting machinery and the like, if the goods are equipment or are inventory leased or held for lease by the debtor to others, and are not covered by a certificate of title . . .

U.C.C. § 9-103(3)(a) (1995). Although vessels are not mentioned expressly, shipping containers are, and so we can assume that vessels are mobile goods.

Ordinarily, perfection of security interests in mobile goods is governed by the law where the debtor is located. See *id.* § 9-103(3)(b).

vessel like an unwanted barnacle, and no sooner was this accomplished but the debtor filed for bankruptcy under old chapter XI of the Bankruptcy Act. Because the secured party was a nonrecourse creditor, the failure to perfect its security interest arguably implied that the secured creditor had no claim at all in the bankruptcy.¹⁴⁴

Judge Ellsworth Van Graafeiland nevertheless ruled that the unperfected security interest was good against the debtor:

[A]lthough [the debtor-in-possession] could exercise the rights of a lien creditor, it obviously was not one. Filing requirements are for the benefit of third parties, not the debtor. . . . [The debtor] was given the right to avoid [the] security interest in order to protect such third parties, not to create a windfall for [the debtor] itself. [The debtor] suffered no prejudice because of the lapse in filing, and we see no reason why it should benefit from such lapse. To the extent that other creditors . . . are not affected adversely by enforcement of [the] security interest, there is no reason why such interest should not be enforced.¹⁴⁵

This passage contains some unsatisfactory metaphysics. How could a trustee with all the rights of a lien creditor not *be* a lien creditor? If a thing has all the properties of a duck, is it not a duck? Putting aside this problem, the above-quoted passage says, in essence, that the strong-arm power should not be used to benefit the debtor-in-possession personally, in its private capacity. Rather, the strong-arm

If, however, the debtor is located in a jurisdiction which is not a part of the United States, and which does not provide for perfection of the security interest by filing or recording in that jurisdiction, the law of the jurisdiction in the United States in which the debtor has its major executive office in the United States governs the perfection . . . of the security interest through filing.

Id. § 103(3)(c). Hence, a filing where the debtor had its major executive office in the United States would have perfected the security interest no matter where the vessels went.

144. These were the balmy days before the section 1111(b)(1)(A), which grants "artificial recourse" to nonrecourse creditors. See David Gray Carlson, *Undersecured Creditors Under Bankruptcy Code Sections 506(a) and 1111(b): Second Looks at Judicial Valuations of Collateral*, 6 BANKR. DEV. J. 253, 279-82 (1989). In any case, it appears that *Vintero* planned to sell the collateral, at least in part. Hence, the recourse provision of section 1111(b)(1)(A) would not have applied.

According to a more recent Second Circuit opinion, security interests in airplanes and vessels covered by Bankruptcy Code section 1110(a) are not subject to trustee avoidance powers. See *California Chieftan v. Air Vermont, Inc.* (*In re Air Vermont, Inc.*), 761 F.2d 130, 133-34 (2d Cir. 1985). Section 1110(a) requires a chapter 11 debtor to "cure" all defaults in a ship mortgage or release it to the debtor 60 days after the petition is filed, but the secured party must claim a mortgage under the Ship Mortgage Act of 1920, which the secured party in *Vintero* was unable to do.

Elsewhere, I presented the argument that lapsed perfection, as in *Vintero*, should never give rise to voidable preference recoveries because of the nature of the hypothetical judicial lien test in section 547(e)(2)(A). See David Gray Carlson, *Lapsed Perfection of Security Interests Under the Bankruptcy Code*, 30 UCC L.J. 126, 158 (1997) [hereinafter Carlson, *Lapsed Perfection*]. The merits of this theory notwithstanding, the case law weighs heavily against the secured party who allows perfection to lapse.

145. *Vintero*, 735 F.2d at 742 (citations omitted).

power could only be used to the extent of the debtor's fiduciary capacity as creditor representative. In short, the strong-arm power had a quantitative limit, defined by the amount of debt the debtor-in-possession represented.

There is a strong hint in *Vintero* that the debtor was a *solvent* chapter XI debtor. If the security interest were to be avoided, the secured party would have no debt claim against the debtor at all and would lose its security interest as well. The debtor would then have received a gift of the artificially created debtor equity. Judge Van Graafeiland could not abide by this. Noting that the nonrecourse nature of A's claim does not rule out A's security interest in cash proceeds, Judge Van Graafeiland ruled:

On the other hand, substantial justice and established law mandate that, despite its security interest, [the secured party] shall not be entitled to priority of payment over other creditors but *must share alike with them*.

On the assumption that [one of the ships] will be sold as part of [the debtor's] plan of arrangement, we hold that [the secured party's] security interest shall attach to the identifiable proceeds of the sale, but that such security interest shall not entitle [the secured party] to a priority of payment as against [the debtor's] general unsecured creditors. Such disposition will protect the interests of [the debtor's] creditors, will recognize the merit of [the secured party's] substantial claim, and will preclude the possibility of [the debtor] reaping an undeserved windfall.¹⁴⁶

Judge Van Graafeiland was correct that A should have a right in the proceeds of its collateral but incorrect on holding that A's rights have the same priority as the other unsecured creditors. In effect, Judge Van Graafeiland turned A into a recourse creditor who could share pro rata with the other creditors. Since D was solvent, this decision guaranteed that A would be fully compensated. In short, Judge Van Graafeiland reasserted the circularity that guarantees total payment of A by granting A recourse.

This opinion, liberally reinterpreted, arguably stands for the proposition that the unperfected security interest was not avoided, but only subordinated.¹⁴⁷ As a result, the general creditors, through the strong-arm power, had priority to the cash proceeds of the collateral. The secured party, as a junior secured creditor, owned the surplus. But Judge Van Graafeiland went too far in ruling that the secured party should *share* with the other general creditors in the pro-

146. *Id.* at 742-43 (emphasis added) (citations omitted).

147. One authority reads *Vintero* as giving birth to the notion that the strong-arm power can be applied only if creditors are benefited. See *Greenbelt Coop., Inc. v. Werres Corp.* (*In re Greenbelt Coop., Inc.*), 124 B.R. 465, 472-74 (Bankr. D. Md. 1991). This latter interpretation amounts to the view that the strong-arm power is founded on subordination, not avoidance.

ceeds. This formulation is fine when the debtor was solvent, but it unduly punishes the unsecured creditors (and awards a windfall to the nonrecourse creditor) when the debtor is insolvent. Based on the numbers used above, if the nonrecourse secured party claimed \$150, the other creditors claimed \$50, and the collateral sold for \$100, then under Judge Van Graafeiland's holding, each creditor would receive fifty cents on the dollar. The secured party would obtain a \$75 recovery on this theory, and the unsecured creditors would receive \$25. This result would have been entirely justified if the secured party had recourse against the debtor. But the secured party had no recourse. Hence, the general creditors should have recovered 100 cents on the dollar, or \$50; the secured party should have taken the surplus of \$50. Under Judge Van Graafeiland's theory, the secured party would obtain more—\$75—and the general creditors would have received less—only twenty-five dollars.¹⁴⁸

But for this conceptual misstep, *Vintero* stands for the proposition that avoidance does not mean obliteration but only subordination. Because *Vintero* emphasized subordination over avoidance,¹⁴⁹ the debtor gained no windfall while its nonrecourse creditor went unpaid.¹⁵⁰

148. Judge Van Graafeiland did not explain how a nonrecourse, unperfected secured party gets recourse solely because a creditor has obtained a senior judicial lien. Bankruptcy Code section 1111(b)(1)(A) was not applicable to the case. Perhaps the bankruptcy trustee had converted the unperfected secured party's property to its own use, though it is hard to argue that the bankruptcy trustee acted wrongfully when the U.C.C. invited it to take priority without regard for the secured party's rights. Hence, in the absence of a theory of *in personam* liability of the debtor or trustee, it must be concluded that Judge Van Graafeiland wrongly granted a recourse claim to the secured party.

149. Avoidance, which I have equated with the senior power of sale, was referred to in the *Vintero* case. See *Vintero*, 735 F.2d at 742 ("If, as is more likely, the ship has to be sold in order to satisfy the claims of [the debtor]'s creditors, the debtor, of course, must be able to convey a title unencumbered by [the secured party's] lien.").

150. For another case in which a court refused to declare an unperfected security interest void when the debtor was solvent, see *In re Chapman*, 51 B.R. 663, 665-66 (Bankr. D.D.C. 1985). Although Judge Bason perceived himself as simply refusing to apply the strong-arm power at all, the decision could easily be viewed as one that emphasizes "subordination" theory of the strong-arm power over the "avoidance" theory.

In considering a nonrecourse, unperfected security interest, Judge Francis Conrad saw only avoidance and no subordination in the strong-arm power. In *Official Committee of Unsecured Creditors of St. Johnsbury Trucking Co. v. Bankers Trust Co.* (*In re St. Johnsbury Trucking Co.*), 174 B.R. 186 (Bankr. D. Vt. 1994), Judge Conrad implied that the strong-arm power does not merely prime unperfected security interests, but destroys them entirely (though Judge Conrad also recognized that these "avoided" security interests are in fact "preserved" under section 551 after all). "It makes no sense to measure the recovery under an avoiding power in terms of a class of creditor which might or might not actually exist," he wrote. *Id.* at 188. This remark is harmless in the typical case, but, as the analysis of *Vintero* showed, it results in wealth transfers from secured creditors to solvent debtors when the unperfected security interest is nonrecourse. Those following the section 550(a) theory have no mechanism to explain how A's nonrecourse claim might be enforced against a surplus in the \$100 thing once the trustee's \$50 judicial lien is satisfied.

D. Voidable Preferences

In *Vintero*, the court, more or less, found a quantitative limit to the trustee's strong-arm right against an unperfected security interest. Of course, security interests unperfected on the day of bankruptcy are not only "subordinated" to the rights of the trustee as lien creditor, but are "avoided" as preferences as well. Hence, *Vintero*, a strong-arm case, could have been a voidable preference case.¹⁵¹ Section 544(a) refers (indirectly) to subordination,¹⁵² but section 547(b) uses only the word "avoid." It would be convenient, in a case like *Vintero*, if the word "avoid" did not mean "disappear;" otherwise, *D* alone would profit because *A*'s security interest was a voidable preference. Surely only unsecured creditors of *Vintero*—not *D*—should benefit from voidable preference liability.

The strong-arm theory presented here solves this problem. According to this theory, "avoidance" under section 547(b) does not mean that the security interest disappears. It only means that *A*'s security interest is made susceptible to the trustee's hypothetical judicial lien. Beyond the strong-arm power, the unperfected security interest is still good. Once this judicial lien has exhausted itself—in other words, the creditors have been fully paid—the avoidance power under section 547(b) is likewise exhausted.¹⁵³ *A*'s unperfected security interest then continues to exist. The unperfected secured creditor can use it to claim the surplus after the recourse creditors are paid.

The strong-arm theory solves a different, otherwise intractable voidable preference problem with regard to rents in real estate cases. For the purpose of illustrating this point, assume that *A* has a recorded mortgage. The mortgaged premises have been rented out to

151. Judge Van Graafeiland emphasized the trustee's status as a lien creditor under U.C.C. § 9-301(1)(b), but he also alluded to the security interest being a preference. See *Vintero*, 735 F.2d at 740-41. In fact, *Vintero* was a case of lapsed perfection. I have argued elsewhere that lapse of perfection can never be a voidable preference. It can only be a strong-arm matter if unperfection still exists on bankruptcy day. Where lapse is cured before bankruptcy, the security interest ought not to be voidable at all. See Carlson, *Lapsed Perfection*, *supra* note 144, at 129.

152. Actually, section 544(a) says that the trustee has "the rights and powers" of a judicial lien creditor or may "avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by" a judicial lien creditor. 11 U.S.C. § 544(a) (1994). Since U.C.C. § 9-301(1)(b) allows only for subordination and not avoidance, subordination is the relevant concept for the strong-arm power. See Frank R. Kennedy, *The Trustee in Bankruptcy as a Secured Creditor Under the Uniform Commercial Code*, 65 MICH. L. REV. 1419, 1429 & n.40 (1967).

153. See *Olsen v. Russell (In re Kleckner)*, 81 B.R. 464, 465-66 (Bankr. N.D. Ill. 1988) (pleadings that invoked section 547(b) also thereby invoked section 544(a) as well). This is not to say that a trustee has the duty to bring an action under section 544(a) before she can avoid a preference. See *Mayka v. Dollar Bank (In re Biggs, Inc.)*, 159 B.R. 737, 745 (Bankr. W.D. Pa. 1993). It is only to say that, when a trustee sues under a voidable preference theory, the trustee's hypothetical judicial lien attaches to the property that was otherwise transferred to the debtor. *But see id.* ("Moreover, the trustee's avoiding powers as set forth in Sections 544 through 549 are self-contained They are not interdependent.").

tenants, and the tenants owe rent. These obligations of the tenants I will call "rent receivables." A mortgage lien automatically attaches to these rent receivables. The question at hand is whether the lien on the receivables is a voidable preference. The validity of the underlying mortgage is not at issue.

