

2004

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Recommended Citation

David G. Carlson, *Indemnity, Liability, Insolvency*, 25 *Cardozo Law Review* 1951 (2004).

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INDEMNITY, LIABILITY, INSOLVENCY

David Gray Carlson*

INTRODUCTION

Suppose *A* has a claim against *B* ("*A v B*"). *B* has a claim over against *C* ("*B v C*").¹ *B*, however, is insolvent and has not actually paid *A*. *B*'s chief asset is, in fact, *B v C*. To what extent can *C* claim that *B v C* is valueless—that *B* was not damaged because *B* is too broke to pay *A*?

This question raises the fundamental legal distinction between indemnity and liability. If *C* has a duty to *indemnify*, *C*'s duty is strictly contingent on *B*'s actual, historic payment of *A*. If *C* is *liable* to *B*, then *A v B* is an element of the damages *C* owes *B* in *B v C*.²

The distinction between indemnity and liability becomes important whenever *B* is insolvent.³ And it is precisely here that the distinction is beginning to break down. The harbinger of meltdown is *Feldman v. New York City Health & Hospitals Corp.*,⁴ where *B* had a contribution right against *C*. Contribution is like indemnity, in that the right is contingent on *B* actually paying *A*.⁵ In *Feldman*, *B* could not afford to pay *A*.

In order to snatch from *C* the ignoble cover of *B*'s insolvency, *A*'s lawyer (*X*) lent the amount of *A v B* to *B*. In exchange, *B* issued a promissory note to *X* and assigned the proceeds of *B v C* as collateral. Newly solvent (or at least liquid), *B* paid *A* by check. *A* guaranteed *X* that *X* would be paid from the proceeds of *B v C*. As collateral for *A*'s

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¹ To conserve punctuation, I have eliminated the periods after "v" in the hypothetical cases of "*A v B*" or "*B v C*."

² *A v B* would not be the only element in *B v C*. *B* can also recover attorneys' fees and related costs from *C*. *Ingersoll Milling Machine Co. v. M/V Bodena*, 829 F.2d 293, 309 (2d Cir. 1987) ("Where a breach of contract has caused a party to maintain a suit against a third person, courts have permitted recovery from the breaching party of counsel fees and other litigation expenses incurred in the suit.")

³ It is also important for the statute of limitations in *B v C*. An action for indemnity accrues only when *B* actually pays *A*. An action for damages accrues when *A v B* comes into existence—a time perhaps long prior to actual payment of *A*.

⁴ 437 N.Y.S.2d 491 (N.Y. Spec. Term 1981), *rev'd*, 445 N.Y.S.2d 555 (N.Y. App. Div. 1981), *rev'd*, 439 N.E.2d 398 (N.Y. 1982).

⁵ See *Klinger v. Dudley*, 361 N.E.2d 974 (N.Y. 1977).

suretyship obligation, *A* pledged to *X* the check *B* had written to *A* in satisfaction of *A v B*. The pledge was accomplished by *A*'s deposit of *B*'s check in *X*'s fiduciary account. Assuming *X*'s bank was the only bank involved in the transaction,⁶ then no funds changed hands *ever*. The whole transaction was financially meaningless. Neither the bank, *X* or *B* ever surrendered control of any capital.⁷

Nevertheless, the *Feldman* court held that *A* was "paid." *A*'s payment vested *B* with a contribution right against *C*. *C* therefore had to pay contribution to *B*, even though *B* was hopelessly insolvent before the loan from *X*. *C*'s payment reimbursed *X*, which released *X*'s security interest in the funds used to pay *A*. Through the magic of secured lending, *indemnity* was transformed into *liability*.

In this article, I argue for the "legal realist" position that, after *Feldman*, the distinction between indemnity and liability is, or ought to be, erased in any case where *B* is insolvent. If the courts can authorize the *Feldman* ploy, they can generally declare that *A* is already deemed paid whenever *B* has any kind of theory against *C* for either indemnity or liability, provided that a mechanism is in place for *A* actually to receive the proceeds of *B v C*. In effect, *A* has a *security interest* in *B v C* as a matter of law. No matter what *B*'s theory is against *C*, this relation should guarantee that *C* can never benefit from *B*'s insolvency.

This solution answers a contradiction that otherwise exists in *B*'s bankruptcy proceeding. The current view is that, in *A v B*, *A* is but an unsecured creditor in *B*'s bankruptcy. As such, *A* has only a pro rata claim against *B*'s bankruptcy estate.⁸ If *B v C* depends on *A*'s payment or assurance of future payment, a certain infinite regress is generated that absolves *C* from paying. Suppose *A* claims \$100 from *B*, but *B* is paying only 10 cents on the dollar in her bankruptcy. This implies that *A* will obtain only \$10, which means that *B v C* is only for \$10. Yet if *C* pays the \$10, *A* will receive only \$1 of this amount. This in turn implies that *B*'s cause of action against *C* is worth only \$1. An infinite regress benefits *C*, until *C*'s obligation to *B* approaches (but never reaches) zero.

All this changes if the law recognizes *A* as *B*'s secured creditor, claiming *B v C* as collateral. In such a case, *C* must pay *B* \$100, but these \$100 are *A*'s cash collateral. *A* therefore ultimately receives \$100 from *C* via the mediation of *B*. Being fully paid, *A* departs from *B*'s bankruptcy proceeding. *B*'s other creditors are benefited by this, since fewer creditors remain to share the existing bankruptcy estate of *B*. The only one who loses out is *C*—as is appropriate. *C* should not obtain a

⁶ This is not entirely clear from the *Feldman* opinion, but most likely appears to be the case.

⁷ This ritual was first suggested in Richard T. Farrell, *Civil Practice*, 29 SYRACUSE L. REV. 449, 488-89 (1978).

⁸ 11 U.S.C. § 726(a)(2) (2000).

windfall just because his victim is broke. Indeed, in many cases, it will be *C*'s wrongful action that caused *B*'s insolvency in the first place. *C* should not be able to benefit just because her villainy was *thoroughly* devastating. The situation is rather like ancient tort law in which a defendant who severely injured the plaintiff had to pay, but the defendant who *killed* the plaintiff was off the hook. Wrongful death statutes were generated precisely to address this anomaly. Something similar is called for in the indemnity cases where the indemnitee is insolvent. *C* ought to be made to pay the full scope of her liability to *B*—whether *B* survives or succumbs financially.

This paper explores the possibility, given the current law, for courts to declare the distinction between indemnity and liability to be erased in the face of the pure possibility that *B* can always effect a secured transaction, where *B v C* is the collateral. In light of this possibility, *A* should *actually* be deemed a secured creditor in *B*'s bankruptcy.

Any such exploration requires an examination of the legal premises of *B v C*. There are two theories relative to *B v C*. (1) *C* is an insurer and *B* is the insured. Pursuant to an express or implied contract, *C* is liable to or has a duty to indemnify *B* for *A v B*. (2) *C* has committed a tort against or breached a contract with *B*. *A v B* is then an incident of *B*'s consequential damages.

This article considers these two theories in turn, to assess the effect of *B*'s insolvency, and the doctrinal possibility that *A* can be a secured creditor in *B*'s bankruptcy proceeding, where *B v C* is *A*'s collateral.

I. INDEMNITY

A. Liability Policies Compared

Suppose *B* wants to buy insurance from *C*. *B* and *C* benefit jointly if they agree that *C* does not have to pay *B* to cover *A*'s liability where *B* is broke. From *B*'s perspective, if *B* is broke and *C* must nevertheless pay, only *A* captures the benefit of the insurance. If *B* has no net worth to protect, what cares *B* if *A* is never paid? (We assume here a certain hardness of spirit in *B*.) Meanwhile, *C*'s exposure is reduced, and for this *C* can afford to offer *B* a lower insurance premium. Such a deal, trafficking in *A*'s misfortune, is called an "indemnity" or "pay first" policy,⁹ because *C* need not pay *B* until *B* presents evidence that *B* has already paid *A*. Where *B* cannot pay, *C* is off the hook. Indemnity

⁹ *Continental Oil Co. v. Bonanza Corp.*, 677 F.2d 455, 459 (5th Cir. 1982), *rev'd*, 706 F.2d 1365 (5th Cir. 1983) (en banc).

policies are motivated specifically by the financial incentive of *C* to hide like a coward behind the insolvency of *B*.¹⁰

Many states have intervened legislatively to prevent *C* from offering indemnity insurance. According to New York Insurance Law section 3420:

(a) No policy . . . insuring against liability for injury to person [or] property shall be issued or delivered in this state, unless it contains in substance the following provisions or provisions which are equally or more favorable to the insured and to judgment creditors so far as such provisions relate to judgment creditors:

(1) A provision that the insolvency or bankruptcy of the person insured . . . shall not release the insurer from the payment of damages for injury sustained or loss occasioned during the life of and within the coverage of such policy or contract.

(2) A provision that in case judgment against the insured . . . shall remain unsatisfied at the expiration of thirty days from the serving of notice of entry of judgment upon the attorney for the insured, or upon the insured, and upon the insurer, then an action may . . . be maintained against the insurer . . . for the amount of such judgment not exceeding the amount of the applicable limit of coverage under such policy or contract.¹¹

In *American Bank & Trust Co. v. Davis (In re F.O. Baroff Co.)*,¹² the court interpreted these provisions to mean that *A* was a secured creditor in *B*'s bankruptcy. In *Baroff*, *C* owed \$100,000 under a policy. *B*'s bankruptcy trustee, having already paid *A* \$93,621, asserted the right to take this amount from the insurance proceeds and add it to the bankruptcy estate. The *Baroff* court, however, ruled that, since *A*'s unsecured deficit exceeded \$100,000, the entire policy should go to *A*. In short, *A* was a secured creditor in *B*'s bankruptcy for the amount of the insurance policy. The above-quoted statute, the court ruled:

was intended by the Legislature to mitigate the effects of an insured person's bankruptcy on those to whom the insured has liability within the scope of the policy, by creating in effect a trust fund of the insurance proceeds for the benefit of the injured person. Therefore, [*A*] acquired rights in the policy superior to [*B*'s] . . .¹³

¹⁰ Economists might be tempted to say here that an indemnity policy cuts out "free riders" like *A* who wish to capture the benefits of *B*'s insurance. Or, alternatively, they might say that indemnity policies facilitate the externalities *B* imposes on the public by undercapitalization. Or, still alternatively, economists might point out that *A v B* is based on jury awards which have nothing at all to do with the true cost of *A*'s injury, so that no scientific prediction of social policy is possible in this (or any other) legal arena.

¹¹ This provision relates back to a 1909 enactment. *Am. Bank & Trust Co. v. Davis (In re F.O. Baroff Co.)*, 555 F.2d 38, 41 (2d Cir. 1977). Where an insurance policy does not contain the clauses required by § 3420(a), the courts will read a policy as if the clauses were there. *Id.* at 41 n.4. For a similar statute, see MICH. COMP. LAWS § 500.3006 (2002).

¹² 555 F.2d 38 (2d Cir. 1977).

¹³ *Id.* at 42.