Some background on mortgages is necessary to set the scene. By way of warning, the real estate law of mortgages is extremely diverse, and applications of federal avoidance law to them are even more so. Many authorities will disagree with the account that follows, but at least some courts would have agreed (prior to 1994) that mortgage liens on rent receivables fall prey to the trustee's strong-arm power when a debtor in possession of real estate files for bankruptcy.¹⁵⁴

Real estate liens on rent receivables often differ from U.C.C. security interests in a subtle but important way. Under the U.C.C., a security interest on personal property implies a security interest on proceeds.¹⁵⁵ If encumbered personal property is rented out, rent receivables are proceeds, belonging to the secured party. If the debtor collects rent, the secured party claims a lien on all cash collected, so long as it can still be identified.¹⁵⁶

Not so in real estate. In many states, tenants owe rent to the possessor of the reversionary interest. In the typical mortgage, the debtor is left in possession. Accordingly, until dispossessed, the debtor owns all rents free and clear of the mortgage lien to the extent they are actually collected. That is to say, the very act of collecting disencumbers the mortgage lien on the receivable, so that the debtor owns any dollar actually collected free and clear.¹⁵⁷ Under the U.C.C., the secured party would have owned those dollars.

154. For a useful state-by-state appendix, see Glenn R. Schmitt, *The Continuing Confusion Over Real Property Rents as Cash Collateral in Bankruptcy: The Need for a Consistent Interpretation*, 5 DEPAUL BUS. L.J. 1, 56-58 (1992). For a detailed description of the diversity of law on mortgages and avoidance, see David Gray Carlson, *Rents in Bankruptcy*, 46 S.C. L. REV. 1075 (1995).

155. See U.C.C. § 9-306(2) (1995).

156. *But see* American President Lines, Ltd. v. Lykes Bros. Steamship Co. (*In re* Lykes Bros. Steamship Co.), 216 B.R. 856, 864 (Bankr. M.D. Fla. 1996) (holding incorrectly that rent is not proceeds because the property is not allegedly disposed of).

157. See Carlson, *supra* note 154, at 1091-97. After realizing the consequence of such a rule upon real estate bankruptcies, some pro-creditor state legislatures changed the law of rent receivables, in order to conform to the U.C.C. rule. See, e.g., Act of Oct. 5, 1991, ch. 501, 1991 Cal. Legis. Serv. (West) (codified as amended at CAL. CIV. CODE § 2938 (West 1997)); Act of Oct. 1, 1987, ch. 217, § 1, 1987 Fla. Laws 1346, 1346 (codified as amended at FLA. STAT. § 697.07 (1997)); Act of Apr. 27, 1989, ch. 213, § 2, 1989 Tenn. Adv. Legis. Serv. (codified as amended at TENN. CODE ANN. § 66-26-116 (1998)). For a discussion of such legislation, see Bonnie Kay Donahue & W. David Edwards, *The Treatment of Assignments of Rents in Bankruptcy: Emerging Issues Relating to Perfection, Cash Collateral, and Plan Confirmation*, 48 BUS. LAW. 633, 654-68 (1993).

Suppose, prior to dispossession, a judicial lien creditor garnishes a tenant. Such a creditor obtains all debtor property in the receivable. Since the debtor can collect rent free and clear of the senior mortgage, so can a judicial lien creditor.¹⁵⁸ But the lien creditor takes *only* the debtor's interest in the rent receivable—nothing more. Just as mortgagee can dispossess the debtor and end the debtor's power to disencumber rent receivables, the mortgagee can do the same to a judicial lien creditor.¹⁵⁹ In short, a judicial lien creditor can obtain temporary superiority to the real estate mortgage, but the mortgagee can take back the receivable by the appropriate dispossessory act.

Prior to 1994, it was commonly held that when a debtor goes bankrupt before any act of dispossession, the bankruptcy trustee inherits the debtor's power to disencumber rent receivables. In the case of real estate, the trustee is both the purchaser of the real estate and a judicial lien creditor. Both parties succeed to the debtor's right to disencumber rent receivables through collection. Rents collected by the bankruptcy trustee therefore belong to the bankruptcy estate free and clear of the mortgage. That is to say, the rents collected are not cash collateral.¹⁶⁰

The mortgagee continues to own the right to terminate the power of any purchaser or lien creditor to collect rent receivables free of the mortgage lien. This power might ordinarily be subject to the automatic stay, preventing any creditor perfection of liens. But Bankruptcy Code section 362(b)(4) makes clear that acts described under section 546(b) are not stayed. And, as it turns out, section 546(b) does indeed describe the mortgagee's act of dispossession,¹⁶¹ and even sub-

158. See *Commerce Bank v. Mountain View Village, Inc.* (*In re Mountain View Village*), 5 F.3d 34, 39 (3d Cir. 1993) ("We recognize that mortgagees have no right to the rents until a default has occurred and, before they give notice, a junior lienor can attach rents that otherwise would come into the possession of the mortgagor.").

159. In *In re Wheaton Oaks Office Partners, Ltd.*, 27 F.3d 1234 (7th Cir. 1994), Judge Daniel Manion wrote:

[U]nder Illinois law, even if a junior lienholder "wins the race" to possession, his right to collect the rents is still subject to the previously recorded, yet unenforced rent assignment of a previous mortgagee. If it were not so, that is, the mortgagee's superior right to the rents could be extinguished by virtue of an intervening judgment creditor, then how could the Illinois Supreme Court . . . declare the intervening judgment creditor to be a "subordinate" lienholder?

Id. at 1245.

160. Many courts declare the security interest on rents to be "perfected" and hence totally valid against the trustee's strong-arm power. In other words, recording is said to be perfection, and many courts think this observation closes the matter. Debtor dispossession is said to be an "enforcing" act, not a "perfecting" act. See, e.g., *Commerce Bank*, 5 F.3d at 39; *Vienna Park Props. v. United Postal Sav. Ass'n* (*In re Vienna Park Props.*), 976 F.2d 106, 111 (2d Cir. 1992); *In re Columbia Office Assocs. Ltd.*, 175 B.R. 199, 202 (Bankr. D. Md. 1994); James McCafferty, *The Assignment of Rents in the Crucible of Bankruptcy*, 94 COM. L.J. 433, 471 (1989) (equating perfection with public notice). This view simply ignores the fact that the trustee's hypothetical purchase of real estate permits collection free and clear of the mortgage lien until the purchaser is actually dispossessed.

161. Section 546(b) provides:

stitutes notice to the trustee in lieu of the dispossessory act.¹⁶² Section 546(b) implies that the trustee has only *temporary* strong-arm rights against rent receivables.¹⁶³

One of the unacknowledged mysteries of real estate bankruptcies is: Why don't trustees cry "voidable preference!" whenever a mortgagee dispossesses the debtor within ninety days of bankruptcy? Section 547(b) "avoids" transfers by the debtor. Hence, the trustee might take back the receivable and keep all proceeds from it. Furthermore, under section 547(e)(2)(B), the lien on the rent receivable is deemed to be transferred to the mortgagee only when the mortgagee takes sufficient action to assure that a subsequent bona fide purchaser of the real estate could not take a superior right to the rent. Only when the mortgagee dispossesses the debtor does the mortgagee have a

(1) The rights and powers of a trustee under sections 544, 545, and 549 of this title are subject to any generally applicable law that—

(A) permits perfection of an interest in property to be effective against an entity that acquires rights in such property before the date of such perfection; . . .

. . . .

(2) If— (A) [such] a law . . . requires seizure of such property or commencement of an action to accomplish such perfection . . . and;

(B) such property has not been seized or such action has not been commenced before the date of the filing of the petition; such interest in such property shall be perfected . . . by giving notice within the time fixed by such law for such seizure or commencement.

11 U.S.C. § 546(b) (1994).

162. This is established in the last sentence of section 546(b). See *supra* note 161.

163. See, e.g., *Virginia Beach Fed. Sav. & Loan Ass'n. v. Wood*, 901 F.2d 849, 852-53 (10th Cir. 1990) (per curiam) (Oklahoma law); *Wolters Village, Ltd. v. Village Props., Ltd. (In re Village Props., Ltd.)*, 723 F.2d 441, 445 (5th Cir. 1984) (Texas law); *Waldron v. Northwest Acceptance Corp. (In re Johnson)*, 62 B.R. 24, 27 (B.A.P. 9th Cir. 1986) (Washington law); *Consolidated Capital Income Trust v. Colter, Inc. (In re Consolidated Capital Income Trust)*, 47 B.R. 1008, 1011 (Bankr. D. Colo. 1985) (Colorado law).

Many courts have professed themselves unable to find any relation back theory under state law. Because section 546(b) requires relation back, these courts have proclaimed the mortgage lien on rent receivables as entirely subordinate to the trustee's strong-arm power. See *Sears Sav. Bank v. Tucson Indus. Partners (In re Tucson Indus. Partners)*, 129 B.R. 614, 623 (B.A.P. 9th Cir. 1991) (Arizona law); *In re Princeton Overlook Joint Venture*, 143 B.R. 625, 632 (Bankr. D.N.J. 1992); *In re Harbour Town Assocs.*, 99 B.R. 823, 825-26 (Bankr. M.D. Tenn. 1989); *Northwestern Nat'l Life Ins. Co. v. Metro Square (In re Metro Square)*, 93 B.R. 990, 998-1000 (D. Minn. 1988) (Minnesota law); *Exchange Nat'l Bank v. Gotta (In re Gotta)*, 47 B.R. 198, 202 (Bankr. W.D. Wis. 1985).

For what it is worth, Justice Antonin Scalia in *United Savings Ass'n of Texas v. Timbers of Inwood Forest Associates*, 484 U.S. 365 (1988), cited with apparent approval cases in which the strong-arm power avoided in whole or in part security interests on rent receivables. See *id.* at 374 ("Section 552(b) sets forth an exception, allowing postpetition 'proceeds, product, offspring, rents, or, profits' of the collateral to be covered only if the security agreement expressly provides for an interest in such property, and the interest has been perfected under 'applicable nonbankruptcy law.'") (citing *Casbeer v. State Fed. Sav. & Loan Ass'n (In re Casbeer)*, 793 F.2d 1436, 1442-44 (5th Cir. 1986) (partial avoidance under Texas law)); see also *Waldron*, 62 B.R. at 28-30.

better right than a subsequent bona fide purchaser.¹⁶⁴ In short, whenever a trustee brought a strong-arm case against a mortgagee who never dispossessed the debtor, the trustee might have brought a voidable preference case as well.

Under the orthodox view of avoidance powers, voidable preferences are completely void. Under this view, rent receivables are completely disencumbered, and all rents collected during the pendency of the bankruptcy should belong to the trustee free and clear. Section 546(b) protects mortgagees from the strong-arm power, but it leaves them vulnerable to the voidable preference power, orthodoxly interpreted.

The strong-arm theory obviates this bad result. According to that theory, voidable preference law does *not* terminate the mortgagee's rights in rent receivables. Rather, preference "avoidance" simply makes the rent receivable susceptible to the trustee's strong-arm power. This strong-arm power, however, is fully subject to section 546(b). Hence, a mortgagee can defeat the voidable preference theory by showing that the strong-arm power is defeated. This can be done by taking the action prescribed in section 546(b)—sending a notice to the trustee in lieu of dispossessing the debtor. Because avoidance under section 547(b) does not negate the mortgagee's interest altogether, the voidable preference theory can never do more for the bankruptcy trustee than the strong-arm power theory could have done.

Oblivious to these points, Congress intervened in 1994 on behalf of the mortgagee. Section 552(b)(2) now upholds security interests in rents "[e]xcept as provided in [section 544] and notwithstanding section 546(b) of this title."¹⁶⁵ The reference to section 546(b) is mysterious. The legislative history, however, indicates that mortgagees should have valid mortgages even if they have not fully perfected un-

164. If the debtor is never dispossessed before bankruptcy, the rent receivable is deemed transferred to the mortgagee just before the bankruptcy petition. See 11 U.S.C. § 547(e)(2)(C) (1994).

The Supreme Court has now ruled that federal grace periods preempt longer state grace periods—a blow against the real estate mortgage. In *Fidelity Financial Services, Inc. v. Fink*, 118 S. Ct. 651 (1998), Justice David Souter considered the case of a security interest on a car which was not perfected within the twenty-day grace period of section 547(c)(3) but was perfected under a longer grace period provided in Missouri certificate of title legislation. In so ruling, Justice Souter emphasized that, prior to perfection, a lien creditor could be temporarily senior. This was enough to defer timing to the time a perfecting act was performed.

As applied to real estate mortgages on rents, *Fink* implies that temporary superiority of the buyer is all that the trustee needs to defer timing of the mortgage lien on rents. So long as no enforcing act has occurred within ten days of the creation of the rent receivable—this will be almost every case—section 547(e)(2)(B) or (C) will supply the timing rule. On the issue of timing, then, a mortgagee will be at a severe disadvantage—if we may hypothesize a buyer who actually collects rent.

165. 11 U.S.C. 552(b)(2) (1994) (emphasis added).

der state law.¹⁶⁶ While it is hard to get this meaning from the actual statutory language, courts are frequently willing to ignore the statutory language and follow instead the more lucid instruction of the legislative history. Those courts not shackled to the golden calf of "plain meaning" may now declare that the trustee's strong-arm theory against mortgage lien on rent receivables is dead.¹⁶⁷

Even so, how can these courts explain why these liens are not voidable preferences? Unless any such theory is available, the 1994 amendment in favor of mortgage liens on rent is useless. The strong-arm theory just presented explains why voidable preference law cannot push avoidance any further than the strong-arm power. At best, voidable preference law makes third party property amenable to the trustee's strong-arm power. But if that strong-arm power does not exist after "avoidance" of the preference, then the trustee can have no recovery.

IV. THE CENTRALITY OF SECTION 550(a) TO AVOIDANCE THEORY

A. Deprizio

Orthodox theory says that section 541(a) created the bankruptcy estate. The fundamental theory of section 541(a) is successorship of the trustee to the debtor's legal and equitable interests in property. Property recovered from *A* is an add-on achieved in section 541(a)(3), with its reference to section 550(a). In orthodox thought, section 550(a) plays a central mediating role.

The competing theory of avoidance powers holds that transfers to third parties are set aside so that the trustee's strong-arm power can attach itself to this property. This theory de-centers section 550(a) as the fount from which all avoidance law flows, so that section 544(a) can take the central organizing role.

Perhaps the most famous exemplar of section 550(a) imperialism is the notorious *Deprizio* case¹⁶⁸—now supposedly repealed by Con-

166. See 140 CONG. REC. H10752, H10768 (daily ed. Oct. 4, 1994) (statement of Rep. Brooks).

167. See *In re Wrecclesham Grange, Inc.*, 221 B.R. 978, 981 (Bankr. M.D. Fla. 1997); see also *In re Newberry Square, Inc.*, 175 B.R. 910, 915 (Bankr. E.D. Mich. 1994) ("The primary purpose of those amendments . . . was to provide lenders with valid security interests in post-petition rents notwithstanding their failure to have fully perfected those interests under state law."). *But see* *Condor One, Inc. v. Turtle Creek, Ltd.* (*In re Turtle Creek, Ltd.*), 194 B.R. 267, 276 n.6 (Bankr. N.D. Ala. 1996) (calling the meaning of the amendment "debatable"). According to Supreme Court jurisprudence, "a court appropriately may refer to a statute's legislative history to resolve statutory ambiguity." *Toibb v. Radloff*, 501 U.S. 157, 162 (1991).

168. *Levit v. Ingersoll Rand Fin. Corp.* (*In re V.N. Deprizio Constr. Co.*), 874 F.2d 1186, 1200 (7th Cir. 1989).

gress.¹⁶⁹ In *Deprizio*, regular creditors received transfers more than ninety days before bankruptcy.¹⁷⁰ At first glance, these parties were immune from liability under section 547(b). But these creditors were also guaranteed payment by insiders. Insiders suffer through a one year preference period,¹⁷¹ and they are liable if they merely *benefit* when the creditors they guarantee are paid off.¹⁷² Hence, the regular creditors were the initial transferees of the insiders' voidable preferences, and, under section 550(a)(1), they were liable for them, even though they themselves were not insiders. In effect, *Deprizio* extended the preference period from ninety days to a year whenever the creditor had obtained an insider guaranty.

Judge Easterbrook's *Deprizio* opinion is based on a reading of section 550(a). Section 550(a) states "to the extent that a transfer is avoided under section . . . 547 . . . the trustee may recover . . . from . . . (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made."¹⁷³ It can be seen easily enough that, once section 547 proclaims a transfer voidable, section 550(a)(1) makes the initial transferee liable whether or not the initial transferee independently transgresses the elements of section 547(b). Judge Easterbrook's reading of section 550(a) was straightforward.

Though Judge Easterbrook based his opinion on section 550(a), he could have decided the case the same way from the words of section 547(b) alone.¹⁷⁴ Section 547(b) "avoids" transfers received by the initial transferee if some other creditor benefited preferentially. Thus, even though the transfer is not preferential if the beneficiary is ignored, the initial transferee holds property subject to the trustee's avoiding power. That is, the creditor holds property that is susceptible to the trustee's strong-arm power. Section 550(a) was not central—or even necessary—to the *Deprizio* result.

In 1994 Congress attempted to repeal the *Deprizio* doctrine. According to newly amended section 550(c):

If a transfer made between 90 days and one year before the filing of the petition—

(1) is avoided under section 547(b) of this title; and

169. See Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 202, 108 Stat. 4106, 4121. For a discussion of the extent to which *Deprizio* is not repealed, see David Gray Carlson, *Tripartite Voidable Preferences*, 11 BANKR. DEV. J. 219, 296-97 (1995).

170. See *Deprizio*, 874 F.2d at 1187-88.

171. See 11 U.S.C. § 547(b)(4)(B) (1994).

172. See *id.* § 547(b)(1).

173. *Id.* § 550(a).

174. See Melissa M. Cowan, Comment, *Determining Insider Status Under Bankruptcy Code Section 547(b)(4)(B): When "I Resign" May Not Be Enough to Terminate Insider Status*, 41 UCLA L. REV. 1541, 1545-46 n.14 (1994) (recognizing that section 547(b) imposes *Deprizio* liability without the aid of section 550).

(2) was made for the benefit of a creditor that at the time of such transfer was an insider; the trustee may not recover *under subsection (a)* from a transferee that is not an insider.¹⁷⁵

Notice that this amendment assumes that section 550(a) is the fount of avoidance. The drafters of the 1994 amendments assumed that if section 550(a) were sufficiently chlorinated against the *Deprizio* virus, commercial law was saved. But the amendment is quite ineffective if section 547(b) operates independently of section 550(a). If the trustee uses section 547(b) straight out, the 1994 amendment has no effect.¹⁷⁶ That is, the initial transferee of a *Deprizio* transfer is holding property under a transfer which has been avoided. This is property of the estate, and the transfer should return it to the trustee under section 542(a).

Courts like to apply the legislative history straight out, irrespective of what the statute actually says. Hence, it may be expected that courts will rule that trustees can no longer recover from the initial transferee on a *Deprizio* theory where the transfer is older than ninety days.¹⁷⁷ The premise of these rulings will undoubtedly be that section 550(a) is the portcullis through which all avoidance actions must travel. If section 550(a) recoveries are barred by the new section 550(c), then the initial transferees will have no *Deprizio* liability.

To those dwindling few who still care what the statute actually says, initial transferees will face the following difficulty. According to section 551: "Any transfer avoided under section . . . 547 . . . is preserved for the benefit of the estate but only with respect to property of the estate."¹⁷⁸ Suppose an initial transferee takes a transfer in collateral 100 days before bankruptcy, and the transfer benefits an insider guarantor. This transfer is voidable under section 547 but not under section 550(a). Nevertheless, under section 551, the transfer is expropriated from the initial transferee and is now held by the bankruptcy trustee. Section 551, then, constitutes a second postern gate

175. 11 U.S.C. § 550(c) (1994) (emphasis added).

176. See Margaret Howard, *Avoiding Powers and the 1994 Amendments to the Bankruptcy Code*, 69 AM. BANKR. L.J. 259, 267 (1995). Professor Howard suggests that the failure to repeal *Deprizio* applies only to security interests granted to the initial transferee before the ninety days. She stops short at suggesting that payments can still be avoided, hinting that section 550(a) must govern any case in which the funds cannot be traced. See *id.* Thus, the 1994 amendment prevents the recovery of the value of any untraceable transfer since any *in personam* liability must travel through the portal of section 550(a). In fact, state notions of conversion liability are adequate to establish the initial transferee's liability for payments or other untraceable transfers. The failure to repeal *Deprizio* is therefore quite thoroughgoing.

177. See, e.g., *Erie Marine Enter., Inc. v. Nationsbank, N.A.* (*In re Erie Marine Enter., Inc.*), 216 B.R. 529, 536 (Bankr. W.D. Pa. 1998).

178. 11 U.S.C. § 551 (1994).

through which a trustee's *Deprizio* theories might pass.¹⁷⁹ This proves that section 550(a) is not the central moment that orthodox theory assumes. *Deprizio*, on the black letter of the Bankruptcy Code, is by no means repealed.

It might be tempting to argue that section 550(c) proves that Congress has adopted the orthodox theory in which section 550(a) is central. Otherwise, the *Deprizio* theory is not repealed. But the points just concluded prove that both sections 547(b) and 551 suggest that *Deprizio* has been unsuccessfully dispatched. Two separate provisions point to the survival of *Deprizio*, in spite of the 1994 amendments to the Bankruptcy Code.

B. Statutory Evidence

The orthodox view being attacked in this Article holds section 550(a) to be the glorious planet Sol in a heliocentric system of trustee powers, whose medicinale eye corrects the ill aspects of the avoidance planets. To the contrary, the strong-arm power belongs in the center of this solar system. Many provisions of the Bankruptcy Code can be cited to prove this is so.

1. Statute of Limitations

Perhaps the best evidence that section 550(a) is not the organizing center of avoidance powers is that these individual avoidance powers have a statute of limitations that is entirely separate from the statute of limitations governing section 550(a). According to section 546(a):

An action or proceeding under section 544, 545, 547, 548, or 553 of this title may not be commenced after the earlier of—

(1) the later of—

(A) 2 years after the entry of the order for relief; or

(B) 1 year after the appointment or election of the first trustee under section 702, 1104, 1163, 1202, or 1302 of this title if such appointment or such election occurs before the expiration of the period specified in subparagraph (A); or

(2) the time the case is closed or dismissed.¹⁸⁰

Notice this statute of limitation refers directly to the avoiding powers. A different statute of limitations exists for an action under section 550(a). According to section 550(f), "An action or proceeding un-

179. Even if these difficulties are papered over, the 1994 amendment applies only to transfers more than 90 days old at the time of the bankruptcy. *Deprizio* still must be considered good law when the transfer is within the 90-day preference period. Thus, if the initial transferee is an oversecured creditor and some junior undersecured party is benefited, the oversecured party has *Deprizio* liability for transfers within 90 days of bankruptcy. See Carlson, *supra* note 169, at 305-08.

180. 11 U.S.C. § 546(a) (1994).

der this section may not be commenced after the earlier of one year after the avoidance of the transfer on account of which recovery under this section is sought or the time the case is closed or dismissed.”¹⁸¹ This second statute of limitation proves that avoidance under section 547(b) and avoidance under section 550(a) are separate, independent theories.¹⁸²

2. Dismissals

Reference to dismissals of a bankruptcy case proves that section 550(a) is not crucial to the avoidance theory. According to Bankruptcy Code section 349, when a bankruptcy case is dismissed, “any transfer avoided under section 522, 544, 545, 547, 548, 549, or 724(a)” is resurrected.¹⁸³ Section 349 does not say that transfers voided under section 550(a) are resurrected. It must follow that each individual avoidance power—in conjunction with the all-important strong-arm power—is capable of avoiding transfers all by itself. Section 550(a) is a superfluity.

3. Lien Preservation

Section 551 provides that “[a]ny transfer avoided under section 522, 544, 545, 547, 548, 549 or 724(a) . . . is preserved for the benefit of the estate.”¹⁸⁴ This likewise implies that the individual avoidance powers are adequate to bring third party property into the bankruptcy estate, without the aid of section 550(a). These two sections therefore prove that section 550(a) is not the all-important gatekeeper of liability that it is supposed to be.

Classically, the purpose of section 551 is to prevent junior lien creditors from benefiting when a senior lien is avoided. For example, suppose *D* conveys a mortgage on real estate to *A*. *A* omits to record the mortgage. *D* then conveys a mortgage to *B*. *B* records, but *B* has knowledge of *A*. Under real estate recording acts, *B* is junior to *A*. But *D*'s bankruptcy trustee may avoid *A*'s senior mortgage (because it is unperfected).¹⁸⁵

181. *Id.* § 550(f)(1)-(2).

182. See *Weaver v. Aquila Energy Mktg., Corp.*, 196 B.R. 945, 955 (Bankr. S.D. Tex. 1996); 2 EPSTEIN, *supra* note 114, § 6-80, at 204-05.

183. 11 U.S.C. § 349(b) (1994).

184. *Id.* § 551.

185. This can sometimes be done under the hypothetical judicial lien status, where local law protects creditors, as in Florida. See FLA. STAT. § 695.01(1) (1997). More commonly, other states protect only subsequent bona fide purchasers who record first. N.Y. REAL PROP. ACTS. § 291 (1997). In such states, the trustee must use section 544(a)(3), which accords trustees the status of subsequent bona fide purchasers. *A*'s unrecorded mortgage might also be a voidable preference, but, per our theory, the voidable preference statute only renders *A*'s mortgage susceptible to the trustee's strong-arm power.

Elsewhere, I have argued that lien preservation is entirely superfluous of the strong-arm power.¹⁸⁶ If section 551 were repealed, the trustee could still expropriate avoidable liens by means of the strong-arm power. These liens, brought into the estate, would include the power to foreclose junior liens. Hence, section 551, like section 550(a), is largely irrelevant to avoidance theory. It may also be noted that, under the quantitative limit being proposed here, *A* would be the owner of any surplus, once the trustee's hell-governed strong-arm is exhausted with its butchery. *B* follows thereafter. The priority between *A* and *B* would be retained with regard to any surplus.