Proof of *A*'s status as a secured creditor was the fact that New York gives *A* a direct right of action against *C* when *C* insures against the personal liability of *B*:

By giving the injured person a direct action against the insurer, section [3420(a)(2)]¹⁴ clearly demonstrates that the fundamental policy underlying the statute is that injured claimants be protected against their injurers' bankruptcies; had the Legislature's concern been focused solely on the avoidance of windfalls by insurance companies, it could have provided merely that the proceeds of the insurance policy accrue to the bankrupt's estate. Moreover, section [3420(a)(2)] contains no suggestion that the Legislature intended the injured person's right of direct recovery from the insurance company to depend on whether the insured had also suffered loss in the transactions in question. Therefore, section [3420(a)(2)] leaves no doubt that, had [*A*] been able to secure a judgment against [*B*] prior to the latter's being placed in liquidation, [*A*] would have had rights in the insurance proceeds notwithstanding the insured's loss within the scope of the policy.¹⁵

Baroff therefore does directly what this article advocates.¹⁶ It recognizes *A* as a secured creditor in *B*'s bankruptcy, and it awards *B v C* to *A* as collateral.¹⁷

¹⁴ At the time of the *Baroff* case, § 3420 was codified at 11 U.S.C. § 167(1)(b).

¹⁵ *Baroff*, 555 F.2d at 42.

¹⁶ Some aspects of *Baroff* have, however, come under attack. In *Baroff*, *C* issued a fidelity bond—*C*'s promise to reimburse *B* if *B*'s employees caused losses to *B*. In *Baroff*, the court assumed that employee thefts from customers were covered. In short, the fidelity bond was held to be a liability policy. In *175 East 74th Corp. v. Hartford Accident & Indemnity Co.*, 416 N.E.2d 584 (N.Y. 1980), the New York Court of Appeals ruled that fidelity bonds were *not* liability policies. Rather, they covered *B*'s loss of property due to embezzlement and the like. The court conceded that the policy covered *B*'s liability to *A* when *B*'s employee stole *A*'s property. *Id.* Nevertheless, the fidelity bond was declared not a liability policy, for some undisclosed reason. *Accord Anderson v. Employers Ins. of Wausau*, 826 F.2d 777 (8th Cir. 1987).

¹⁷ Directors' and officers' (D&O) insurance stands on a different footing. Typically, *B* is the director and *C* is her insurance company. *A* is often the company of which *B* is director, and it is *A* that is the bankrupt. *C* has promised to cover *B*'s liabilities, which means that, if *A* has a claim against *B*, *A* has a direct action against *C*. But *C* has likewise promised to pay *B*'s legal expenses in *A v B*, and these expenses reduce the amount of insurance *A* can get. If *A* is bankrupt, *A*'s bankruptcy estate has a security interest on *B v C*. Does *B* violate the automatic stay by taking part of *B v C* for *B*'s own legal expenses? In *Louisiana World Exposition, Inc. v. Fed. Ins. Co.* (*In re Louisiana World Exposition, Inc.*), 832 F.2d 1391 (5th Cir. 1987), the court ruled no. *A*'s interest in the policy was limited by its terms. Under the terms of the D&O policy, *B* could invade *B v C* over the opposition of *A*. *A*'s bankruptcy does not change this rule. See *Feld v. Zale Corp.* (*In re Zale Corp.*), 62 F.3d 746 (5th Cir. 1995) (*C* could not get a discharge from liability to *B* for bad faith settlement out of *A*'s bankruptcy); *Homsy v. Floyd* (*In re Vitek*), 51 F.3d 530, 534 n.17 (5th Cir. 1995) (*C* could give proceeds to *A* over the opposition of *B*, provided *C* acted in good faith). But see George Ong, *Directors and Officers Insurance Proceeds in Bankruptcy: The Impact on an Estate and its Claimants*, 13 BANK. DEV. J. 235 (1996) (arguing that *B v C* should be part of *A*'s bankruptcy estate).

The situation is not unlike the circumstance in which *O* conveys a mortgage to *A* and then a mortgage to *B*. *B* files for bankruptcy, and *O* defaults. Does *B*'s automatic stay restrain *A* from foreclosing on *O*, when such an act prejudices *B*? Most authorities say no, though this is hard to

By now it has become standard practice for bankruptcy courts to help *A* pursue *C* on *B*'s insurance, in spite of some apparent obstacles in the Bankruptcy Code. For example, New York and many states require *A* to obtain a judgment against *B* as a condition precedent to the pursuit of *C* directly.¹⁸ The bankruptcy courts have found a way to permit *A* to obtain a judgment against *B* even though *B* has technically been discharged.

Here is how *B*'s discharge can be evaded to assure that *C* actually pays *A*. Bankruptcy Code § 524(a) describes the meaning of discharge. One of the principal effects is that an injunction exists against *A v B*. But this injunction can be lifted, if equity requires. The court in *Hendrix v. Page (In re Hendrix)*,¹⁹ for example, suggested that, at any time after discharge, *A* can return to bankruptcy court, long after a case is closed, to apply for modification of the injunction.²⁰ Even more striking, the *Hendrix* court invited state courts to ignore the injunction under § 524(a) in awarding a judgment in *A v B*. Naturally, the bargain is that the discharge is waived *only* to permit the technical judgment to be entered. *B*, who is discharged, never has to pay anything in terms of liability or even defense costs.²¹ The bankruptcy court simply aids *A* in pursuing *C* directly.²²

justify in ordinary bankruptcy terms, in that the creditors of *B* might benefit from the appreciation value of *B*'s junior secured claim. 1 GRANT GILMORE & DAVID GRAY CARLSON, GILMORE AND CARLSON ON SECURED LENDING: CLAIMS IN BANKRUPTCY § 12.03 (2000).

How is liability insurance different from suretyship? In suretyship, the guarantor is *B* not *C*. *B v C* is *B*'s subrogation right against *C* if *B* is compelled to pay *A*. Still, *A* has a security interest in this subrogation right, as Bankruptcy Code § 509(c) proves. See 11 U.S.C. § 509(c) (2000). Suppose *B* (the surety) is bankrupt. Of course, *C* is principal obligor, and *A* can pursue *C* directly. *C* is often bankrupt simultaneously. Bankruptcy Code § 509(c) makes clear that *B*'s subrogation right is subordinate to *A*'s direct right against *C*. This ends up amounting to precisely *A*'s security interest in *B v C*. See David Gray Carlson, *The Logical Structure of Fraudulent Transfers and Equitable Subordination*, 45 WM. & MARY L. REV. 157, 203-05 (2003).

¹⁸ *Galecor, Inc. v. Institute of London Underwriters*, 729 F. Supp. 1101 (E.D. Pa. 1990); *Tillman v. Fireman's Fund Ins. Co.*, 590 F. Supp. 246 (S.D.N.Y. 1984).

¹⁹ 986 F.2d 195 (7th Cir. 1993).

²⁰ *Accord Green v. Welsh*, 956 F.2d 30 (2d Cir. 1992); *In re Jet Florida Sys., Inc.*, 883 F.2d 970 (11th Cir. 1989); *Houston v. Edgeworth (In re Edgeworth)*, 993 F.2d 51, 54-55 (5th Cir. 1993) (injunction no impediment even though *A* filed no proof of claim in *B*'s bankruptcy). *But see Citibank, N.A. v. White Motor Corp. (In re White Motor Credit)*, 761 F.2d 270 (6th Cir. 1985) (giving this relief only to those creditors who filed proofs of claim). Why proof of claim has anything to do with such relief is a mystery. Why should *C* cower behind the insolvency of *B* in the latter case but not the former case? *White Motors* is rightly criticized in *Green*, 956 F.2d at 34.

²¹ *Greiner v. Columbia Gas Transmission Corp. (In re Columbia Gas Transmission Corp.)* 219 B.R. 716 (S.D. W.Va. 1998) (§ 524(a) not lifted where *B* had to bear legal cost of defense).

²² This was not done in *Freed v. United States Aviation Underwriters, Inc.*, 82 B.R. 9 (S.D.N.Y. 1987), where *A*, subject to discharge in *B*'s bankruptcy, tried to bring a direct action against *C*. The *Freed* court ruled that *A* had not met the condition precedent of obtaining a judgment against *B*. Nor could *A* ever do so, because *B* had been discharged in bankruptcy. *Id.* at 12 (referring to "the finality inherent in the permanent [discharge] injunction"). Under *Hendrix*, however, *A* could revive her rights against *C* by bringing a post-discharge action against *B*,

This ad hoc system works well enough when *A* is the only creditor of *B* with rights against *C*, and where multiple *As* are not pursuing *C*'s policy obligation to *B*. This is the era of mass torts, however, and it is now the custom for insurance proceeds to run out before the *As* are fully paid. Courts have improvised here, too. While the basic rule from state law is the "rustic"²³ one of "first come first served,"²⁴ even state courts have found occasion to impose pro rata sharing on a surfeit of *As*, in certain circumstances. In particular, where numerous *As* join in a law suit against *C*, and where the claims exceed *B v C*, courts have ordered pro rata sharing.²⁵ Given this instinct at state law, it has proved an easy thing for the bankruptcy courts to institute pro rata sharing among the *As*.²⁶

Accordingly, bankruptcy courts have taken charge of the insurance proceeds from *C*, labeling it property of the estate,²⁷ and have administered this fund on behalf of a subset of *B*'s creditors who are covered by this policy.²⁸ Although courts have not yet articulated the ground on which bankruptcy should administer a special fund for the benefit of only a subset of *B*'s creditors, such ground can easily be located in Bankruptcy Code § 725. Section 725 is the all-important provision which states that secured creditors are entitled to receive collateral before the unsecured creditors receive distributions of the bankruptcy estate. According to § 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

thereby vesting a right against *C*.

²³ Robert Keeton, *Preferential Settlement of Liability-Insurance Claims*, 70 HARV. L. REV. 27, 38 (1956).

²⁴ *Negron v. Everady Ins. Co.*, 385 N.Y.S.2d 87 (N.Y. App. Div. 1976); see also *Hartford Cas. Ins. Co. v. Dodd*, 416 F. Supp. 1216 (D. Md. 1976) (Delaware law). *Dodd*, however, involved, in part, a special right of passenger's in *B*'s car. Delaware law prevents *C* from favoring *B* over *A*, when *A* is a passenger. In *Dodd*, *C* did not warn *A* that *C* would pay *B*, thereby exhausting the policy. *C* therefore had a duty to withhold payments to *B* once *C* became informed of *A*'s claim.

²⁵ Keeton, *supra* note 23; Note, *Pro-rating Automobile Liability Insurance to Multiple Claimants*, 32 U. CHI. L. REV. 337 (1965); V.H. Cooper, Annotation, *Basis and Manner of Distribution Among Multiple Claimants of Proceeds of Liability Insurance Policy Inadequate to Pay All Claims in Full*, 70 A.L.R.2d 416 (1960).

²⁶ See generally Barry L. Zaretsky, *Insurance Proceeds in Bankruptcy*, 55 BROOK. L. REV. 373 (1989).