4. Exempt Property

The Bankruptcy Code permits a debtor to use the avoiding powers to retrieve exempt property under certain circumstances.¹⁸⁷ In pursuing this end, section 522(h) makes clear that the avoiding powers are unmoored from section 550(a):

The debtor may avoid a transfer of property of the debtor . . . to the extent that the debtor could have exempted such property under subsection (g)(1) of this section if the trustee had avoided such transfer, if—

- (1) such transfer is avoidable by the trustee under section 544, 545, 547, 548, 549, or 724(a) of this title or recoverable by the trustee under section 553 of this title; and
- (2) the trustee does not attempt to avoid such transfer.¹⁸⁸

This provision indicates quite clearly that the trustee has avoidance rights separate and apart from section 550.¹⁸⁹

5. Disallowance

A further piece of evidence that section 550(a) is not the fount of avoidance is section 502(d), which provides:

Notwithstanding subsections (a) and (b) of this section, the court shall disallow any claim of any entity from which property is recoverable under section 542, 543, 550, or 553 of this title or that is a transferee of a transfer avoidable under section 522(f), 522(h), 544, 545, 547, 548, 549, or 724(a) of this title, unless such entity or transferee has paid the amount, or turned over any such property,

186. See David Gray Carlson, *The Trustee's Strong-Arm Power Under the Bankruptcy Code*, 43 S.C. L. REV. 841, 863-72 (1992).

187. The debtor must not have conveyed away the exempt property voluntarily. See 11 U.S.C. § 522(g)(1)(A) (1994).

188. *Id.* 522(h).

189. Exempt property, however, is in other respects quite problematic for the strong-arm theory. See *infra* Part IV.B.4.

for which such entity or transferee is liable under section 522(i), 542, 543, 550, or 553 of this title.¹⁹⁰

This section says, in the main, that when a creditor has liability under section 550 or has received a voidable preference under section 547, that creditor's claim must be disallowed. But this disallowance is conditioned. The claim shall be allowed after all if the entity has paid the amount or turned over such property for which the entity is liable under sections 542, 543, or 550.

This provision proves that avoidance (as supplemented by the strong-arm power) is quite independent from section 550(a). If a trustee avoids a preference, the trustee's hypothetical judicial lien creditor describes the quantitative limit of the trustee's avoidance power. Suppose we say that a nonrecourse undersecured creditor has received a payment within the preference period. Suppose for the moment that this payment is still identifiable—a cashier's check that has not yet been presented, for instance. Section 547(b) potentially avoids that payment.¹⁹¹ That payment is susceptible to the strong-arm power if the transfer is "avoided." Property lien by the strong-arm power can be recovered under section 542(a).¹⁹² All of this plausibly occurs without any reference to section 550(a).

This *morceau* of evidence that section 550(a) is no fount was used in a startling way by Judge Cornelius Blackshear in *United States Lines, Inc. v. United States (In re McLean Industries, Inc.)*,¹⁹³ in which an undersecured creditor claimed a perfected \$20 million ship mortgage. Judge Blackshear proclaimed the creation of this receivable a voidable preference,¹⁹⁴ but the Second Circuit chose to reverse

190. 11 U.S.C. § 502(d) (1994) (emphasis added).

191. This conclusion can be disputed. The transfer must be on account of "an antecedent debt owed by the debtor before such transfer was made." *Id.* § 547(b)(2). If the debt is nonrecourse, the debtor does not "owe" it. The point in the text assumes we have gotten beyond this difficulty. That is, a debtor "owes" a nonrecourse debt, somehow, for the purposes of section 547(b)(2). In addition, it likewise must be true that the payment is less than the unsecured deficit claim of the nonrecourse secured creditor. For instance, the collateral is worth \$100, the total nonrecourse debt is \$150, and the payment is \$40. If the payment were \$60, then \$50 it is preferential; \$10 of the payment releases the security interest. The released security interest is considered "new value." *See id.* § 547(a)(2). New value given back contemporaneously with the payment constitutes a defense against voidable preference liability, *see id.* § 547(c)(1), or perhaps a failure of the *prima facie* case. *See* David Gray Carlson, *Security Interests in the Crucible of Voidable Preference Law*, 1995 U. ILL. L. REV. 211, 280-83.

192. Or so I have argued. *See supra* text accompanying notes 62-64.

193. 184 B.R. 10, 14-16 (Bankr. S.D.N.Y. 1995), *aff'd*, 196 B.R. 670 (Bankr. S.D.N.Y. 1996) [hereinafter *McLean 3*]. The undersecured creditor also received a transfer of a \$2 million receivable shortly before bankruptcy. *See* *United States Lines, Inc. v. United States (In re McLean Industries, Inc.)*, 132 B.R. 247, 252-54 (Bankr. S.D.N.Y. 1991), *aff'd*, 162 B.R. 247 (Bankr. S.D.N.Y. 1993) [hereinafter *McLean 1*].

194. *See McLean 1*, 132 B.R. at 247.

on a questionable reading of the statute of limitations.¹⁹⁵ The statute of limitations is provided for under section 546(a), but section 502(d) disallows any claim made by a person who is holding a preference that is voidable under section 547. Therefore, *Blackshear* saw no im-

195. *United States Lines, Inc. v. United States (In re McLean Industries, Inc.)*, 30 F.3d 385 (2d. Cir. 1994) [hereinafter *McLean 2*]. According to section 546(a), an action under section 547 may be brought within "1 year after the . . . appointment of the first trustee under section . . . 1104 . . . ; or . . . the time the case [was] closed or dismissed." 11 U.S.C. § 546(a) (1994). The circuit court in *McLean 2* ruled that, since debtors-in-possession are trustees under section 1107, the statute of limitations starts to run immediately upon the filing of a voluntary chapter 11 petition. See *McLean 2*, 30 F.3d at 388.

Although the statute of limitations holding is beyond the scope of this Article, it bears pointing out that the matter was wrongly decided. Under section 546(a), the statute begins to run when a trustee is *appointed under* section 1104—for cause or in the best interests of the creditors. The holding in *McLean 2* opened wide the door for insider abuse, as when a debtor-in-possession forgets to sue officers and shareholders for the voidable preferences they have received.

For other cases erroneously holding that the statute of limitations starts to run when the chapter 11 proceeding commences, see *Construction Management Servs., Inc. v. Manufacturers Hanover Trust Co. (In re Coastal Group Inc.)*, 13 F.3d 81, 86 (3d Cir. 1994); *Zilkha Energy Co. v. Leighton*, 920 F.2d 1520, 1524 (10th Cir. 1990). The Ninth Circuit managed to make the following distinctions: (1) Chapter 11 petition; debtor-in-possession only; no trustee appointed: two years from the bankruptcy petition; see *Upgrade Corp. v. Government Tech. Servs., Inc. (In re Software Centre Int'l, Inc.)*, 994 F.2d 682, 683 (9th Cir. 1993); (2) Chapter 11 petition; chapter 11 trustee appointed; second chapter 7 burial trustee appointed after conversion: two years from appointment of the chapter 11 trustee, see *M. Ford v. Union Bank (In re San Joaquin Roast Beef)*, 7 F.3d 1413, 1416 (9th Cir. 1993); (3) Chapter 11 petition; no chapter 11 trustee; plan confirmed, appointing a representative to pursue postconfirmation preferences: two years from chapter 11 petition, see *Liquidation Estate of DeLaurentiis Entertainment Group v. Technicolor, Inc. (In re DeLaurentiis Entertainment Group, Inc.)*, 87 F.3d 1061, 1063-64 (9th Cir. 1996); (4) Chapter 11 petition; no chapter 11 trustee; conversion to chapter 7 and new burial trustee appointed: two years from the chapter 11 petition, see *Mosier v. Kroger Co. (In re IRFM, Inc.)*, 65 F.3d 778, 781 (9th Cir. 1995); (5) Chapter 11 petition; chapter 11 trustee appointed; no conversion: two years from appointment of chapter 11 trustee, see *John Mitchell, Inc. v. Steinbrugge (In re Hanna)*, 72 F.3d 114, 117 (9th Cir. 1995).

In 1994 Congress amended section 546(a). If the intent were to overrule cases like *McLean 2*, it may have failed. Prior to 1994, section 546(a) provided that avoidance actions had to be brought no later than the earlier of: "(1) two years after the appointment of a trustee . . . or; (2) the time the case is closed or dismissed." 11 U.S.C. § 546(a) (1990). Now, section 546(a) requires the action to be brought no later than:

- (1) the later of—
 - (A) 2 years after the entry of the order for relief; or
 - (B) 1 year after the appointment or election of the first trustee under section 702, 1104, 1163, 1202, or 1302 of this title if such appointment or such election occurs before the expiration of the period specified in subparagraph (A); or
- (2) the time the case is closed or dismissed.

This amendment does not clearly contradict the premises of *McLean 2*. Thus, courts could still hold that all debtors-in-possession are trustees "appointed" under section 1104, and that the one-year period commences to run in chapter 11 cases as soon as the debtor files a chapter 11 petition. If a *second* trustee is "appointed" under section 702 in a converted case, the one-year period does not start to run again. Such a holding, however, would be unfortunate for the reasons already described. In any case, early returns show that judges are willing to read the new amendment in a pro-trustee fashion, in spite of the poor draftsmanship. See *Steege v. Helmsley-Spear, Inc. (In re Superior Toy & Mfg. Co.)*, 175 B.R. 693, 698 (Bankr. N.D. Ill. 1994).

pediment to holding that, even though the statute of limitations had run under section 546(a), the undersecured creditor was holding a transfer voidable under section 547(b)—the \$2 million receivable.¹⁹⁶ The entire claim of the undersecured creditor was therefore not allowed.

The consequence of this ruling was profound. According to section 506(d):

To the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void, unless—

- (1) such claim was disallowed only under section 502(b)(5) or 502(e) of this title; or
- (2) such claim is not an allowed secured claim due only to the failure of any entity to file a proof of such claim under section 501 of this title.¹⁹⁷

Most students of the Bankruptcy Code will recognize this provision as the one emasculated in the famous case of *Dewsnup v. Timm* (*In re Dewsnup*).¹⁹⁸ Prior to *Dewsnup*, virtually every judge and lawyer read section 506(d) to mean that if a creditor were undersecured, the claim must be bifurcated under section 506(a). Thus, if a creditor claimed \$100 but only had \$80 in collateral, the creditor was deemed by section 506(a) to have two claims—a secured claim for \$80 and an unsecured deficit claim for \$20. Meanwhile, section 506(d) stated that lien on the collateral was “void” to the extent it purported to secure the \$20 unsecured claim. If the collateral were to appreciate in value to \$90, the lien was capped at \$80. It was entirely “void” to secure the \$20 claim. This pro-debtor strategy was called “lien strip-down.”¹⁹⁹

In *Dewsnup*, Justice Blackmun overruled this strategy. According to Blackmun, “allowed secured claim” meant “allowed claim” as defined under section 502(b).²⁰⁰ In the above example, “allowed secured claim” as used in section 506(d) meant \$100, even though the same phrase in section 506(a) defines “allowed secured claim” as \$80.²⁰¹ As a result of *Dewsnup*, undersecured creditors obtain all appreciation value that accrues after bankruptcy. The decision has been roundly and justifiably excoriated for ascribing different meanings to the same phrase throughout the Bankruptcy Code.²⁰²

196. See *McLean 3*, 184 B.R. at 14-16.

197. 11 U.S.C. § 506(d) (1994).

198. 502 U.S. 410 (1992).

199. See generally David Gray Carlson, *Bifurcation of Undersecured Claims in Bankruptcy*, 70 AM. BANKR. L.J. 1 (1996).

200. *Dewsnup*, 502 U.S. at 417.

201. See *id.*

202. See generally Margaret Howard, *Dewsnapping the Bankruptcy Code*, 1 J. BANKR. L. & PRAC. 513 (1992); Newborn, *supra* note 35, at 547.

After *Dewsnup*, most people thought section 506(d) was rendered meaningless because it could not be used in lien stripdown. Judge Blackshear, however, showed otherwise. Since, in *McLean Industries*, the entire claim of the creditor who received a voidable preference was not allowed, the entire \$20 million valid ship mortgage was “void” under section 506(d).²⁰³

Although Judge Blackshear can be seen as following the plain meaning of section 506(d),²⁰⁴ the entire structure of section 506(d) can be questioned, if it results in permanent and irreversible lien avoidance. The idea of section 502(d) is presumably to hold the current claim of a creditor hostage until the creditor returns the voidable preference. Thus, section 502(g), referring directly to section 502(d), suggests that, once the voidable preference is returned, the disallowed claim springs back to life. Yet section 506(d) suggests that a lien for the same claim is “void”—or, more accurately, transferred from the creditor to the bankruptcy estate.²⁰⁵ Obviously, if the disallowed claim revives, the lien should too. The Bankruptcy Code nowhere says as much, however.²⁰⁶ Judge Blackshear’s decision comports with the black letter of the Bankruptcy Code but undoubtedly not its spirit. The letter killeth, but the spirit would have given life to the creditor’s ship mortgage.

For our purposes, Judge Blackshear’s theory implies that section 550(a) is not the only means for the trustee to recover an avoided transaction. The statute of limitations blocked the section 550(a) liability. Yet section 547 had a separate life which could trigger the remarkably harsh confluence of sections 502(d) and 506(d).