²⁷ E.g., *Minoco Group of Cos., Ltd. v. First State Underwriters Agency of New England*, 799 F.2d 517 (9th Cir. 1986) (automatic stay prevents cancellation of policy since policy was property of the estate); *A.H. Robbins Co., Inc. v. Piccinin*, 788 F.2d 994 (4th Cir. 1986). But see *Houston v. Edgeworth (In re Edgeworth)*, 993 F.2d 51 (5th Cir. 1993) (asserting that the policy is, but the proceeds of the policy are not, property of the bankruptcy estate). The Fifth Circuit has backed off from the distinction between the policy itself and proceeds of the policy. See *Homsy v. Floyd (In re Vitek)*, 51 F.3d 530, 534 n.17 (5th Cir. 1995).

²⁸ *MacArthur Co. v. Johns-Manville Corp.*, 837 F.2d 89, 92 (2d Cir. 1988).

as a lien, and that has not been disposed of under another section of this title.

If all the *As* claiming insurance proceeds from *C* are conceived as secured creditors of *B*, then § 725 comfortably applies to justify bankruptcy administration of insurance proceeds. That they should share pro rata, however, is not established in § 725, but can be borrowed from existing state law instincts.

The *Johns-Manville* case has been prominent in establishing the power of a bankruptcy court to administer insurance proceeds. In *MacArthur Co. v. Johns-Manville Corp.*,²⁹ the Second Circuit approved of a plan whereby insurance proceeds, plus other contributions, were given to a trust for distribution to all the *As* who were covered by the *C*'s insurance policies. The bankruptcy court then issued an injunction barring any *A* from suing *C*. This injunction has proved controversial, and it is sometimes denounced as an overreaching attempt to give *C* a discharge out of *B*'s bankruptcy.³⁰ Yet, once it is recognized that insurance proceeds are simply collateral for *A*'s security interest in *B*'s bankruptcy, *Manville* injunctions do not seem controversial at all. The automatic stay itself should protect *C* and *C*'s proceeds, since these proceeds are property of the bankruptcy estate. The *Manville* injunction also included a declaration that *C*'s payment exhausted *C*'s liability to *B* and hence to any *A*, but there is nothing extraordinary about this. Whenever *B* has a payment intangible on which a creditor claims a lien, it can be expected that *B*'s bankruptcy trustee and the account debtor (*C*) might settle on a payment extinguishing the account.³¹ *Manville* does not seem unusual in this respect.³²

²⁹ 837 F.2d at 92 (2d Cir. 1988).

³⁰ *In re Mahoney Hawkes, LLP*, 289 B.R. 285 (Bankr. D. Mass. 2002); Ralph Brubaker, *Nondebtor Release and Injunctions in Chapter 11: Revisiting Jurisdictional Precepts and the Forgotten Callaway v. Benton Case*, 72 AM. BANKR. L.J. 1 (1998); G. Marcus Cole, *A Calculus Without Consent: Mass Tort Bankruptcies, Future Claimants, and the Problem of Third Party Non-Debtor "Discharge"*, 84 IOWA L. REV. 753 (1999); George W. Kuney, *Misinterpreting Bankruptcy Code Section 363(f) and Undermining the Chapter 11 Process*, 76 AM. BANKR. L.J. 235, 268 (2002).

³¹ *Int'l Harvester Credit Corp. v. Valdez*, 709 P.2d 1233, 1236 (Wash. Ct. App. 1985).

³² On the other hand, the injunction in *Feld v. Zale Corp. (In re Zale Corp.)*, 62 F.3d 746 (5th Cir. 1995), did overreach and was properly overruled. In *Zale*, *A* was bankrupt. *A* had bought D&O insurance for *B*, and the bankruptcy court permanently enjoined any lawsuits against *C* by *B* or by *C*'s excess insurers. If the injunction had been limited to proceeds of *C*'s insurance policy covering *A v B*, it might have survived scrutiny. *Id.* Since *A* was a secured creditor of *B* and had a right to collect *A v B* directly from *C*, these proceeds can be viewed as property of *A*'s bankruptcy estate. *C*'s injunctive protection, however, exceeded protection of *A*'s bankruptcy estate. It prevented any suit by *B* or the excess insurers, whether part of the proceeds of the policy or not. *B* or the excess insurers might have claims against *C* personally that are entirely distinct from *C*'s contractual obligation to pay to *B* (and hence to *A*) the amount of *A v B*. See John F. O'Connor, *Insurance Coverage Settlement and the Rights of Excess Insurers*, 62 MD. L. REV. 30 (2003). Why should they be prevented from bringing these actions, since they did not affect property of the estate?

Of course, § 725 is a chapter 7 rule only, not a chapter 11 rule. Nevertheless, it applies indirectly in chapter 11 cases. At least when a plan is actually confirmed, it must give every creditor at least what she would have received in chapter 7.³³ This provision in effect incorporates § 725 by reference. A harder case posed by the popular practice of conducting asset sales pursuant to § 363(b), even though no chapter 11 plan is in the offing.³⁴ Such cases may never culminate in a confirmed plan. Nor is it clear that they are headed for chapter 7. Nevertheless, in both chapter 11 and chapter 7, § 725 is ineluctable, and courts have had no trouble finding the authority to split up *C*'s insurance proceeds equally among all the *As*.³⁵

Baroff stands for the proposition that *A* is a secured creditor of *B* with a claim on *B v C*. Does this mean that, when *A* obtains a judgment against *B* shortly before *B*'s bankruptcy, *A* has received a voidable preference? Apparently not, by ancient fiat of the Supreme Court, which, without sharing its analysis, simply declared the scheme to be consistent with bankruptcy law.³⁶ But this point can be explained by the fact that *A*'s lien against *B v C* is a statutory lien. Statutory liens are never voidable preferences.³⁷ Statutory liens are themselves voidable if a bona fide purchaser of *B v C* could take a senior interest,³⁸ but this hardly seems possible. If *B* sold *B v C* to *X*, a bona fide purchaser, *C* undoubtedly would still be liable to *A*. This is precisely what it means to say that *A* has a security interest in *B v C*. No bona fide purchaser can claim ignorance of *A*'s security interest when *A v B* is the very content of *B v C*.

Still, the *Baroff* concept undoubtedly creates intractable problems. If every *A* is a secured creditor of *B*, this implies a due process right to notice and hearing if, with court permission, *B* tries to settle with *C*.³⁹ The court in *In re Dow Corning Corp.*,⁴⁰ however, denied this

³³ 11 U.S.C. § 1229(a)(7)(A) (2000).

³⁴ See Douglas G. Baird & Robert K. Rassmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751 (2002) (arguing this has become the true function of chapter 11).

³⁵ In *Johns-Manville*, *B* obtained proceeds from *C* and purported to "sell" them to a trustee in exchange for the trustee's promise to distribute the proceeds equally among the *As*. 837 F.2d 89 (2d Cir. 1988). In other words, an assignment for the benefit of creditors was arranged in the middle of a chapter 11 proceeding. The court ruled that the proceeds were disposed of pursuant to § 363(f)(4), which permits sale of debtor assets free and clear of adverse interests if the adverse interests are in bona fide dispute. *Id.* When this is done, the bankruptcy court retains jurisdiction to decide the dispute. Of course, if the underlying rule is pro rata sharing, there is no real bona fide dispute as a matter of law, but there still might be as a factual matter, as the size of any one claim by *A* affects the security interest of any other *A*. In any case, the *Johns-Manville* court saw no jurisdictional impediment to administering the insurance proceeds on behalf of a surfeit of *As*.

³⁶ *Merchs. Mut. Auto. Liab. Ins. Co. v. Smart*, 267 U.S. 126 (1925).

³⁷ 11 U.S.C. § 547(c)(6).

³⁸ *Id.* § 545(2).

³⁹ Such settlements require court approval, when *B* is bankrupt. FED. R. BANKR. P. 9019(a).

⁴⁰ 198 B.R. 214 (Bankr. E.D. Mich. 1996).

proposition for any *A* who did not already have a judgment against *B* by the time of the bankruptcy petition. This implies that those with judgments against *B* (*A_j*) by the time of bankruptcy *do* have security interests already and are entitled to adequate protection of them⁴¹ against subsequent inroads by other *As*. At least one court has already found *A_j* entitled to postpetition interest accruing against *B v C*.⁴² This in turn implies *A_j*'s right to adequate protection against the appearances of yet other postpetition *As*, who might crowd *A_j*'s claim against the insurance proceeds.

There is probably no way to fit *A_j* into a coherent doctrinal vision. Courts will probably just ad hoc it and declare that, whereas *A_j* must have a judgment against *B* to perfect a direct action against *C*, *A_j* shares with all the other *As* who have no judgments, whenever *B* is bankrupt.

B. *Indemnity Policies*

Not all insurance contracts fall under the regulations described above. For example, in maritime insurance written under New York law,⁴³ *C* is permitted to write a "pay first" policy in which *C* is liable to *A* if and only if *B* has already paid *A*.⁴⁴ "Pay first" policies allow *C* to hide behind the insolvency of *B* and avoid paying on the policy for the benefit of *A*. Apparently, New York was unwilling to extend this rule to maritime policies for fear that New York companies would suffer competitive disadvantage, compared to other states.⁴⁵

In addition to express indemnity contracts, indemnity is often implied into contractual relationships.⁴⁶ For example, if *B* employs *C* and *C* commits a tort against *A* within the scope of employment, *A* may sue *B* pursuant to *respondet superior*, but *C* must indemnify *B*.⁴⁷ An

⁴¹ 11 U.S.C. § 363(e) (2000).

⁴² See *Baez v. Med. Liab. Mut. Ins. Co.*, 136 B.R. 65 (S.D.N.Y. 1992).

⁴³ Maritime insurance contracts are governed by state, not federal maritime, law. See *Wilburn Boat Co. v. Fireman's Fund Ins. Co.*, 348 U.S. 310, 316-17 (1955). But see *Aasma v. Am. S.S. Owners Mut. Prot. & Indem. Ass'n, Inc.*, 95 F.3d 400, 404 (6th Cir. 1996) (reading *Wilburn Boat* as authorizing a federal rule when national uniformity is important).

⁴⁴ N.Y. INS. LAW § 3420(i) (McKinney 2003). For cases in which *C* could assert no liability because *B* did not pay *A* first, see *Aasma*, 95 F.3d 400; *Conoco, Inc. v. Republic Ins. Co.*, 819 F.2d 120 (5th Cir. 1987); *Ahmed v. Am. S.S. Owner Mut. Prot. & Indem. Ass'n*, 640 F.2d 993 (9th Cir. 1981).

⁴⁵ *Miller v. Am. S.S. Owners Mut. Prot. & Indem. Co.*, 509 F. Supp. 1047, 1049 n.2 (S.D.N.Y. 1981).

⁴⁶ *Araujo v. Woods Hole, Martha's Vineyard, Nantucket S.S. Auth.*, 693 F.2d 1, 2-3 (1st Cir. 1982) ("[A] contractual right to indemnification will only be implied when there are unique special factors demonstrating that the parties intended that the would-be indemnitor bear the ultimate responsibility for the plaintiff's safety, or when there is a generally recognized special relationship between the parties." (citations omitted)).

⁴⁷ *Rosado v. Proctor & Schwartz, Inc.*, 484 N.E.2d 1354, 1356 (N.Y. 1985).

implied term of the employment contract between *B* and *C* is *C*'s promise to indemnify *B* for the cost of *A v B*.