C. Section 550(a)’s True Function

Section 550(a)(1) is no fount of avoidance wisdom. What then is its function? Have I rendered it superfluous? Superfluity is supposed to be a sign of bad statutory interpretation.²⁰⁷ Fortunately for the strong-arm theory, section 550(a) retains a utility in the scope and compass of my theory. It is avoided-but-preserved, as it were. Section 550(a) contributes to voidable preference jurisprudence (as well as to fraudulent transfer jurisprudence) by making clear that nontransfer-

203. See *McLean* 3, 184 B.R. 10, 16 (Bankr. S.D.N.Y. 1995).

204. See *id.*

205. See 11 U.S.C. § 506(d) (1994).

206. In this regard, it may be noted that contingent suretyship claims are not allowed. See *id.* § 502(e)(1). If that same claim becomes fixed after bankruptcy, the claim is allowed, even though its fixity is a postpetition event. See *id.* § 502(e)(2). Section 506(d)(1) takes care to single out section 502(e) claims as immune from its effect, but it does not likewise refer to section 502(d), thereby suggesting that section 506(d) has the effect of knocking out the principal lien of an undersecured creditor who has received a minor preference.

207. See, e.g., *United Sav. Ass’n of Texas v. Timbers of Inwood Forest Assoc. (In re Timbers of Inwood Forest Assoc.)*, 484 U.S. 365, 374 (1988).

ees can be held liable if they are merely benefited by a transfer to someone else.

The fact that *initial transferees* (of voidable preferences) could be held liable was always well understood under the old Bankruptcy Act. According to section 60(b):

Any such preference may be avoided by the trustee if the creditor receiving it or to be benefited thereby . . . has, at the time when the transfer is made, reasonable cause to believe that the debtor is insolvent. Where the preference is voidable, the trustee may recover the property or, if it has been converted, its value *from any person who has received or converted such property*²⁰⁸

According to this statute, the trustee could only recover from a "transferee." Yet section 60(a) condemned transfers for the benefit of nontransferees. In order to explain how "beneficiaries" might be held liable, when section 60(b) only made transferees liable, courts invented the fiction that the mere benefit emanating from a transfer was itself a transfer. Thus, as Judge Easterbrook explained in *Deprizio*, the "two transfer" theory was "an heuristic device to explain how recoveries could be had from indirect beneficiaries under the 1898 Act."²⁰⁹

At the turn of the century, the Supreme Court made clear (in dictum) that preferences might be recovered from a person not actually the initial transferee of a preference. In *National Bank of Newport v. National Herkimer County Bank*,²¹⁰ Justice Charles Evans Hughes wrote:

To constitute a preference, it is not necessary that the transfer be made directly to the creditor. It may be made to another for his benefit. If the bankrupt has made a transfer of his property, the effect of which is to enable one of his creditors to obtain a greater percentage of his debt than another creditor of the same class, circuity of arrangement will not avail to save it It is not the mere form or method of the transaction that the act condemns, but the appropriation by the insolvent debtor of a portion of his property to the payment of a creditor's claim, so that thereby the estate is de-

208. Bankruptcy Act of 1898, ch. 541, § 60(b), 52 Stat. 840, 870 (1938) (emphasis added). *Deprizio* was impossible under the 1898 Bankruptcy Act for the simple reason that insiders were not subject to any different time period than were ordinary creditors. *Deprizio* only arises because the initial transferees had 90-day periods, while insiders had a one-year period.

209. *Levit v. Ingersoll Rand Fin. Corp.* (*In re V.N. Deprizio Constr. Co.*), 874 F.2d 1186, 1196 n.6 (7th Cir. 1989). A "heuristic" is, basically, a damnable lie. It does not give us any information respecting the constitution of an object. It merely indicates how we ought to *investigate* the constitution and the relations of objects in the world of experience. See IMMANUEL KANT, *CRITIQUE OF PURE REASON* 376 (J.M.D. Meiklejohn trans., 1990).

210. 225 U.S. 178 (1912).

pleted and the creditor obtains an advantage over other creditors.²¹¹

The “two transfer” theory arose to describe this dictum. According to Judge Jerre Williams, who endorsed the theory:

To combat such circuitry, the courts have broken down certain transfers into two transfers, one direct and one indirect. The direct transfer to the third party may be valid and not subject to a preference attack. The indirect transfer, arising from the same action by the debtor, however, may constitute a voidable preference as to the creditor who indirectly benefitted from the direct transfer to the third party.²¹²

If the “two transfer” theory were necessary to explain why beneficiaries could be sued under old section 60(b), this is no longer true. Section 550(a)(1) extends liability to “the entity for whose benefit such transfer was made.”²¹³ This is the true function of section 550(a). It displaces the “two transfer” theory by creating *in personam* liability in nontransferees. Transferees can be held to *in personam* liability on a conversion theory. Section 550(a) is not necessary to hold a transferee liable because the various avoidance powers (coupled with the strong-arm power) suffice to convict transferees of the tort of conversion.

D. Postconfirmation Avoidance

The strong-arm theory recognizes that the trustee’s right of recovery is quantitatively limited. The amount of credit claims the trustee represents defines the limits. Hence, the trustee does not recover in fee simple absolute. That would imply that *A* never owns the surplus. Rather, the trustee recovers only to the extent the trustee represents *creditors* of *D*. In contrast, orthodox theory (honestly applied) holds that *D*, who has a claim against the estate under section 726(a)(6), owns the surplus. This representative capacity ensures that *A* (not *D*) owns the surplus.

Often, an avoidance cause of action survives confirmation of a chapter 11 plan. According to section 1123(b)(3), a plan *may* (but need not) provide for “the settlement or adjustment of any claim or

211. *Id.* at 184. Nevertheless, Justice Hughes also ruled that the beneficiary of a transfer was immune from voidable preference liability because “[i]t was not shown that the bank had anything to do” with the initial transferee’s collateral. *Id.* at 187.

212. *Kellogg v. Blue Quail Energy, Inc. (In re Compton Corp.)*, 831 F.2d 586, 591-92 (5th Cir. 1987), *modified*, 835 F.2d 584 (1988) (per curiam). Judge Williams used the “two transfer” theory to explain why the bankruptcy trustee could not recover collateral from a bank that issued a letter of credit to an unsecured creditor. *See id.* at 596. The bank would otherwise have been liable under *Deprizio* as the initial transferee. For a critique of this proposition, see Carlson, *supra* note 169, at 259-65.

213. 11 U.S.C. § 550(a)(1) (1994).

interest belonging to the debtor or to the estate; or, the retention and enforcement by the debtor, by the trustee, or by a representative of the estate appointed for such purpose, of any such claim or interest."²¹⁴ It may come to pass that a plan (1) discharges all claims, except as otherwise set forth in the plan, and (2) preserves an avoidance action on behalf of the debtor or some third party. Hence, where a plan authorizes a postpetition avoidance action against A, it may appear as if D, not the unsecured creditors, benefits from avoidance.

This phenomenon by no means subverts the strong-arm theory. That theory sets the quantitative limit of the trustee's cause of action. If the trustee later distributes this cause of action to the debtor personally, the debtor may enjoy the proceeds of this cause of action. But the cause of action still has a quantitative limit—the amount of claims represented by the trustee. That is, it does not follow from the fact that the debtor can succeed to the trustee's avoidance cause of action that the cause of action is unlimited in the debtor's hands. Rather, as the trustee's successor, the debtor inherits only what the trustee had—a cause of action limited in amount by the aggregate of claims represented by the trustee in the bankruptcy proceeding.

Some courts are offended by the notion that the debtor should personally keep the proceeds of a cause of action based on a trustee's representative capacity of creditors. Hence, some courts insist that the cause of action—though duly distributed to the debtor—cannot be enforced because section 550(a) requires that the cause of action is for the benefit of the estate.²¹⁵ Such reasoning, based upon the centrality of section 550(a) and hence on orthodox theory of the bankruptcy estate, is not satisfactory. For one thing, following confirmation of the plan, the entire "bankruptcy estate" ceases to exist. Therefore, courts find themselves in the absurd position of calculating the welfare of a nonexistent entity. This standard also condemns courts to valuations on a case-by-case basis.²¹⁶ Courts have proven themselves extremely diverse as to what constitutes a benefit to the "estate." Thus, some courts have ruled that a wealthy debtor is less

214. *Id.* § 1123(b)(3). It is usually required that the intent to assign the avoidance chose in action be very clear. In *Retail Marketing Co. v. King (In re Mako, Inc.)*, 985 F.2d 1052 (10th Cir. 1993), the plan read: "RMC [a buyer of assets] shall be entitled to prosecute all objections to claims which . . . may appear as the real party in interest in any pending or later instituted contested matter or adversary proceeding filed herein." *Id.* at 1055. This was held too vague to support RMC's ownership of the avoidance action. The fact that RMC sought to recover unexpectedly high administrative expenses it had undertaken to pay was irrelevant.

215. Such an idea precedes the Bankruptcy Code and the existence of § 550(a). See *Whiteford Plastics Co. v. Chase Nat'l Bank*, 179 F.2d 582, 584 (2d Cir. 1950).

216. See *Trans World Airlines, Inc. v. Travellers Int'l AG (In re Trans World Airlines, Inc.)*, 163 B.R. 964, 969 (Bankr. D. Del. 1994).

likely to default on the plan. This justifies letting the debtor keep any surplus.²¹⁷

Such reasoning should simply be dispensed with as unnecessary. Just prior to confirmation, the avoidance action existed. Under the strong-arm theory, the avoidance action is defined as coextensive with the amount of preconfirmation credit claims the trustee represents. This chose in action for avoidance is an asset of the estate,²¹⁸ and it is capable of being distributed in a chapter 11 plan.²¹⁹

The rules of confirmation severely restrict how assets may be distributed. For example, no asset can be given to an "interest" holder—a shareholder or partner in the prepetition debtor—if an unpaid unsecured creditor class protests. This is the famous absolute priority rule.²²⁰

A plan that gives an avoidance cause of action to equity owners of the debtor should not be affirmed if the absolute priority rule is violated. However, if a chapter 11 plan be confirmed in which the chose

217. See, e.g., Harstad v. First Am. Bank (*In re Harstad*), 155 B.R. 500, 512 (Bankr. D. Minn. 1993), *aff'd*, 39 F.3d 898 (8th Cir. 1994); Funding Sys. Asset Management Corp. v. Chemical Bus. Credit Corp. (*In re Funding Sys. Asset Management Corp.*), 111 B.R. 500, 523-24 (Bankr. W.D. Pa. 1990); Centennial Indus., Inc. v. NCR Corp. (*In re Centennial Indus., Inc.*), 12 B.R. 99 (Bankr. S.D.N.Y. 1981). In *Citicorp Acceptance Co. v. Robinson* (*In re Sweetwater*), 884 F.2d 1323, 1327 (10th Cir. 1989), there was an avoidance cause of action assigned to administrative creditors as collateral on a consensual basis, with the postconfirmation debtor to receive any surplus. The court upheld this because paying administrative creditors in this way freed up other funds for other creditors. Any surplus made the debtor stronger, which assured the plan would be met.

218. Some debtors-in-possession have attempted to use the trustee's avoidance rights as collateral. See *Trans World Airlines*, 163 B.R. at 964. In *Fleet National Bank v. Doorcrafters* (*In re North Atlantic Millwork Corp.*), 155 B.R. 271 (Bankr. D. Mass. 1993), Judge Joan Feeney approved the assignment of these choses in action, after a fashion, but she cut the legs out from under such assignments by ruling that defendants in the avoidance actions had every right to object to the postpetition lender's standing to bring these assigned adversary proceedings. See *id.* at 284; *accord* Tennessee Wheel & Rubber Co. v. Captron Corp. Air Fleet (*In re Tennessee Wheel & Rubber Co.*), 64 B.R. 721 (Bankr. M.D. Tenn. 1986), *aff'd*, 75 B.R. 1 (Bankr. M.D. Tenn. 1987). Judge Feeney based her ruling on a reading of section 1123(b)(3), which provides that a chapter 11 plan may provide for "the retention and enforcement by the debtor, by the trustee or by a representative of the estate appointed for such purpose, of any [such] claim or interest." 11 U.S.C. § 1123(b)(3) (1994). Although section 1123(b)(3) did not apply to a postpetition loan under section 364, Judge Feeney discerned in section 1123(b)(3) a policy against any private party from taking an assignment of an avoidance action. See *Fleet Nat'l Bank*, 155 B.R. at 281-84.

This policy against alienation of a bankrupt estate's avoidance rights is very questionable. Why shouldn't the trustee be able to raise cash by selling this chose in action to a party better equipped to prosecute it?

219. See 11 U.S.C. § 1123(b)(3) (1994). If it is not specifically preserved, however, the chose in action must perforce disappear under the principle of abandonment. Yet, as we shall see, the strong-arm theory is the one that coherently accounts for abandonment. The orthodox theory is rife with problems. See *infra* Part V.B.

220. See 11 U.S.C. § 1129(b)(2)(B)(ii) (1994).

in action is distributed, the owner of the chose in action is entitled to assert *res judicata* of the confirmation order.²²¹

To give an example, suppose *D* has \$250 of unsecured debt and has made a fraudulent conveyance of a \$100 thing to *A*. *D* also has \$10 in unencumbered assets in her estate. In such a case, the strong-arm theory states that *A*'s thing can be recovered and sold, in which case the estate would have \$110 worth of assets to be distributed to the creditors. One of the assets would be the right to recover the \$100 thing from *A*.