There is also indemnity implied in law. "This is a tort-based right to indemnification found when there is a great disparity in the fault of two tortfeasors, and one of the tortfeasors has paid for a loss that was primarily the responsibility of the other."⁴⁸ Indemnity implied in law was created at a time when contribution between joint tortfeasors was not allowed.⁴⁹ In modern times, when contribution is accepted for negligent torts, indemnity implied in law appears to be simply an extreme form of contribution. Nevertheless, the distinction between this kind of indemnity and ordinary contribution persists. In New York, contribution is governed by New York General Obligations Law section 15-108.⁵⁰ In particular, section 15-108(c) provides: "A tortfeasor who has obtained his own release from liability shall not be entitled to contribution from any other person." Where *B* settles with *A* and then seeks indemnity from *C*, section 15-108(c) can be no impediment to indemnity, since indemnity is to be distinguished from contribution.⁵¹

Whenever *C* must indemnify *B* for *A v B*, *Feldman* payments may be made to provide the illusion that *B* has indeed paid *A*, thereby vesting *B*'s indemnity right against *C*. As we have seen,⁵² the *Feldman* payment is a sham—yet New York courts have knowingly approved of this sham in order to transform indemnity into liability. Obviously, the difference between paying *A* through a *Feldman* payment and simply declaring that *A* is always already the assignee of *B* as a matter of law is purely formal. The New York law of indemnity and contribution is now apparently that, if *A* takes care to set up a *Feldman* payment, *B* can recover from *C* and fund the payment to *A*. But if *A* simply takes a direct assignment of *B*'s right, neither *A* nor *B* recovers anything.⁵³

Such mindless insistence on formality is unworthy of the law. Courts should declare that *Feldman* stands for the proposition that *A* is always already "paid" by an inherent assignment of *B*'s right against *C*

⁴⁸ *People's Democratic Republic of Yemen v. Goodpasture, Inc.*, 782 F.2d 346, 351 (2d Cir. 1986). See generally RESTATEMENT RESTITUTION § 96 (2003) ("A person who, without personal fault, has become subject to tort liability for the unauthorized and wrongful conduct of another, is entitled to indemnity from the other for expenditures properly made in the discharge of such liability.").

⁴⁹ This history is rehearsed in *Dole v. Dow Chemical Co.*, 282 N.E.2d 288 (N.Y. 1972).

⁵⁰ This provision states that a release given to one of multiple tortfeasors will reduce a plaintiff's claim against the other tortfeasors by whichever is the greatest among: (1) the amount of the release; (2) the consideration paid for it; or (3) "the amount of the released tortfeasor's equitable share of the damages under [CPLR article 14], . . ." N.Y. GEN. OBLIG. LAW § 15-108(a) (McKinney 2003). See *Riviello v. Waldron*, 391 N.E.2d 1278, 1283 (N.Y. 1979). The purpose of § 15-108 is to encourage settlement. *Rosado*, 484 N.E.2d at 1356.

⁵¹ *Riviello*, 391 N.E.2d 1278.

⁵² See *supra* text accompanying notes 4-8.

⁵³ Precisely this was tried and was found wanting in *Klinger v. Dudley*, 361 N.E.2d 974 (N.Y. 1977).

over to *A*. Why make the parties go through the magic ritual of arranging for a paper payment?

Nevertheless, courts *do* insist on the ritual. In *Dicola v. American Steamship Owners Mutual Protection & Indemnity Ass'n (In re Prudential Lines, Inc.)*,⁵⁴ the Second Circuit acknowledged *Feldman* as part of New York law, but it uselessly insisted on a literal invocation of the required witchcraft. In *Prudential Lines*, *C* issued a "pay first" policy to *B*, covering up to \$300,000 per tort. *B* also had numerous *As* whom *B* could not afford to pay. *B*'s bankruptcy trustee lit upon the idea of paying *A*₁ \$300,000. *A*₁ would then lend back this payment to *B*'s estate, in exchange for a nonrecourse security interest against insurance proceeds. *B* would then use the proceeds of *A*'s loan to pay *A*₂, who would then lend back the proceeds for another nonrecourse security interest against insurance proceeds. This "recycling" process was repeated until the trustee owed \$13 million in nonrecourse loans.

The *Prudential Lines* court ruled that *A*₁ *et al.* were not really "paid." Therefore, *C* had no liability. It nevertheless held open the possibility that *B* could go back and try again. If *B* could borrow the funds from someone *other* than *A* in order to accomplish payment of all the *As*, the court seemed willing enough to allow *Feldman* payments to erase the distinction between indemnity and liability.⁵⁵ Presumably no harm was done, as *B*'s bankruptcy trustee could, upon the second attempt, invoke the precise magic spells and voodoo incantations that *Feldman* stupidly requires.

In ruling that *B* had not paid *A* in *Prudential Lines*, the court distinguished the more sensible result in *Liman v. American Steamship Owners Mutual Protection & Indemnity Ass'n*⁵⁶ In *Liman*, *C* issued a "pay first" policy to *B* with a \$1,000 deductible per tort claimant. *B* had sufficient assets to pay all the *As*, but it also had to pay \$1,000 to the *As* out of its own pocket. Other creditors claimed this was a preference.

The *Liman* court disagreed. It noted that, although *A* received a preferential \$1,000, *A* returned this sum to *B* once *B* recovered from *C* and forwarded the proceeds to *A*. In effect *B* lent *A* \$1,000 and *A* paid it back from proceeds later obtained (via *B*) from *C*. In contrast, in *Prudential Lines* *B* paid *A* and *A* lent *that* money back to *B*. In one case *B* was the lender and in the other *A* was the lender. Obviously the difference in cash flow was formal only, as no real cash ever changes hands in these recycling rituals.

The *Prudential Lines* court announced itself unbound from *Liman*. *Liman*, it appeared, involved the financing of the deductible, whereas

⁵⁴ 158 F.3d 65 (2d Cir. 1998).

⁵⁵ *Accord* United States Lines, Inc. v. Am. S.S. Owners Mut. Prot. & Indem. Ass'n (*In re United States Lines, Inc.*), 197 F.3d 631, 638-39 (2d Cir. 1999).

⁵⁶ 299 F. Supp. 106 (S.D.N.Y. 1969), *aff'd*, 417 F.2d 627 (2d Cir. 1969) (*per curiam*).

Prudential Lines involved the funding of the whole claim. The purpose of the *Liman* deductible was simply to save *C* the bother of dealing with small claims. To arrange a paper transaction for a *large* claim in *Prudential Lines* did not therefore interfere with the purpose of the deductible. On the other hand, financing the whole claim meant that *C*'s purpose would be defeated.⁵⁷ And what was that purpose? Hiding like a coward behind *B*'s insolvency in order to leave the *As* uncompensated.

This ignoble purpose should not be allowed. The very function of the *Feldman* payment is to prevent *C* from utilizing this strategy.⁵⁸

Nevertheless, the *Prudential Lines* court recognized *Feldman* as a valid statement of New York law.

We think *Feldman* is no help to Claimants here because the non-party lender in *Feldman* performed a real financial service for a real financial reward, whereas the recycling of funds by the Trustee here is an illusion; and the obstacle removed in *Feldman* was a doctrine (*Klinger*) that was intended to protect plaintiffs but in the circumstances had backfired to that plaintiff's detriment, whereas the obstacle faced by Claimants here is a bargained for contract clause that protects an insurer unwilling to waive it.⁵⁹

The *Prudential Lines* court therefore required the presence of some third-party lender. Such a party will always be available and so no real harm was done. Indeed, in *Prudential Lines* itself, the court virtually invited *B* to try a *Feldman* scheme to arrange for *C*'s liability.⁶⁰ Wouldn't it be more elegant for courts to recognize that the meaning of *Feldman* is that *A* always already has a secured claim on *B v C*?⁶¹

Looming over the entire *Feldman* scene is the intractable problem of worker's compensation. Suppose *C* employs *A* and *A* is injured by *C*

⁵⁷ *In re Prudential Lines*, 158 F.3d at 73.

⁵⁸ In *Liman*, *B*, though insolvent, could have paid all the *As*, if preferential payment were permitted in bankruptcy. 299 F.Supp. 106. Therefore, according to the *Prudential Lines* court, *B* had incurred a loss in *Liman*, but not in *Prudential Lines*, where, the court ruled, *B* had no loss because it could not actually pay the *As*. See *In re Prudential Lines*, 158 F.3d 65. This distinction is untenable. Since *B* is borrowing from Peter to pay Paul, what difference does it make whether *B*'s bankruptcy estate theoretically could have financed a (preferential) payment in lieu of borrowing? In any case, it is far from clear that, in *Prudential Lines*, *B* could not have financed total payment of the *As*. In *Prudential Lines*, the aggregate *A* claims were \$13 million. If *Prudential Lines* had \$13 million in unencumbered assets, then indeed the cases are absolutely undistinguishable.

⁵⁹ *In re Prudential Lines*, 158 F.3d at 75-76 (citations omitted).

⁶⁰ *Id.* at 71 ("At oral argument, the parties agreed that there are other available mechanisms (albeit less efficient) for triggering [*C*'s] indemnification obligations. . . . Given the availability of other payment mechanisms, the deductible issue and the allocation issue are of sufficient immediacy and reality to warrant declaratory judgment.").

⁶¹ In *In re Keck, Mahin & Cate*, 241 B.R. 583, 596-97 (Bankr. N.D. Ill. 1999), the court declared that a chapter 11 plan's grant of unsecured creditor rights to *A* constituted payment, for the purpose of perfecting *B*'s indemnity right against *C*. This is tantamount to what I have suggested should happen in every case of *B*'s insolvency.

and *B* jointly. If *A* sues *C*, *A* is under the regime of worker's compensation.⁶² Nevertheless, if *A* can sue *B* in tort generally, and, so long as *A* has suffered a "grave injury,"⁶³ *B* may have contribution from *C*. This was the result of the well-known opinion in *Dole v. Dow Chem. Co.*⁶⁴

In *Reich v. Manhattan Boiler & Equipment Corp.*,⁶⁵ however, the New York Court of Appeals barred *Feldman* payments as a means of perfecting the contribution right, because the *Feldman* ruse was too subversive of the worker compensation system.⁶⁶ This opinion implies that *C* may hide behind the insolvency of *B*—in the name of workers' compensation. But where *B* is solvent and therefore has no need for the *Feldman* ritual, *Dole* implies that workers compensation does not protect *C*.

It is not clear, however, that *Reich* really protects *C* very much. Suppose that *B* has \$100 in unencumbered assets and \$500 in claims against it. *A*'s tort judgment against *B* is precisely \$100. Such a *B* would appear to be "solvent" enough to pay *A* without a *Feldman* payment. *Reich*, it would appear, has bite in the narrow circumstance where *B* has no assets at all.

II. LIABILITY

Where indemnity is the theory, *B v C* is said to be contingent on *B* actually paying *A*. In such a case, *Feldman* payments are apparently necessary to transform indemnity into liability. But there is another, perhaps overlapping, theory. If *C* has committed a wrong against *B*—

⁶² N.Y. WORKERS' COMP. LAW § 11 (McKinney 2003).

⁶³ The "grave injury" requirement was instituted by the New York legislature in 1996. *Id.*; see also *Morales v. Gross*, 657 N.Y.S.2d 711 (N.Y. App. Div. 1997).

⁶⁴ 282 N.E.2d 288 (N.Y. 1972). On the subversion of worker compensation legislation, see Mark C. Zebrowski, Comment, *Indemnity Clauses and Workers' Compensation: A Proposal for Preserving the Employer's Limited Liability*, 70 CAL. L. REV. 1421 (1982). In admiralty law, the Supreme Court famously permitted this evasion in favor of longshorepersons, who are subject to workers' compensation regimes. Longshore & Harbor Workers' Compensation Act, 33 U.S.C. § 905(b) (2000); *Ryan Stevedoring Co., Inc. v. Pan-Atlantic S.S. Corp.*, 350 U.S. 124, 125 (1956) (*B* could have indemnity from *C*, where *B* hired *C* as stevedore); *Seas Shipping Co. v. Sieracki*, 328 U.S. 85, 99 (1946) (*A*, who worked for *C*, could sue *B* because *B*'s vessel was seaworthless).

⁶⁵ 698 N.E.2d 939 (N.Y. 1998).

⁶⁶ Ironically, *Feldman* was a reaction to the unfairness on display in *Klinger v. Dudley*, 361 N.E.2d 974 (N.Y. 1977), which was a consolidated appeal involving several cases. In each of them, *B* assigned the right of contribution over to *A* as a mode of paying *A*. The *Klinger* court insisted that *A* be actually paid by *X*—and not in the form of assigning the contribution right. One of the plaintiffs (*Kaban*) in *Klinger* was *C*'s employee and barred by workers' compensation law from suing *C* directly. Twenty years after the auto accident, *Kaban*'s attorney arranged a *Feldman* payment in order to generate *C*'s liability to *B*. The *Reich* court refused to honor the *Feldman* payment in this one instance.

whether a tort or breach of contract—*A*'s obligation to *B* is part of *B*'s damages against *C*. Under the law of damages, proof that *A* has already been paid is not necessarily required. *B* is entitled to prove any future damage reasonably likely to occur. The fact that *B* has not yet paid *A* is irrelevant, so long as future payment is likely.⁶⁷

The difference between future damages and indemnity becomes a vital consideration for statute of limitations purposes. If the theory is indemnity, *B*'s cause of action accrues only when *B*, at her leisure, pays *A*.⁶⁸ But if tort or breach of contract is the standard, the action accrues at some earlier time.

*People's Democratic Republic of Yemen v. Goodpasture, Inc.*⁶⁹ shows just how difficult this distinction can be. In *Goodpasture*, *B* arguably incurred a "deadfreight" expense to *A* in 1974 because *C* refused to deliver grain. *B* resisted paying the deadfreight but was finally compelled to pay in 1981. *B* then sued *C* for indemnification. The *Goodpasture* court ruled that *B* had no indemnity theory. Sales contracts under Article 2 of the UCC do not give rise to an implied duty to indemnify. Rather, *B* had only a claim for consequential breach-of-contract damages which accrued when *C* became liable to *A* for deadfreight in 1974. Accordingly, the statute of limitations had run.⁷⁰ In other words, the court expected *B* to plead the deadfreight expense long before *B* actually paid it.

Accrual of a damage theory is fraught with metaphysical uncertainty. In *Goodpasture*, *B v C* accrued in 1974, when *A v B* accrued, not in 1981, when *B* paid *A*. In *Torrez v. State Farm Mutual Automobile Insurance Co.*,⁷¹ *B*'s cause of action against *C* accrued only when *A*'s judgment against *B* was entered, not when *A v B* first accrued. Obviously, these rulings contradict each other.⁷²

⁶⁷ For example, in *Lambert Houses Redevelopment Co. v. HRH Equity Corp.*, 502 N.Y.S.2d 433 (N.Y. App. Div. 1986), *A* (a real estate owner) had a contract claim against *B* (the general contractor). *B* admitted liability to *A* and blamed *C* (a subcontractor) for the problem. *B* therefore had an action against *C* for breach of contract. The *Lambert* court permitted *B* to pursue *C* on behalf of *A*, on the understanding that *A* would get the proceeds. This was permitted even though *B* had not yet paid *A*, but was certain to pay *A* because of the assignment of proceeds by *B* to *A*.

⁶⁸ E.g., *McDermott v. City of New York*, 406 N.E.2d 460 (N.Y. 1980).

⁶⁹ 782 F.2d 346 (2d Cir. 1986).

⁷⁰ See also *Int'l Surplus Lines Ins. Co. v. Marsh & McLennan, Inc.*, 838 F.2d 124 (4th Cir. 1988) (*C*, an insurance broker lied to *B*; *B* issued too high a policy to *A*; *B* had a damage, not indemnity claim, against *C*; statute of limitations had run); *Gen. Elec. Co. v. Moretz*, 270 F.2d 780 (4th Cir. 1959) (*B* loaded the truck; *A* drove the truck and was injured by negligent loading; shipper had indemnity action against *C*, the common carrier).

⁷¹ 705 F.2d 1192 (10th Cir. 1982). This seems to be based on the concept of the discovery rule—*B* did not know of the tort until the jury awards *A* the surplus amount. Where, however, *B* injures *A* and discovers that *B*'s insurance broker forgot to obtain insurance, *B* knew of his cause of action before the jury awarded anything to *A*, so that *B*'s discovery precedes *A*'s judgment. See *Zamora v. Prematic Serv. Corp.*, 936 F.2d 1121, 1123 (10th Cir. 1991).

⁷² Even within the Second Circuit, conflicting cases can be observed. In *Bankers Trust Co. v. Rhoades*, 859 F.2d 1096 (2d Cir. 1988), a cause of action accrued only when *A* sued *B* and

Just as *Feldman* presages the transformation of indemnity into liability, courts have, not always wittingly, striven to make liability into indemnity. This instinct is often on display in the cases invoking an insurer's good faith duty to settle a case within the policy limit of the insured. For example, suppose *C* issues a liability policy to *B*. *B* injures *A*. *C* takes charge of the defense in *A v B*. *A* offers *C* a settlement for the amount of *B*'s insurance limit. *C* declines, figuring that if the jury clobbers *B*, it is *B*, not *C*, who will pay the price. Meanwhile, if the jury acquits *B*, then *C* owes nothing. *C* captures the upside of the jury trial and forces *B* to take the downside. As the court in *Pinto v. Allstate Insurance Co.*⁷³ put it:

An insurer has an economic incentive not to settle, hoping a jury will bring in a verdict for less than the policy limits. But when such hope goes awry . . . the insured is the loser, being personally responsible for the excess. These conflicting interests between the insurer and the insured cause them to rub against each other like unmoored rowboats on a placid pond.⁷⁴

In order to re-establish proper incentives in *C*, states commonly impose a tort duty on *C* for a bad faith duty to settle within the policy limits.⁷⁵

It often happens that, at the time of *B*'s tort against *A*, *B* is already insolvent. Whereas *C* may not gamble with *B*'s money in refusing to settle, may *C* go ahead and gamble away when *B* has no money at all?

Courts are divided on the effect of *B*'s insolvency on *C*'s good faith duty to settle. A leading case is *Harris v. Standard Accident & Ins. Co.*,⁷⁶ in which *B* (already insolvent) negligently injured *A* with his car. *B*'s insurance company (*C*) refused to settle. A jury returned a verdict far exceeding the insurance limit. *C* paid the policy amount, leaving *A* substantially underpaid. *B*'s bankruptcy trustee sued *C* for bad faith refusal to settle within the policy limits. The *Harris* Court ruled that, because *B* had been discharged in bankruptcy, *B* no longer had any obligation to pay *A*. Accordingly, the trustee could prove no damages against the insurance company.⁷⁷

obtained a dividend from *B*'s bankruptcy. In *Rhoades*, *C* was a corporate officer who looted *B*. *B* filed for bankruptcy, and *A* spent a decade trying to get a dividend from *B*. *A* then sued *C* on a RICO theory. The *Rhoades* court ruled that *A*'s cause of action accrued only when *A* received a final bankruptcy dividend from *B*. *Id.* Then and only then does *A* know the extent to which *C* harmed *A*. It may be observed that *Goodpasture* involved *B v C*, whereas *Rhoades* involved *A v C*. *Goodpasture*, 782 F.2d 346. Nevertheless, it is not clear that *Goodpasture* and *Rhoades* can be reconciled.

⁷³ 221 F.3d 394 (2d Cir. 2000).

⁷⁴ *Id.* at 396.

⁷⁵ In *Young v. American Casualty Co. of Reading Penn.*, 416 F.2d 906 (2d Cir. 1969), a bad faith duty to communicate a settlement offer above the policy limits was found, over one dissent.

⁷⁶ 297 F.2d 627, 635 (2d Cir. 1961).

⁷⁷ *Harris* has been criticized in John E. Bagalay, Jr., Note, *Damage to Insured by Unpaid*

If, on the other hand, *B* had net worth at the time of the accident, then, the *Harris* court emphasized, *B*'s bankruptcy trustee could collect the full face value of *A*'s claim.⁷⁸ In such a case, total payment of *A* is necessary to reestablish the net worth. For example, if *B*'s net worth prior to the accident was \$20 and *A*'s claim was \$100, *B* can recover \$100 from *C*, according to the *Harris* court. Any other result threatens *B*'s net worth. Suppose, for example, the court were to award only \$20—the lost net worth. Then *A*, claiming \$100, would obtain the \$20 award, and *B* would still be insolvent. Only if *A* is paid off entirely is *B*'s net worth protected.⁷⁹

The starkest of all the cases in which *B* was insolvent at the time of *A v B* is *Bourget v. Government Employees Insurance Co.*⁸⁰ In this case, *B* negligently injured *A* and killed himself to boot in an accident. *B*'s estate consisted only of the insurance proceeds for *B*'s car. This humble amount was entirely consumed by funeral expenses and *B*'s meager widow's allowance, which had priority over *A*'s judgment.⁸¹ In light of *B*'s death and the utter dissipation of *B*'s estate, *C* refused to settle, and the jury awarded a judgment far in excess of policy limit. A Connecticut statute made *A* subrogee to *B*'s tort action against *C* for the tort of bad faith refusal to settle. In the name of *B*, *A* sued *C*, claiming *C* had unwisely gambled on a jury verdict. The *Bourget* court held:

The basis for [the] duty to exercise good faith or due care with respect to opportunities to settle within the policy limits "is that the

Judgment When Insurer Wrongfully Refuses to Settle Claim Within Policy Limits, 41 TEX. L. REV. 595 (1963) and James A. McDermott, Note, *Action for Wrongful Refusal to Settle Claim Precluded by Bankruptcy of Insured*, 60 MICH. L. REV. 517 (1962); see also Note, *Insolvency of Insured and His Discharge in Bankruptcy Precludes Recovery for Insurer's Wrongful Refusal to Settle*, 62 COLUM. L. REV. 896 (1962); Note, *Excess Liability of Insurer for Bad Faith Refusal to Settle*, 30 FORDHAM L. REV. 188 (1961).