Often, plans are confirmed in which the creditors obtain the \$10. In addition, the cause of action against *A* is preserved and becomes an asset of the debtor personally. All claims of the creditors are discharged. Now, when *D* enforces the fraudulent conveyance action, *D* keeps the proceeds and the creditor gets none. It is precisely this situation which led courts to conclude that the fraudulent conveyance action does not "benefit" the estate within the meaning of section 550(a).

In fact, the cause of action was of great benefit to the estate before confirmation. The cause of action specifically was preserved in the plan. The *res judicata* effect of the plan should preserve the cause of action after confirmation.²²² Perhaps the plan should not have been confirmed because the cause of action was inappropriately valued. This valuation error should not be used as a pretext for stating that the cause of action does not exist.

The cause of action must be valued, and the creditors must receive the benefit, if the plan is to be confirmed. If the cause of action has variance—for example, there is a 50% chance the debtor will recover \$200 and a 50% chance the debtor will recover zero—a chapter 11 plan ought to be drafted with care to assure that the creditors—not the debtor—receive the value.²²³ The best way of proceeding is to give creditors \$10 *and* a nonrecourse security interest on the recovery. This way, any proceeds later realized benefit the creditors and never the debtor.²²⁴

221. On the *res judicata* effect of plans, see *Sanders v. Heller Financial, Inc.* (*In re Sanders Confectionery Prods., Inc.*), 973 F.2d 474, 480-81 (6th Cir. 1992). According to Judge Peter Walsh, "How, in any particular case, a recovery is used and whether any of it is distributed to creditors is a function of the conduct of the case and the negotiations of the plan of reorganization." *Trans World Airlines*, 163 B.R. at 973.

222. See *Amarex, Inc. v. Marathon Oil Co.* (*In re Amarex, Inc.*), 74 B.R. 378, 381 (Bankr. W.D. Okla. 1987) (presuming creditors traded away avoidance causes of the action to debtor for something of value), *aff'd*, 88 B.R. 888 (Bankr. W.D. Okla. 1988).

223. See *Citicorp Acceptance Co. v. Robison* (*In re Sweetwater*), 884 F.2d 1323, 1329 (10th Cir. 1989) (acknowledging that valuation is a problem when the cause of action has variance and that valuation problems "might allow finagling creditors to get better treatment than other similarly situated creditors").

224. Such a plan was confirmed in *Wellman v. Wellman*, 933 F.2d 215 (4th Cir. 1991). Creditors were issued nonrecourse notes payable out of a fraudulent conveyance action the

If, however, this is not done, *res judicata* should still prevent a court from revisiting valuation of the avoidance cause of action after the fact. The cause of action has a quantitative limit—as defined by the trustee's preconfirmation representative capacity. The plan is capable of assigning this cause of action, and the assignee should have whatever right the bankruptcy trustee had to convey—even if the plan itself discharges the valid claims of *D*'s creditors.²²⁵

E. Transferees of Transferees

In spite of everything that has been said, one aspect of section 550 does point to the centrality of that provision to avoidance theory and, hence, away from the independent integrity of the strong-arm power. If section 550(a) is the sacred fount of avoidance power, then the good faith transferee defenses seem to work logically. If the strong-arm power is the center of avoidance theory, then the defenses do not apply, and the trustee can evade what Congress surely intended.

There are two such defenses. First, section 550(b) states:

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

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

(2) any immediate or mediate good faith transfer or such transferee.²²⁶

Only entities described in section 550(a)(2) have this defense—transferees of a transferee. Second, section 550(e)(1), which applies to initial and remote transferees alike, provides:

[a] good faith transferee from whom the trustee may recover under subsection (a) of this section has a lien on the property recovered to secure the lesser of—

(A) the cost, to such transferee, of any improvement made after the transfer, less the amount of any profit realized by or accruing to such transferee from such property; and

(B) any increase in the value of such property as a result of such improvement, of the property transferred.²²⁷

debtor had the right (but not the duty) to bring. See *id.* at 216. Nevertheless, the court dismissed the cause of action because the debtor might get a surplus over what the creditors might receive. See *id.* at 219. The court was also disturbed that the debtor had the freedom to drop the lawsuit altogether, in which case the creditors would get nothing. See *id.* This led the court to believe the creditors would have voted for the plan anyway, even if the cause of action had not been preserved in the plan. See *id.* All this violated the *res judicata* quality of chapter 11 plan confirmation.

225. See *J.E. Jennings, Inc. v. William Carter Co. (In re J.E. Jennings, Inc.)*, 46 B.R. 167, 170-71 (Bankr. E.D. Pa. 1985).

226. 11 U.S.C. § 550(b) (1994).

227. *Id.* § 550(e)(1).

Both these defenses key into section 550(a). Since the orthodox theory exalts section 550(a) as the source of avoidance, these defenses are always available.

If, however, avoidance could be sustained under section 544 (in conjunction with other avoidance powers), these defenses are not available. Instead, the trustee's judicial lien would encumber the voidably conveyed property, even in the hands of a subsequent bona fide transferee.

If the transferee of a transferee took the conveyance before bankruptcy, then a common law answer might be available. The avoiding powers in effect create a "voidable title" in A. Voidable title always presupposes a power in A to give good title to bona fide purchasers for value.²²⁸ Even so, if the transferee of a transferee is a nonpurchaser, the common law answer would not be as extensive as section 550(b), which protects transferees generally (not just purchasers). Of course, common law being malleable, perhaps courts could borrow the principles of section 550(b) (protecting nonpurchasers) to extend the usual principle of bona fide purchaser protection.

Such a solution is more difficult in the case of a transferee of a transferee who takes her conveyance after the bankruptcy petition. Such property, at the time of the conveyance is, *ex hypothesi*, already encumbered by the trustee's judicial lien. Judicial liens are often (though not always)²²⁹ good against subsequent bona fide transferees. To the extent the trustee could proceed directly under section 544(a), without reference to section 550(a), the transferee of a transferee would lose the defense under section 550(b) in cases of postpetition transfers. Likewise, the improvement lien under section 550(e) would not be available.²³⁰

Still, this must aid *against* the orthodox theory. If the defenses in section 550 point to the centrality of section 550 in general, what can be said of section 551? Anything the trustee "avoids" under section 544, section 547, or various other provisions is preserved for the estate. Thus, even if a transferee of a transferee has a defense under section 550(b) for an action under section 550(a)(2), there is no defense against section 551, which gives the trustee property rights in the disputed thing. Hence, the trustee might bring a turnover action under section 542(a) for a thing preserved to the estate under section 551. Under such a theory, the section 550(b) defense would not technically apply. Even orthodox theory must admit a gaping hole exists in the theory of defense to avoidance powers.

228. See U.C.C. § 2-403(1) (1995).

229. See N.Y. C.P.L.R. § 5202(a), (b) (1997).

230. An improvement lien is separately protected under section 548(c). In addition, improvement of the voidably conveyed property would probably give rise to a section 547(c)(4) defense if the theory of avoidance is preference.

One case invoking the orthodox theory to evade these difficulties is *Black & White Cattle Co. v. Shamrock Farms (In re Black & White Cattle Co.)*.²³¹ This case involved the bankruptcy of a feed lot that maintained cattle belonging to others. In California, as of 1983, if cattle were enrolled by their owner in a feed lot for fattening, then purchasers, creditors, or encumbrancers without knowledge were entitled to assume that the cows belong to the lot owner, unless the true owner filed notice in the public records.²³² More precisely, the cows were treated as having been fraudulently conveyed by the feed lot operator to the real owners of the cattle.²³³ The California statute requiring notice filing had long been forgotten by most ranchers. Perceiving this, the feed lot owner in *Black & White Cattle Co.* induced ranchers to matriculate their cattle into the feed lot before filing for chapter 11 reorganization.²³⁴ In its guise as a hypothetical judicial lien creditor without knowledge, the debtor-in-possession claimed to own the cattle free and clear of the beneficial owners of the cattle.²³⁵ The trustee was, in short, the ideal cattle rustler.²³⁶

The owners of the cattle, however, had been paying for feed all along. This, they claimed, gave rise to an improvement lien under section 550(e)(1). For this theory to work, it had to be the case that section 550(a) was the source of the trustee's right.

The debtor-in-possession resisted, claiming that it could avoid the transfer directly under section 544(b), without regard to section 550(a).²³⁷ Judge Robert Beezer, however, decided for the owners.²³⁸ In effect, Judge Beezer ruled that all avoidance is a "recovery" under section 550(a). This implies that "recovery" is mandatory under section 550(a). Otherwise, avoidance would not be subject to section 550(e)(1), which specifies itself as applying *only* to recoveries under section 550(a).

231. 30 B.R. 508 (B.A.P. 9th Cir. 1983), *rev'd*, 746 F.2d 1484 (9th Cir. 1984) (per curiam).

232. See CAL. CIV. CODE § 2980.5(b) (West 1974) (repealed 1984).

233. See *Black & White Cattle Co.*, 30 B.R. at 525-26.

234. See *id.* at 511.

235. See *id.*

236. As a result of Judge Katz's opinion, the California legislature immediately repealed the forgotten recording system for feed lots, so that rustling by bankruptcy has become impossible. Also, the Ninth Circuit reversed in an unpublished opinion. See *Black & White Cattle Co. v. Shamrock Farms Co. (In re Black & White Cattle Co.)*, 746 F.2d 1484 (9th Cir. 1984) (per curiam). The Ninth Circuit ruled that a trustee would have paid the cows a visit after all, would have observed the brands, and would have concluded that the feed lot owner did not own the branded cows in his lot. See *Black & White Cattle Co. v. Granada Cattle Services, Inc. (In re Black & White Cattle Co.)*, 783 F.2d 1454 (9th Cir. 1986).

237. See *Black & White Cattle*, 783 F.2d at 1462 ("Similarly, B & W argues that since it at all times retained physical possession of the animals, it merely avoided the transfer rather than recovered the property transferred, making § 550(d) inapplicable.").

238. See *id.*

This aspect of section 550 does point toward the centrality of that provision after all. Strong-arm theory does not easily account for how it could be that section 544(a) states an independent cause of action, yet the defenses in sections 550(b) and 550(e)(1) still apply.

To further complicate matters, however, there is one situation in which the defense in section 550(b) points away from the centrality of section 550(a). Consider the case of *Torgenrud v. Missoula Federal Credit Union (In re Reinertson)*,²³⁹ where a car dealer extended secured credit to one of its buyers. Before the buyer trod the path to bankruptcy (somehow especially popular just after the debtor has bought a car on credit), the car dealer sold the "chattel paper"²⁴⁰ to a financier. Thereafter, the buyer filed a petition in bankruptcy.

The security interest was not perfected within the grace period of section 547(e)(2)(A) or section 547(c)(3)(B). It was therefore a preference—a transfer on antecedent debt. The financier's security interest was, accordingly, avoided.

In this case, the court implicitly imposed a section 547 theory without reference to section 550(a). If section 550(a) were the operative theory, then the court would have been forced to concede that the financier was a transferee of a transferee within the meaning of section 550(a)(2). Such persons are entitled to a defense of good faith under section 550(b). Yet, this defense was never raised. This implies that section 547(b) was the implicit theory—not section 550(a)(2).

V. MISCELLANEOUS MATTERS

Aside from avoidance theories, various other incidental matters testify as to whether ordinary "successorship" theory or the strong-arm theory best describes the constitution of the bankruptcy estate. These are: (a) the rules on postpetition interest; (b) abandonment of estate property by the trustee; and (c) the status of exempt property. The first matter cuts in favor of the strong-arm theory. The latter two categories cut against it and in favor of the orthodox account.

A. *Postpetition Interest*

Perhaps the most important case under the Bankruptcy Code is *United Savings Ass'n of Texas v. Timbers of Inwood Forest Associates (In re Timbers of Inwood Forest Associates)*,²⁴¹ where Justice Scalia ruled that an undersecured creditor is not entitled to "opportunity costs"—that is, post-petition interest on the secured portion of the

239. 224 B.R. 137 (Bankr. D. Mont. 1998).

240. "Chattel paper" is the buyer's obligation to pay, secured by personal property collateral. See U.C.C. § 9-105(b) (1995).

241. 484 U.S. 365 (1988).

undersecured claim.²⁴² Thanks to this opinion, chapter 11 relieves debtors of debt service during the pendency of the bankruptcy and provides every incentive for debtors to prolong the bankruptcy proceeding as much as possible.

The statutory basis for this decision is extremely shaky. The weaknesses of the argument need not be rehearsed here.²⁴³ For present purposes, I only emphasize that the status of the trustee as a hypothetical judicial lien creditor explains why undersecured creditors should have no claim against the trustee for postpetition interest.

The trustee's hypothetical lien creditor status is a kind of "what if" exercise based on the idea that bankruptcy can be viewed as a collective creditors' remedy that displaces individual remedies. Subjunctive, "counterfactual" speculation has always played a huge part in the debate over adequate protection and postpetition interest entitlements. Usually, the argument for giving undersecured parties postpetition interest rests on the supposition that, but for bankruptcy, the secured party would have repossessed the collateral, foreclosed on it, and earned interest.²⁴⁴ Instead of imagining that there had been no bankruptcy, as is usually done, the strong-arm theory asks us to imagine that, but for the bankruptcy, a judgment creditor under state law has induced a sheriff to levy the collateral. This collateral cannot be sold, however, because there is no debtor equity. Now the sheriff cannot know there is no debtor equity until she holds an auction and fails to get a bid. Until then, the absence of debtor equity is a mere *prediction*. Pending the attempted sale, the sheriff is obliged to retain the collateral. Once it is clear that there can be no sale because there is no debtor equity, the sheriff then releases the collateral back to the secured party.²⁴⁵ If *this* were the counterfactual history, it ought to be clear that the undersecured party could not collect interest for the delay from either the sheriff or the judgment creditor. Similarly, in bankruptcy, when a trustee "levies" for the benefit of all the general creditors, undersecured parties should not be able to get postpetition interest from the trustee or the general creditors. Under this view, the strong-arm theory coheres with the idea that undersecured parties should not get postpetition interest.