A different approach was taken in *Bourget v. Gov't Employees Ins. Co.*, 456 F.2d 282, 285 (2d Cir. 1972). In this case, *B* was killed in the accident with *A*. *C* refused to settle, and *A* obtained a judgment against *B*'s estate far in excess of the policy limit. Because the estate of *B* was hopelessly insolvent, the court found there was no duty owing to *B* to settle. This seems different from the *Harris* conclusion that no damage existed.

⁷⁸ *Harris*, 297 F.2d at 632.

⁷⁹ *Accord* *Young v. Am. Cas. Co.*, 416 F.2d 906 (2d Cir. 1969); *Levantino v. Ins. Co. of North Am.*, 422 N.Y.S.2d 995, 1002 (N.Y. Spec. Term 1979) (where *B* was solvent before the first tort occurred, a jury could conclude that the face amount of *A*'s claim could be collected as future damages, without prior payment).

In *McClarty v. Gudenau*, 176 B.R. 788 (E.D. Mich. 1995), the court considered the claim of *B*'s bankruptcy estate that *C*'s malpractice led to *B*'s liability in excess of covered amounts. Because of this *B* went bankrupt and was discharged. The court refused to let *B* recover the face amount of *A*'s claim, claiming that it could find no authority for it. *Id.* at 792. Yet the court also implied that *B*'s bankruptcy trustee could recover for *B*'s emotional injuries and the cost to *B* of litigating the bankruptcy, as these were caused by *C*'s alleged malpractice. These went into the bankruptcy estate to enrich all the creditors of *B*.

⁸⁰ 456 F.2d 282 (2d Cir. 1972).

⁸¹ CONN. GEN. STAT. § 45-250 (2003); *Bennett v. Ives*, 30 Conn. 329, 335 (1862) (expenses for funeral and settlement of estate rank before other debts of estate).

company has exclusive control over the decision concerning settlement within policy coverage, and company and insured often have conflicting interests as to whether settlement should be made . . ." [W]hat gives rise to the duty and measures its extent is the conflict between the insurer's interest to pay less than the policy limits and the insured's interest not to suffer liability for any judgment exceeding them. In the rare instance where the insured has no such interest, there can be no conflict and the duty does not arise

There could scarcely be a case where the insured's lack of interest in avoiding a judgment exceeding the policy limits was as clear as this one. [B] had no assets at all except his car. The insurance proceeds on this were completely consumed by claims to which Connecticut gave priority over [A's]. Satisfaction of [A's] claim was thus unnecessary to pass even a small amount to [B's] heirs. Counsel's suggestion that some asset now unknown might fall into the estate at some future time ignores reality. Since [B] was killed, the threat of a judgment hanging over him was nil.⁸²

The court made clear that if there had been net worth of even a dollar, the result would have been different.⁸³ The duty of an insurance company to settle within policy limits is cast in terms of the exercise of judgment. C is supposed to give equal weight to B's welfare as well as C's own welfare. Yet, in *Bourget*, only A's welfare was at stake. *Bourget* could stand for the not unreasonable proposition that C owes its duty to settle to B alone, not to A. Where B lies in his grave after life's fitful fever, why shouldn't C gamble on victory, where no further malice domestic can be visited on B?

In holding B undamaged when C caused B's excess liability to A, the *Harris* and *Bourget* courts equated B's very personhood with net worth. Where B had no net worth, B was in effect not a person. Such a view of personhood, however grounded in modern habits of civility, is untenable in law. Suppose, for example, that instead of refusing to settle with A, C instead steals, smashes or otherwise converts B's car to its own use. Presumably no court would hear C to claim B undamaged because the car would have gone to B's creditors. Or, if C physically injures B and B incurs medical expenses, C could not argue that B was not really harmed, since any tort award would simply go to B's creditors.

Furthermore, in our modern utilitarian age, it is usually alleged that the very purpose of tort law is to provide proper incentives for C to behave properly. A rule that denied the very personhood of insolvents would invite C to commit torts at will, so long as their consequences are

⁸² *Bourget*, 456 F.2d at 285 (citations and footnotes omitted).

⁸³ *Id.* (citing *Lee v. Nationwide Mut. Ins. Co.*, 286 F.2d 295, 296 (4th Cir. 1961) (Maryland law)).

calculated to visit insolvents only.

Corporate scholars discovered twenty years ago that a corporation is merely a "nexus of contracts."⁸⁴ The postmodern instinct is to view corporate existence as in no sense different from human personhood. Both are purely legal ideas. If a corporation is a nexus of contracts, then so is every human being. So viewed, every person is a fiduciary for his creditors. He is bound to use his human and financial capital and his very body to make sure that his creditors are paid. In harming any of these things, *C* stands as an obstacle to the performance of *B*'s fiduciary duty to her creditors. Accordingly, *C* should bear liability, even when the entire judgment goes to pay *B*'s creditors.

But one need not rest on the undecidable metaphysics of personhood to show that *Bourget* and *Harris* are wrong. Although cases like *Bourget* present the strongest imaginable case for letting *C* off the hook because *B* is insolvent, nevertheless even *B*'s estate in *Bourget* could have made a *Feldman* payment. The beauty of secured lending is that even the poor can borrow, if they have collateral. And *B*'s estate always has collateral—namely, *B v C*. In *Bourget*, *X* (*A*'s lawyer) could have lent the amount of *A v B* to *B*'s estate. *B*'s executor could have pledged *B v C* to *X* as collateral. *B*'s administrator could then have used those funds to pay *A*. *A* could have guaranteed *X*'s repayment and could have posted the payment from *B*'s estate as collateral. *B*'s estate would then have generated an out-of-pocket loss that makes incontrovertible the fact that *B* has been damaged by *C*'s wrong. In short, just as *Feldman* turns indemnity into liability, it should stand against the instinct inherent in *Harris* and *Bourget*, to turn liability into indemnity.

Bourget and *Harris* aside, a majority of jurisdictions⁸⁵ hold that, in the good faith settlement environment, *B* may recover the face amount of *A v B*, even if *A* has not been paid.⁸⁶ Even in New York, *Harris* and *Bourget* have been superseded in *Pinto v. Allstate Insurance Co.*,⁸⁷

⁸⁴ For a history of the phrase, see William W. Bratton, Jr., *The 'Nexus of Contracts' Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407 (1989).

⁸⁵ *Gray v. Grain Dealers Mut. Ins. Co.*, 871 F.2d 1128, 1131 (D.C. Cir. 1989).

⁸⁶ *Gray*, 871 F.2d at 1131 (North Carolina law); *Southern Farm Bureau Cas. Ins. Co. v. Mitchell*, 312 F.2d 485 (8th Cir. 1963) (Arkansas law); *Wolfberg v. Prudence Mut. Cas. Co.*, 240 N.E.2d 176, 180 (Ill. App. Ct. 1968) ("The rule of damage is that incurrence is equivalent to outlay."); *Wooten v. Cent. Mut. Ins. Co.*, 182 So. 2d 146 (La. Ct. App. 1966); *Carter v. Pioneer Mut. Cas. Co.*, 423 N.E.2d 188 (1981); see Annotation, *Insured's Payments of Excess Judgment, or a Portion Thereof, as Prerequisite of Recovery Against Liability Insurer for Wrongful Failure to Settle Claim Against Insured*, 63 A.L.R.3d 627, 641-69 (1975 & Supp. 1986). In *Wolkowitz v. Redland Insurance Co.*, 5 Cal. Rptr. 3d 95 (Cal. Ct. App. 2003), *A v B* was settled without *C*'s participation by motion of *B*'s bankruptcy trustee. The court ruled that the *B v C* had no value because the settlement could not be trusted to represent the real value of *A v B* (even though *C* was given the opportunity of intervening to prevent the settlement). *Wolkowitz* is quite questionable in its outcome, because *C* had the contractual obligation to assume defense of *A v B* and was in breach of that obligation.

⁸⁷ 221 F.3d 394 (2d Cir. 2000).

where *B* had "no assets."⁸⁸ The courts following the "liability" position give a variety of reasons for rejecting *Harris* and its ilk. For example, it is said that, where *A* has a judgment against *B*, this will follow *B* all *B*'s life, unless *A* is paid off. This very possibility of future harm justifies *C*'s liability where *A* has not yet been paid.⁸⁹ "An insured may be damaged by the effect on his credit of an outstanding claim where he cannot pay it."⁹⁰ This instinct has been extended to cases where *B* has been killed in the course of injuring *A*, since *B*'s death should not adhere to *C*'s benefit.⁹¹ A better view of the matter, however, is that no matter how insolvent or dead *B* is, the estate of *B* always has the power to borrow the funds needed to pay *A*. Given the mere possibility of secured lending, courts should simply erase the distinction between indemnity and liability.

But this raises the possibility that *B* will already be *discharged* in a bankruptcy proceeding before *A* is actually paid. How does bankruptcy discharge affect *Feldman*? I take this question up in the next section.

III. BANKRUPTCY DISCHARGE

The *Harris* rule invites *C* to hide like a coward behind the skirts of *B*'s insolvency in order to avoid its tort liability. The *Harris* court implied that *B*'s discharge in bankruptcy had something to do with this.⁹² That is to say, given the fact of *B*'s discharge, *B* owes *A* nothing and therefore *C* has not damaged *B*.⁹³

⁸⁸ *Id.* at 402. Presumably this means relatively minor non-exempt assets, or, at least insolvency in light of *A*'s judgment. The *Pinto* court proceeds as if *B* was definitely insolvent. *Id.*

⁸⁹ *Carter v. Pioneer Mut. Cas. Co.*, 423 N.E.2d 188, 191 (Ohio 1981).

⁹⁰ *Jenkins v. Gen. Accident Fire & Life Assurance Corp.*, 212 N.E.2d 464, 467 (Mass. 1965).

⁹¹ *Wolfberg*, 240 N.E.2d at 180. One court found a contractual waiver against any reference to *B*'s insolvency, even in *B*'s tort suit against *C*. *Maguire v. Allstate Ins. Co.*, 341 F. Supp. 866 (D. Del. 1972). Presumably, insurers have learned from *Maguire* and now write policies that make no such unnecessary waivers.

⁹² *Harris v. Standard Accident & Ins. Co.*, 297 F.2d 627, 635 (2d Cir. 1961) ("Since [*B*] has] been discharged from paying the excess judgment, [*B*] will not suffer any damages if recovery is denied.").

⁹³ Two complex cases have recently decided or held open the possibility that *B*'s discharge terminates *C*'s indemnity obligation.

In *Chapman v. Bituminous Insurance Co. (In re Coho Resources, Inc.)*, 345 F.3d 338 (5th Cir. 2003), *A* had a Mississippi judgment against *B*. *B* arguably had an indemnity policy from *C* and an excess liability policy from *D*. Both *A* and *D* had an interest in establishing that discharge is no necessary impediment to indemnity. In *Coho*, *A* obtained a jury verdict against *B* in Mississippi state court. *B* made post-trial motions to reduce the verdict. While these motions were pending, *B* filed a bankruptcy petition. Not knowing this, the Mississippi court ordered remittitur of the jury award to a lower amount (meaning that there would be a new trial if *A* did not accept the lower amount). *A* accepted the lower amount and obtained writs of garnishment against *C* and *D*. *C* and *D* removed the garnishments to federal court. About this time, *B*'s

There are a great many reasons why this suggestion must be rejected. First, the implication of *Harris* contradicts at least the spirit of Bankruptcy Code § 524(e): “[e]xcept as provided in subsection (a)(3) of this section, discharge of a debt of the debtor does not affect the liability of any other entity on, or property of any other entity for, such debt.”⁹⁴

Superficially, this section may not seem to implicate the *Harris* facts, where *C* tortiously injured *B* by causing *A v B*. Section 524(e) applies only if *C* is liable for *B*'s debt (as where *C* is a surety). In *Harris*, *C* owed nothing to *A* for the debt of *B*. Rather, *C* was a tortfeasor that owed a duty to *B* only.