242. See *id.* at 379.

243. For a detailed treatment, see David Gray Carlson, *Postpetition Interest Under the Bankruptcy Code*, 43 U. MIAMI L. REV. 577 (1989).

244. See Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 108, 115 (1984).

245. Ordinarily, junior judicial lien creditors cannot foreclose or affect senior security interests. See Carlson, *Death and Subordination*, *supra* note 45, at 569.

B. Abandonment

The Bankruptcy Code authorizes a trustee to abandon property with court approval.²⁴⁶ Abandonment as such is hard for orthodox theory to conceptualize. If the trustee renounces property, then in whose favor shall it be renounced? Orthodox theory undoubtedly announces, “[t]o whomever owned it prior to bankruptcy.” Within the context of orthodox theory, however, this answer makes no sense. It is an ad hoc solution not driven by the theory itself. (But then perhaps the orthodox theory is nothing *but* an ad hoc collection of rules with no unity whatsoever.)

The strong-arm theory has an elegant solution. Abandonment constitutes a renunciation of the trustee’s judicial lien on assets. Hence, if the debtor owns the surplus, the debtor’s property is now unencumbered if the trustee abandons it. If *A* owns the surplus, then *A* owns it.

The strong-arm view, however, cannot be obtained from the Bankruptcy Code itself. According to section 554(c), “Unless the court orders otherwise, any property scheduled under section 521(1) of this title not otherwise administered at the time of the closing of a case is abandoned to the debtor and administered for purposes of section 350 of this title.”²⁴⁷

Similarly, in chapter 11 cases, section 1141(b) states, “Except as otherwise provided in the plan or the order confirming the plan, the confirmation of a plan vests all of the property of the estate in the debtor.”²⁴⁸ These provisions suggest that, if a trustee has avoidance rights against *A*, the debtor inherits these causes of action. Thus, in the case of a fraudulent transfer, *D* might be able to avoid her own gift to *A* to the extent the trustee could have done so.

Courts, however, are clearly prepared to override the “plain meaning” of these statutes in order to reach the strong-arm result. Thus in *Harstad v. First American Bank (In re Harstad)*,²⁴⁹ joint debtors filed for chapter 11 and became debtors-in-possession.²⁵⁰ Prior to filing the debtors in *Harstad* paid some funds to a bank to cover an overdraft in their checking account.²⁵¹ The bank seemed to

246. See 11 U.S.C. § 554(a) (1994).

247. *Id.* § 554(c). Section 350 of the Bankruptcy Code in turn provides:

(a) After an estate is fully administered and the court has discharged the trustee, the court shall close the case.

(b) A case may be reopened in the court in which such case was closed to administer assets, to accord relief to the debtor, or for other cause.

Id. § 350.

248. *Id.* § 1141(b).

249. 39 F.3d 898 (8th Cir. 1994).

250. See *id.* at 902.

251. See *id.* at 901.

have been an initial transferee of a voidable preference;²⁵² the chapter 11 plan had been confirmed, however, before the voidable preference had been recovered. The debtors nevertheless tried to sue after confirmation, thinking themselves the heir to the estate's avoidance power and citing section 1141(b) to prove it.²⁵³

Judge Pasco Bowman dismissed the debtor's cause of action against the bank.²⁵⁴ This result is perfectly consistent with the strong-arm theory of abandonment. According to this theory, confirmation of a plan terminates the estate. Termination of the estate is termination of the judicial lien. The voidable preference action depends upon the perpetuation of the judicial lien. The plan itself might perpetuate the judicial lien and distribute it to the debtor, or to an assignee who might then enforce it. The plan did not do so, however. The voidable preference action simply drifted away, because it needed the trustee's strong-arm power to supplement it.

Yet how can this be sustained in light of section 1141(b)? Judge Bowman managed to avoid the plain meaning of section 1141(b) with a weak argument. Judge Bowman noted that section 1123(b)(3) states that a plan *may* (but need not) provide for the settlement or adjustment of "any claim or interest belonging to the debtor or to the estate; or . . . the retention and enforcement by the debtor, [of that claim or interest] by the trustee, or by a representative of the estate appointed for such."²⁵⁵ This section, Judge Bowman reasoned, would be rendered superfluous if the debtors inherited choses in action under section 1141(b):

The Harstads would have us rely on [§1141(b)], rather than § 1123(b)(3), in deciding whether they may maintain this cause of action Were we to adopt the Harstads' argument, we would render § 1123(b)(3) a nullity. As the Harstads see it, § 1123(b)(3) gives debtors discretion to reserve to themselves, in their plans, post-confirmation claims, which claims are subsumed in the broad category of "property of the estate" that already vests in the debtors automatically upon plan confirmation under § 1141. Why then would a debtor ever bother to retain a power by specific plan language when the Bankruptcy Code gives him that power automatically? We think that the affirmative course of action set forth in § 1123(b)(3), to be followed by the debtor who wishes to retain the right to bring preference claims, preempts the general provision of § 1141 that dumps all remaining post-confirmation estate property into the lap of the debtor.²⁵⁶

252. *See id.*

253. *See id.* at 902.

254. *See id.*

255. *Id.* (quoting 11 U.S.C. § 1123(b)(3) (1994)).

256. *Harstad*, 39 F.3d at 902-03.

Thus, the plain language of section 1141(b) must be overridden by the mere possibility that a phrase or two from section 1123(b)(3) might be superfluous.²⁵⁷

The trouble with such arguments is that they are defeated if one can think of even the slightest utility for the supposedly superfluous provision. Thus, it might be said of section 1123(b)(3) that the reference to "debtor" was simply to signal that a chose in action might be retained by the debtor *or* conveyed to a third person. It establishes a choice as to whom the chose in action might be conveyed. Hence, section 1123(b)(3) is utile after all.

Judge Bowman's principle also leads to absurd results. It suggests that, if a debtor does not deal with a chose in action in a plan, the account debtor²⁵⁸ is automatically discharged. Suppose a chapter 11 debtor has a tort claim and simply forgets to deal with it in the plan. On Judge Bowman's logic, the tortfeasor is discharged because the plan did not specifically state that the debtor retained the chose in action. Surely chapter 11 discharges debtors, not account debtors of the debtor.²⁵⁹

As a second rationale, Judge Bowman also ruled that the postconfirmation voidable preference action would benefit the debtors personally, not the estate.²⁶⁰ Yet section 550(a) enjoins a trustee to recover for the benefit of the estate.²⁶¹ This argument was criticized earlier for ignoring the fact that equity claims against the estate are just as valid as creditor claims.²⁶² Still it cannot be denied that the cause of action for voidable preference did exist. This cause of action would have benefited the estate if enforced before. And all property is

257. At trial, Judge Robert Kressel made an excellent policy point: The creditors do not know whether a voidable preference or a fraudulent transfer action exist unless the debtor-in-possession discloses them. See *Harstad v. First Am. Bank (In re Harstad)*, 155 B.R. 500, 509-10 (Bankr. D. Minn. 1993), *aff'd*, 39 F.3d 898 (8th Cir. 1994). If the debtor could stay mum and retain all choses in action, the creditors would be cheated and misled into voting for plans they would otherwise oppose. See *id.* at 509. This fine point I take to be what Justice Antonin Scalia has scorned as a "policy intuition of a legislative character." *Dewsnup v. Timm*, 502 U.S. 410, 422 (1992) (Scalia, J., dissenting). This Article, however, stands aloof from so-called policy and tries to let the Bankruptcy Code speak for itself.

258. The account debtor is "the person who is obligated on an account, chattel paper or general intangible." U.C.C. § 9-105(1)(a) (1995). In other words, the account debtor is the debtor of a debtor.

259. See *Venture Properties, Inc. v. Norwood Group, Inc. (In re Venture Props., Inc.)*, 37 B.R. 175, 177 (Bankr. D.N.H. 1984) ("It has been a cardinal principle of bankruptcy law from the beginning that its effects do not normally benefit those who have not themselves 'come into' the bankruptcy court with their liabilities and all of their assets."). On the power of chapter 11 plans *overtly* to discharge non-debtors, see Ralph Brubaker, *Bankruptcy Injunctions and Complex Litigation: A Critical Reappraisal of Non-Debtor Releases in Chapter 11 Reorganizations*, 1997 U. ILL. L. REV. 959, 994-1001. Of course, we speak here of *covert* discharges—an even more questionable proposition.

260. See *Harstad*, 39 F.3d at 904.

261. See *id.*

262. See *supra* text accompanying notes 76-79.

deemed conveyed to the debtors upon confirmation.²⁶³ Nothing in section 550(a) clearly states that a cause of action goes out of existence. In contrast, the strong-arm theory of estate creation tells a valid tale of estate termination and abandonment of property back to A.

In short, successorship may be an adequate (but imperfect) theory of estate *creation*, but, as executed by the drafters of the Bankruptcy Code, it is an inept concept of *terminating* the bankruptcy estate. Here is an occasion where the drafters would have been well advised to have adhered to the strong-arm theory.

C. Exempt Property

The strong-arm theory helps to solve some problems that are intractable for the orthodox theory. There are some problems it cannot solve—problems for which orthodox theory is superior.

If the strong-arm theory explained the Bankruptcy Code, then we would expect to find that the trustee's hypothetical judicial lien never attaches to the debtor's exempt property. Whatever a debtor could exempt in state law could be exempted in federal law. Prior to the Bankruptcy Code, the Bankruptcy Act *did* more or less follow a strong-arm theory. Only the state exemptions were honored.²⁶⁴ This characterization might be challenged, however, in that the Bankruptcy Act honored state exemptions only if the debtor had been domiciled in the state for a majority of a six month period.²⁶⁵ Under state law, judicial lien creditors probably could not reach exempt property, regardless of the length of the domicile.

The Bankruptcy Code changed the entire theory of exemptions thereby damaging the entitlement of the strong-arm theory to structural dominance. In 1978 Congress created exemptions that were valid in bankruptcy only. Apparently, this move was controversial. As a result of regional sentiment for local exemption law, Congress also allowed each state to 'opt out' of the federal exemptions.²⁶⁶ Thirty-five states have opted out.²⁶⁷ Nevertheless, fifteen states have permitted federal exemptions to exist. In those states, a debtor might own property that is exempt from the bankruptcy estate but subject

263. See 11 U.S.C. § 1141(b) (1994).

264. See Bankruptcy Act of 1898, ch. 541, § 6, 30 Stat. 544, 548 (1898); William Houston Brown, *Political and Ethical Considerations of Exemption Limitations: The "Opt-Out" as Child of the First and Parent of the Second*, 71 AM. BANKR. L.J. 149, 157 (1997).

265. According to section 6 of the Bankruptcy Act, a debtor could have the exemptions "[p]rescribed by the State laws in force at the time of the filing of the petition in the State wherein they have had their domicile for the six months or the greater portion thereof immediately preceding the filing of the petition." Bankruptcy Act of 1898, ch. 541, § 6, 30 Stat. 544, 548 (1898). Section 6 went on to prohibit exemptions from property the debtor transferred or concealed.

266. See 11 U.S.C. § 522(b)(1) (1994).

267. NATIONAL BANKRUPTCY REVIEW COMMISSION, BANKRUPTCY: THE NEXT TWENTY YEARS, FINAL REPORT 299-301 (1997).

to judicial liens. It is understood (though nowhere stated) that the trustee's strong-arm power cannot be used to obtain the debtor's exempt property where state law would allow the lien. The whole purpose of the federal exemption was to give debtors more exemptions than they might get under often-antiquated state law.

Procedurally, the initial treatment of exempt property might seem to violate the strong-arm theory. Typically, exempt property is simply immune from judicial liens. Occasionally, though, property might be subject to judicial liens but recoverable from the judicial lien by a subsequent declaration of a homestead.²⁶⁸ These were the rules followed by the Bankruptcy Act, which had a true strong-arm flavor to it. Exempt property never entered the bankruptcy estate, or could be removed after the fact in the case of a subsequent declaration of homestead.

The Bankruptcy Code does not adhere to this logic. Today, *all* exempt property enters the bankruptcy estate.²⁶⁹ The exemptions must be claimed by the debtor after the fact. Only then does the exempt property leave the estate.²⁷⁰ At least for a time, the trustee's power over exempt property exceeds the power of judicial lien creditors, and therefore, we cannot properly say that the Bankruptcy Code follows the strong-arm theory when it comes to exemptions.

Another place in which orthodox theory works better than strong-arm theory is with regard to the prepetition transfer by *D* of exempt property. The Bankruptcy Code makes clear that such property might be recoverable for the benefit of the estate—not the debtor—under the voidable preference statute of the strong-arm power. But if avoidance merely means property is made susceptible to the trustee's judicial lien, how can the trustee recover the property when the property is exempt from judicial liens? Section 550(a), however, fully permits the recovery of conveyances “avoided” under section 547(b). Hence, orthodox theory has no problem with voidably transferred exempt property.