But suppose, following my thesis, that *A* is deemed the secured creditor of *B*, with *B v C* as her collateral. On this premise, it can be seen that § 524(e) applies quite directly. *C* is liable *directly* to *A* because, according to what I have suggested, *A* is the assignee of *B v C*.

bankruptcy proceeding resulted in a confirmed chapter 11 plan. Provided the plan was *not* a liquidating plan under 11 U.S.C. § 1141(d)(3), confirmation implies that *A v B* was discharged. Pursuant to the district court's suggestion, *A* moved for permission from the bankruptcy court to garnish *C*. The bankruptcy court denied permission because *A* never filed a proof of claim in *B*'s bankruptcy. On appeal, the Fifth Circuit properly held the proof of claim to be irrelevant. The key was the discharge. The Fifth Circuit elected to let the district court in Mississippi, sitting in diversity, to determine what *B*'s discharge meant to *A*'s attempt to garnish *B v C*.

Bank of India v. Trendi Sportswear, Inc., is even more complicated. 2002 U.S. Dist. LEXIS 894 (S.D.N.Y. Jan. 18, 2002), *aff'd*, 64 Fed Appx. 827 (2d Cir. 2003), *cert. denied*, 124 S. Ct. 934 (2003). In *Bank of India*, *C* committed a lender liability tort against *B*. As a result, *B* lost all net worth and owed a substantial amount to *A*. *B* sued *C* in the district court while *A* sued *B* before another judge in the same district court. *B* then impleaded *C*, so that *two* courts had *B v C* before them. The second judge suspended his version of *B v C*, and the first action proceeded to trial. In this first action, the court excluded any evidence from *A v B*. A jury awarded *B* a substantial sum, representing *B*'s loss of net worth. *See also* *Indu Craft, Inc. v. Bank of Baroda*, 47 F.3d 490 (2d Cir. 1995).

Rather than pay the jury award to *B*, *C* instead interpleaded the amount, tying up the funds. Since *B* intended to use these funds to finance the recovery of *A v B* damages from *C*, *B* filed a bankruptcy petition to regain control of the funds. In this bankruptcy proceeding, a liquidating plan was confirmed. Although § 1141(d)(3) makes clear that there can be no discharge, the plan nevertheless *purported* to discharge *B*. 11 U.S.C. § 1141(d)(3) (2000). The plan authorized the bankruptcy court to determine the amount of *A v B* and to authorize *B* to recover the *A v B* damages from *C* for distribution primarily to *A*.

Meanwhile, *A v B v C* was still pending before the second district court judge. This second judge ruled that *B* was precluded from proving *A v B* damages because this should have been done in the first case, where *B* won a jury verdict. This was properly reversed, because the first judge would not permit these damages to be proved. *Bank of India v. Trendi Sportswear, Inc.*, 239 F.3d 428 (2d Cir. 2000).

On remand, the second district court had a *new* reason why *B* could not prove *A v B* in an action against *C*. Because *B* had supposedly been discharged in a chapter 11 plan, *B* did not owe *A* and therefore had not been damaged by *C*. *Bank of India* therefore follows *Harris* on the meaning of the bankruptcy discharge. This interpretation of the discharge was upheld on appeal (in an unpublished opinion). *See* *Bank of India v. Trendi Sportswear, Inc.*, 64 Fed. Appx. 827 (2d Cir. 2003), *cert. denied*, 124 S. Ct. 934 (2003). Presumably, it should still be possible for the bankruptcy court in *Trendi* to suspend the discharge injunction to permit *B* to prove *A v B* damages against *C*.

⁹⁴ Although *Harris* is a pre-Code case, even the old Bankruptcy Act of 1898 codified the principle of § 524(e). Bankruptcy Act of 1898 § 16, 11 U.S.C. § 34 (1976) (repealed).

The meaning of § 524(e) is that *C* may make no reference to *B*'s discharge from *A v B* as a reason why *C* should not have to pay *B v C*.

There are other reasons to think that *Harris* embodies an incorrect concept of discharge. According to pre-Code law, bankruptcy discharge was conceived as preventing the remedy without denying the existence of the debt itself. According to the Supreme Court in *Kessler v. Department of Public Safety*:⁹⁵

[A] discharge does not free the bankrupt from all traces of the debt, as though it had never been incurred. This Court has held that a moral obligation to pay the debt survives discharge and is sufficient to permit a State to grant recovery to the creditor on the basis of a promise subsequent to discharge, even though the promise is not supported by new consideration. The theory, the Court declared, is that "the discharge destroys the remedy but not the indebtedness"⁹⁶

What *Kessler* implies is that debts exist after they have been discharged.⁹⁷ Accordingly, *B* can make a *Feldman* payment to *A* even after *B* is discharged. Discharge, then, is *never* an excuse for *C* to assert *B*'s insolvency as a reason for not paying, whether the underlying theory is indemnity or liability.

The *Kessler* principle is largely forgotten today because § 524(c) prohibits any contract to affirm a discharged debt unless the agreement pre-dates the discharge itself and the court has approved the reaffirmation agreement. Nevertheless, the *Kessler* principle is legislated directly into the Bankruptcy Code itself, in a passage rarely cited and little noticed. According to Bankruptcy Code § 524(f), "[n]othing contained in subsection (c) or (d) of this section prevents a debtor from voluntarily repaying any debt." Section 524(f) expresses the ancient notion that discharged debts are still debts, and they can be paid.⁹⁸ A historic discharge, then, should have no effect on a *Feldman*

⁹⁵ 369 U.S. 153, 170-71 (1962).

⁹⁶ *Id.* (citing *Zavelo v. Reeves*, 227 U.S. 625, 629 (1913)); see also *Houston v. Edgeworth* (*In re Edgeworth*), 993 F.2d 51 (5th Cir. 1993) ("A discharge in bankruptcy does not extinguish the debt itself, but merely releases the debtor from personal liability for the debt."). For histories of this principle, see A.W.B. SIMPSON, *A HISTORY OF THE COMMON LAW OF CONTRACT* 453-54 (1975); Kevin M. Teeven, *Origin and Scope of the American Moral Obligation Principle*, 46 CLEV. ST. L. REV. 585 (1998).

⁹⁷ It has been suggested that the true soul of discharge is the consensual creditor composition, which eventually became mandatory, rather than consensual. See John C. McCoid, II, *Discharge: The Most Important Development in Bankruptcy History*, 70 AM. BANKR. L.J. 163, 185 (1996). The law of composition was that discharge was contingent on the debtor paying the agreed-upon consideration. Accordingly, the mere fact of the composition could not mean that the debt had disappeared. It continued to exist, even after the composition agreement was exercised.

⁹⁸ Perhaps §524(e) makes the same point. See Guy B. Moss, *The Risks of Purchasing and Collecting Consumer Debt*, 10 AM. BANKR. INST. L. REV. 643, 645 (2002) ("[B]ecause the discharge is personal to the debtor and the debt is not canceled, it does not affect the liability of third parties to the holder of the claim." (footnote omitted)).

strategy.

Even if *Kessler's* view of discharge is ignored, we have already seen that discharge constitutes an injunction against debt enforcement, but this injunction can be lifted for the benefit of *A*. Courts have even insisted that the injunction be lifted, or that non-bankruptcy courts simply ignore the discharge for the purpose of establishing a judgment in *A v B*, provided this judgment is enforced against *C* only.⁹⁹ These cases fully apply in any indemnity or liability case with regard to *Feldman* payments. And if *Feldman* payments are possible and easy to achieve, then courts should simply lay to rest the very distinction between indemnity and liability whenever *B* is insolvent. Or, even if they insist on seeing the *Feldman* ritual actually performed, discharge provides no reason why this voodoo ritual should not be performed.

Finally, if courts recognize that *A* has a lien on *B v C*, then *A's* claim against *B* is not discharged but rather constitutes a nonrecourse secured claim against *B*. The Supreme Court itself has affirmed that creditors rendered nonrecourse by discharge of *B's* personal liability are nevertheless creditors of *B*.¹⁰⁰ If *A* is conceived as *B's* nonrecourse creditor claiming *B v C* as collateral, then *A* can still be "paid," for indemnity or liability purposes. It therefore follows that bankruptcy discharge cannot possibly serve to shield *C's* liability to *A*, who is inherently the assignee of *B v C*.

IV. ASSIGNMENT AND RELEASE

If liability, not indemnity, is the theory, *B's* insolvency can never shield *C* from liability for the simple reason that *B* can assign *B v C* over to *A*.¹⁰¹ Liability, of course, turns on the ability to prove that future damages are more likely than not to occur. That is, *B* must prove that *A* is likely to be paid. Yet when *B* assigns *B v C* over to *A*, payment of *A* is absolutely *certain* to occur, and this element of *B's* case is proven by the very fact of the assignment.

Commonly, *B* assigns *B v C* to *A* in exchange for *A's* release of *B*

⁹⁹ See *supra* text accompanying notes 19-22.

¹⁰⁰ *Johnson v. Home State Bank*, 501 U.S. 78 (1991). In *Johnson*, a debtor with a mortgaged farm filed for chapter 7 and received a discharge. He then filed a subsequent chapter 13 case, where he hoped to cram down the secured creditor in a reorganization plan. The secured creditor responded that, because of the discharge, it was no longer a "creditor" and was therefore immune from cram down. The Supreme Court rejected this claim. *Id.*

Many courts permit a debtor to reinstate security agreements after chapter 7 discharges. *Capital Communications Fed. Credit Union v. Boodrow (In re Boodrow)*, 126 F.3d 43 (2d Cir. 1997). These cases, too, assume that payment of the nonrecourse secured party constitutes a genuine "payment" that prevents the conclusion that the security agreement is in default.

¹⁰¹ New York courts have called this a "liquidating agreement" between *A* and *B*. *Lambert Houses Redevelopment Co. v. HRH Equity Corp.*, 502 N.Y.S.2d 433, 435 (N.Y. App. Div. 1986).

from any further liability. In the context of an insurance company's good faith duty to settle *A v B* within *B*'s policy limit, many courts have ruled that *B* may validly assign *B v C* to *A*, in exchange for *A*'s release of *B*.¹⁰²

But if *A* has released *B* in exchange for this assignment, does this not mean that *B v C* has no value, because *B*'s release portends that *B* has no liability to *A* and was therefore not damaged? At least one court has so concluded. In *Perno v. For-Med Medical Group, P.C.*,¹⁰³ the court viewed *A*'s release as proof that *B v C* had evaporated, thereby defeating the assignment which *B* executed in exchange for the release. In *Perno*, *C* was a trio of doctors who allegedly committed malpractice. *B* was the medical group that employed *C*. *A* was a victim of *C*'s malpractice. *A* had a *respondeat superior* cause of action against *B*, which had an indemnity right against *C*.