It is possible at least to mitigate the damage done to the strong-arm theory from the challenge of voidably conveyed exempt property. To see why, let us examine the following basic state law situation. Suppose *D* owns exempt property. Under state law this merely implies that judicial lien creditors may not levy on such property. But *D* is quite free to grant security interests on such property. These security interests may end up being voidable preferences, but only after we solve a metaphysical puzzle related to the “hypothetical judicial lien creditor” test in section 547(e).

268. See, e.g., *In re Wilkinson*, 196 B.R. 311, 315 (Bankr. E.D. Va. 1996) (Virginia law).

269. See 11 U.S.C. § 541(a) (1994).

270. See *id.* § 522(l).

In some states, such as New York, the law simply provides that certain “things” may never be levied by judicial lien creditors.²⁷¹ Suppose one of these “things” is encumbered by *A*’s unperfected security interest not avoidable under section 522(f)(1)(B). Can a judicial lien creditor, who could not have levied upon the “thing” if it were unencumbered, do so because *D* has conveyed it away to an unperfected secured party?

On one view, the judicial lien creditor can have no priority to the exempt item, even though Article 9 specifies that “an unperfected security interest is subordinate to the rights of . . . a person who becomes a lien creditor before the security interest is perfected.”²⁷² The judicial lien creditor loses because she never gets a judicial lien in the first place and, therefore, does not “become a lien creditor” within the meaning of U.C.C. section 9-301(1)(b). If *D* were to become bankrupt in New York, the unperfected security interest might survive the trustee’s strong-arm power because the trustee’s status as a hypothetical judicial lien creditor is entirely parasitic of state law.²⁷³ Neither is the unperfected security interest a voidable preference. Voidable preference law defers the timing of unperfected security interests until such time as they are “perfected.”²⁷⁴ “Perfection” is defined as “a transfer of a fixture or property other than real property . . . when a creditor on a simple contract cannot acquire a judicial lien that is superior to the interest of the transferee.”²⁷⁵ Under this definition, if a judicial lien creditor can never levy a thing at all, a security interest on the thing is self-perfecting for purposes of federal voidable preference law.

But there is another and better way of viewing the matter. These exemption statutes that make whole “thing” exempt may imply that only the debtor equity in the named “things” is really exempt once the rest of the thing has been given away to a secured party. That part of the “thing” encumbered by an Article 9 security interest is no longer exempt, and may now be reached by a judicial lien when the security interest itself is unperfected. On this view, an unperfected security interest on exempt property in states like New York can be subject to the strong-arm power of the trustee, and hence the voidable preference power.²⁷⁶

271. See N.Y. C.P.L.R. 5205(a) (McKinney 1978).

272. U.C.C. § 9-301(1)(b) (1995).

273. See 11 U.S.C. § 544(a)(1) (1994).

274. A grace period of 10 days after attachment is provided. See *id.* § 547(e)(2)(A).

275. *Id.* § 547(e)(1)(B).

276. One problem with this view is that, if the property is exempt for *D*, it is likely to be exempt for *A* as well. It is odd to think that an unperfected security interest in the family bible might be exempt property for *A*. Exemptions are supposed to be the stuff of a fresh start and hence logically should be limited to debtor equity interests in the exempt things.

In other states, this result is more clearly reached. Sometimes, exemption law specifies that security interests on the collateral are to be valid.²⁷⁷ They may otherwise specify that only the debtor equity in property is considered exempt.²⁷⁸ Either way, these statutes imply that the part of the exempt item which represents the security interest cannot be exempted; only debtor equity is capable of exemption. Under these statutes, the judicial lien more easily fills in the space opened up by the unperfected security interest, because the part of the thing encumbered by the security interest is not exempt property at all.

On this latter line of reasoning, unperfected security interests can be avoided on exempt property. But who benefits when exempt property is disencumbered? The answer to this question is elucidated by section 522(g), which states:

[T]he debtor may exempt under subsection (b) of this section property that the trustee recovers under section 510(c)(2), 542, 543, 550, 551, or 553 of this title, to the extent that the debtor could have exempted such property under subsection (b) of this section if such property had not been transferred, if—

(1)(A) such transfer was not a voluntary transfer of such property by the debtor; and

(B) the debtor did not conceal such property; or

(2) the debtor could have avoided such transfer under subsection (f)(2) of this section.²⁷⁹

How does this section reflect on the theory at hand? If the trustee could recover property under section 547 in conjunction with section 544(a)(1), then the trustee can avoid recovery and could then keep the property in the estate, even though *D* could have exempted it but for the transfer. Section 522(g) in effect overrides *D*'s power to exempt the thing from the trustee's judicial lien, and this in turn cuts against the validity of the strong-arm theory.

A question arises. Judicial liens on exempt property are "void" under section 522(f)(1)(A). Could *D* avoid the trustee's hypothetical judicial lien under section 522(f)(1)(A) and retake the exempt property from the trustee, even though it was voluntarily conveyed to *A*? If so, *D* may obtain the exempt property in contravention of section

New York law nowhere limits exemptions to debtor equity interests, but undoubtedly a court would so find, if the case were ever presented.

277. See, e.g., MISS. CODE ANN. § 85-3-1(e) (1998) ("Nothing . . . shall in any way affect the rights . . . of the . . . owner of a . . . voluntary security interest.")

278. See, e.g., COLO. REV. STAT. § 13-54-107 (1987).

279. 11 U.S.C. § 522(g) (1994). In 1994 Congress moved the avoidance provision formerly in section 522(f)(2) into section 522(f)(1)(B). Congress neglected to repair the cross-reference in subsection (g), however. The following discussion will assume that the cross-reference is to section 522(f)(1)(B).

522(g). Such a result was never intended, and section 522(g) in this different way cuts against the strong-arm theory.

One debtor tried to avoid the trustee's hypothetical judicial lien under section 522(f)(1)(A), only to be defeated. According to Judge Jo Ann Stevenson, "The Trustee does not have a judicial lien on the Debtors' automobile. Rather, he merely has the rights of a judicial lienholder . . . for avoidance purposes."²⁸⁰ This is the same metaphorical paradox we faced earlier: can a person with the rights of a lienholder be distinguished from a lienholder? Or is a thing with all the properties of a duck not a duck?

A better answer for Judge Stevenson is that the potentially exempt property is included in the bankrupt estate by virtue of section 541(a)(3) and does not precisely depend on the trustee's hypothetical judicial lien. Indeed, the property was recovered on a voidable preference theory. But this is just to say that the strong-arm theory is wrong. Section 550(a) is the fount of avoidance wisdom after all—as far as section 522(g) is concerned.

VI. AVOIDANCE, NULLIFICATION, AND RECOVERY

The most detailed account of avoidance powers (prior to this one, of course) is provided by Professors Epstein, Nickles, and White in their otherwise excellent treatise on bankruptcy law.²⁸¹ They, too, wish to de-center section 550(a) and preserve some independent validity to avoidance generally, for which they are to be commended. They do not, however, tie avoidance to the strong-arm power. Their terminology is needlessly complex, and they surreptitiously change the meaning of terms as they develop their theory.

Team Epstein defines "avoidance" as "annul[ment]" of a transfer.²⁸² Avoidance, however, is not automatic. Rather, it constitutes an event.²⁸³ This "event" is seen to have three consequences: (1) nullification of the transfer as against the trustee; (2) preservation of the transfer for the benefit of the estate; and (3) in an appropriate case, recovery from transferees or beneficiaries.²⁸⁴

In this account, nullification is *retroactive*. In effect, Epstein and company hold that the trustee *already* owns A's property as soon as the petition is filed but must do something to gain physical control over it. Nullification is said to predicate the other two consequences.

Preservation is simply the concept of section 551. The authors, however, stop short of collapsing the two steps of nullification and preservation. In effect, nullification and preservation (contradictory

280. *In re Milcher*, 86 B.R. 103, 104 (Bankr. W.D. Mich. 1988).

281. See 2 EPSTEIN ET AL., *supra* note 114, § 6-79, at 202.

282. See *id.* at 206.

283. See 1 *id.* at 498-99.

284. See 2 *id.* at 200-01.

terms, except in Hegelian philosophy) together constitute the transfer of *A*'s property back to the estate. This happens *ab initio* as soon as the bankruptcy petition is filed. If we add that this transfer is quantitatively limited to the trustee's representative capacity, we would then have the strong-arm theory straight out.

The third step is "recovery." Recovery is said to exceed avoidance.²⁸⁵ Recovery includes the *in personam* remedy against non-transferees such as beneficiaries of transfers. Yet, conversely, avoidance is a precondition to recovery. Since avoidance is not automatic and must be achieved, it would seem to follow that recovery from a beneficiary cannot occur until avoidance against a transferee is achieved. Yet case law shows that the trustee can pursue the beneficiary directly without first "avoiding" anything in the Epsteinian sense.²⁸⁶

Later in their discussion, however, these authors seem to change the meaning of their terms. "Nullification" comes to mean that the trustee already possesses things encumbered with liens, but the lien disappears.²⁸⁷ In short, nullification is only something that happens to liens. Yet such provisions as section 547(b) do what they do to "transfers" generally. No distinction can be found there between liens, which are "nullified," and other transfers, which are not.

In this new usage "nullification" no longer predicates "recovery," as they had indicated earlier. Avoidance no longer always results in "nullification"—except in lien cases. Finally, it appears that "avoidance" no longer means "annulment." Rather, it means the bare invocation of one of the theories found in sections 547, 548, etc. Such a theory might result in no recovery where a defense under section 550(b) or 550(e)(1) results.

On the narrower meaning of nullification, "recovery" is not needed when the trustee possesses the encumbered thing. On this basis, Epstein and company are able to deny that section 550(a) is central to avoidance. It is utterly not needed when the trustee already possesses the thing and wishes to dissolve the lien that encumbers it. This account, however, is not capable of explaining *Black & White Cattle Co.*,²⁸⁸ where the trustee had possession of the thing encumbered by a voidable lien, yet the lien creditor was able to assert a section 550(e)(1) improvement lien against its own avoided lien. (Of course, the strong-arm theory cannot do so either, since section 550(e)(1) is tied into section 550(a)—not into section 544(a).)

285. See *id.* at 201.

286. See *Crafts Plus+, Inc. v. Foothill Capital Corp. (In re Crafts Plus+, Inc.)*, 220 B.R. 331, 334 (Bankr. W.D. Tex. 1998).

287. See 2 EPSTEIN, *supra* note 114, § 6-79, at 202.

288. See *supra* notes 231-38 and accompanying text.

In the end, Epstein is, like the orthodox theorists, in the thrall of the metaphoric confusion surrounding the term "avoidance." Underlying their theory is the notion that the debtor still owns property voidably conveyed. It enters the estate under section 541(a)(1). A's right in the thing is utterly obliterated. Avoidance power has no quantitative element. Only the qualitative element is recognized. Hence, while Epstein and company are to be commended for heaping scorn on section 550(a), their total theory of the bankruptcy estate does not hold together.

VII. CONCLUSION

This Article has tested the proposition that the trustee's status as a hypothetical judicial lien creditor on the day of the bankruptcy petition is bankruptcy's organizing principle. That is, the creation of the bankruptcy estate is tantamount to the creation of a judicial lien. The judicial lien, however, is quantitatively limited by the amount of claims the trustee represents. Avoidance theories such as fraudulent conveyance or voidable preference never obliterate the property interests of third parties. Rather, these theories merely indicate that third party property is susceptible to a trustee's judicial lien. Avoidance extends only as far as necessary to satisfy the trustee's lien.

The competitor to this theory is the notion that the bankruptcy estate is created by fiat of section 541(a). Section 541(a) gathers together a series of ad hoc notions that cannot be unified. First, the trustee succeeds to the debtor's interests in prepetition property under section 541(a)(1). Second, the estate, per section 541(a)(3), includes what the trustee recovers under section 550. Section 550 then becomes the fount of all the avoidance powers. A third, but neglected, idea is that voidable conveyances preserved for the benefit of the estate under section 551 enter the estate under section 541(a)(4)—undercutting the claim that all avoidance actions must be brought under section 550.

The strong-arm theory does a better job of describing bankruptcy doctrine. It can explain the following: (a) why a trustee of a solvent estate cannot recover a fraudulent conveyance from or avoid a nonrecourse lien of a third party transferee; (2) why the automatic stay prevents private creditors from pursuing fraudulent conveyances in competition with the bankruptcy trustee; (3) why mortgage liens on rent are not voidable preferences; (4) why undersecured creditors do not get postpetition interest; and (5) why abandoned property reverts back to third party transferees rather than the debtor (though the statutory language is not very comfortable with its account).

Still, the strong-arm theory is not perfect. Most importantly, it does a poor job with exempt property, due in large part to positivist interference imposed on bankruptcy law by the ham-handed drafters

of the Bankruptcy Code. Likewise, orthodox theory conforms better to the statutory provisions concerning abandonment of property but at the expense of bad results when property is or ought to be abandoned to third parties.

In the main, the strong-arm theory has shown itself to be a strong competitor in describing how bankruptcy doctrine is organized. It solves problems little dreamt of in orthodox bankruptcy philosophy.