After *A* brought her claim against *B*, *B* filed for bankruptcy. *B* assigned its indemnity right against *C* to *A*. *A* "expressly renounced"¹⁰⁴ any bankruptcy dividend from *B*. The court ruled that *A* had "released" *B* from liability, thereby foreclosing *B*'s claim for indemnity.¹⁰⁵

The *Perno* court must be criticized—and severely so—for imposing a harsh trick on *A* and *B* that they could hardly have expected. Obviously, *B* intended to "pay" *A* by assigning to *A* the proceeds of *B v C*. In effect, *A* agreed to be a nonrecourse creditor with a claim of an asset of *B*. *A* and *B* were not seeking to enrich *C*.

If a *Feldman* payment had been made in *Perno*, the court would

¹⁰² See *Haugh v. Allstate Ins. Co.*, 322 F.3d 227 (3d Cir. 2003); *Pinto v. Allstate Ins. Co.*, 221 F.3d 394 (2d Cir. 2000); *Torrez v. State Farm Mut. Auto. Ins. Co.*, 705 F.2d 1192 (10th Cir. 1982); *MacArthur Bros. Co. v. Kerr*, 107 N.E. 572 (N.Y. 1915); *Ardsley Constr. Co., Inc. v. Port of New York Auth.*, 403 N.Y.S.2d 43 (N.Y. App. Div. 1978). But see *Lambert Houses*, 502 N.Y.S.2d at 435 (warning that release is inconsistent with the assignment).

¹⁰³ 673 N.Y.S.2d 849, 851 (N.Y. Gen. Term 1998), *appeal dismissed*, 679 N.Y.S.2d 280 (N.Y. App. Div. 1998).

¹⁰⁴ See *Perno*, 673 N.Y.S.2d at 852 ("Despite the fact that [A], in entering into the bankruptcy settlement agreement, retained the right to pursue her action against [B] to judgment, and despite the fact that she might conceivably be entitled to a money judgment against [B] based on [B]'s vicarious liability for the torts of one or more of the defendant doctors, [A] expressly renounced any right to execute a judgment against [A], so as to subject [B] to any out-of-pocket loss.").

¹⁰⁵ Contribution was also ruled out by New York General Obligations Law §15-108(c), which provides: "A tortfeasor who has obtained his own release from liability shall not be entitled to contribution from any other person." N.Y. GEN. OBLIG. LAW §15-108(c) (McKinney 2003).

In *Gonzales v. Armac Indus., Ltd.*, 611 N.E.2d 261 (N.Y. 1993), *A* was *C*'s employee. *A* sued *B* and *B* sued *C*—but on a contribution (not indemnity) theory only. *A* and *B* settled. According to their agreement, *B* was released "except as [*Feldman*] loan arrangements may be necessary to permit [*A*] to collect any monies from [*C*] in the event that there is an apportionment of liability against [*C*] by the jury." *Id.* at 262. The court ruled this was a release nevertheless, within the meaning of New York General Obligations Law §15-108, with the effect that *B* had forfeited all right to contribution from *C*. *Id.*

Gonzales has no impact on the apparently separate theory of indemnity, which does not fall under the rule of § 15-108, but we have already seen the New York Court of Appeals abolishing *Feldman* whenever *C* is *A*'s employer. See *supra* text accompanying notes 62-66.

have been compelled to recognize that $B \nu C$ was a valuable right which A could validly collect. Why should such a bad result follow just because this ritual was not performed?¹⁰⁶

In fact, the assignment in *Perno* should have been analyzed as follows. Since B assigned to A in exchange for a release, the assignment should be deemed an "asset payment"—that is, a transfer of an asset in satisfaction of a debt. Ordinarily, one thinks of "payment" as the transfer of United States currency. But there is no reason why some other asset might not satisfy a debt. In chapter 11 bankruptcies, asset payments are even common.¹⁰⁷ For example, where a debtor has mortgaged premises to a secured creditor, the debtor might write a plan that deeds the equity to the secured creditor in satisfaction of the secured claim. When this occurs, the creditor has received an "asset payment."¹⁰⁸

Similarly, in *Perno*, A was paid by means of B 's asset. The asset in question was $B \nu C$. True, $B \nu C$ is valuable only if A has been paid. The very assignment to A should accomplish A 's payment. Or, in liability (as opposed to indemnity) terms, the assignment proves that A is certain to be paid, thereby establishing the value of $B \nu C$.

To look at it from another perspective, suppose, in *Perno*, that B had granted a lien to A on $B \nu C$, in exchange for a release. In this transaction A has not been "paid"—only "secured." A would then be a nonrecourse creditor of B . Non-recourse creditors of B are still creditors.¹⁰⁹ Certainly a *Feldman* payment could be made to vest B 's indemnity right against C .

If a secured transaction is a valid way to vest A with the right to collect from C , then how sensible is it to bar the asset payment version of the deal? *Perno*, then, must be rejected as a cruel hoax on A that is by no means theoretically required.¹¹⁰

V. THE NEED FOR B 'S VOLUNTARY ACT

The *Perno* decision aside, courts seem willing enough to honor the

¹⁰⁶ Presumably, A could still sue C directly for malpractice without relying on assignment of the indemnity cause of action. There is no hint in the *Perno* opinion of whether this is possible or not.

¹⁰⁷ See GILMORE & CARLSON, *supra* note 17, § 8.03[c].

¹⁰⁸ Colorfully, the above-described chapter 11 plans have been nicknamed "eat dirt" plans—a phrase even less pleasant than "cram down." *In re May*, 174 B.R. 832, 834 (Bankr. S.D. Ga. 1994).

¹⁰⁹ 11 U.S.C. § 102(2) (2000) ("claim against the debtor" includes claim against property of the debtor").

¹¹⁰ For a case following *Perno*, see *Bank of India v. Trendi Sportswear, Inc.*, 2002 U.S. Dist. LEXIS 894 (S.D.N.Y. January 18, 2002), *aff'd*, 64 Fed Appx. 827 (2d Cir. 2003), *cert. denied*, 124 S. Ct. 934 (2003).

assignment of *B v C*. To the extent this suffices without the formal performance of a *Feldman* payment, courts effectively recognize that *A* is *B*'s secured creditor with a claim to *B v C*. But the assignment requires the cooperation of *B* to execute the assignment formalities. This problem of *B*'s voluntariness is generally also a problem with the *Feldman* payment. Payment is a voluntary act¹¹¹—*B* never has to pay. What happens if *B* is not in the mood to cooperate?

Here is why courts should view the *Feldman* payment as accomplished in advance, and *B v C* should be viewed as assigned to *A* by operation of law. Why should the will of *B* stand in the way of this result? This is especially inappropriate in insurance cases where *B* typically assigns the defense of *A v B* over to *C*. It can be observed that, as an insolvent, *B* has a fiduciary duty to maximize her estate for the benefit of creditors. All the creditors benefit if *B* voluntarily assigns *B v C* to *A* or voluntarily pays *A* and then collects *B v C* from *C*. Equity courts are accustomed to viewing as done what ought to be done.¹¹² Given this fiduciary duty, the law should view *A* as always already paid—already the assignee of *B v C*.

That *A* is *B*'s secured creditor in *B*'s bankruptcy is already established directly by the UCC in a narrow band of cases. According to UCC section 2-722:

Where a third party so deals with goods which have been identified to a contract for sale as to cause actionable injury to a party to that contract:

- (a) a right of action against the third party is in either party to the contract for sale who has title to . . . goods . . . ;
- (b) if at the time of the injury the party plaintiff did not bear the risk of loss as against the other party to the contract for sale and there is no arrangement for the disposition of the recovery, his suit or settlement is, subject to his own interest, as a fiduciary for the other party to the contract;
- (c) either party may with the consent of the other sue for the benefit of whom it may concern.

Section 2-722 presupposes that *A* and *B* jointly have some property interest in goods subject to a sales contract, whether it be "title, a security interest, or an insurable interest in the goods, or maintains risk of loss with respect to the goods."¹¹³ If so, then either *A* can sue *C*

¹¹¹ *E.g.*, United States v. Isthmian S.S. Co., 359 U.S. 314, 318 (1959).

¹¹² *E.g.*, Meddaugh v. Wilson, 151 U.S. 333, 345 (1884).

¹¹³ *Crysen/Montenay Energy Co. v. Esselen Assocs., Inc. (In re Crysen/Montenay Energy Co.)*, 902 F.2d 1098, 1110 (2d Cir. 1990). In *Crysen*, *A* sold oil to *B* and *B* resold to *C*. *C* refused to pay the full price because *C* claimed it did not receive all the oil *B* claimed to deliver. *B* then filed for bankruptcy, giving rise to an automatic stay. *A* nevertheless sued *C*, claiming authorization to do so under UCC § 2-722. The *Crysen* court ruled that *A* had no cause of action against *C* under the authority of § 2-722, because *A* had no property interest in the goods

directly,¹¹⁴ or *B* can do so, as fiduciary for *A*.¹¹⁵ Section 2-722 "is designed to overturn the rule prevailing in some jurisdictions that only one party could hold title to goods, and only that party had standing to sue a third party for damage to the goods."¹¹⁶

Where section 2-722 applies, *A* is deemed to be the assignee of *B v C*. Accordingly, whether *A* or *B* is the plaintiff, neither needs to prove a pre-existing payment to *A* in order to recover. It is precisely this instinct that I argue must apply in any indemnity or liability case, where *B* is insolvent.

CONCLUSION

In this article, I have argued that the New York courts have abrogated the distinction between indemnity and liability. Where *B* owes *A* and *C* owes *B*, and where the payment of *A* is the condition precedent to *B v C*, *B* is invited to enter into a secured transaction which allows for the payment of *A* without any real transfer of capital. Given that this illusion is fully permitted, it is time for the courts to confess that the distinction between indemnity and liability is a false one that should be entirely erased.

themselves, after they were sold to *B*. *Id.* Rather *B v C* belonged to *B* alone.

¹¹⁴ *Aetna Ins. Co. v. Ortiguera*, 583 F. Supp. 671 (S.D.N.Y. 1984).

¹¹⁵ Thus, *B*'s settlement with *C* binds *A*. *Mitsui & Co. (USA) v. Hudson Tank Terminals Corp.*, 790 F.2d 226 (2d Cir. 1986); *Int'l Harvester Credit Corp. v. Valdez*, 42 Wash. App. 189, 709 P.2d 1233, 1236 (1985); *cf. Nationwide Ins. Co. v. Bank of Forest*, 368 So. 2d 1273 (Miss. 1979) (*C* owed duty to *A* not to release insurance proceeds to *B*, where *A* had a security interest on the insured collateral).

¹¹⁶ *Mitsui & Co. (USA) v. Hudson Tank Terminals Corp.*, 790 F.2d 226, 231 (2d Cir. 1986); *see also Ross Cattle Co. v. Lewis*, 415 So. 2d 1029 (Miss. 1982) ("The effect of [§ 2-722] is that third parties will be liable for conversion, physical damage to goods, or interference with the buyer's rights in goods.").