UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF NEW YORK

In re

WILLIAM J. KAYO Bk. No. 91-14919

Debtor

This case presents the interesting question of whether a Chapter 7 bankruptcy estate may be permitted to profit from the fact that an asset that has no intrinsic value for the estate could nonetheless make a lot of trouble for, and perhaps even extinguish the rights of, an innocent third party. Specifically, the Debtor has little more than "bare legal title" to a certain cause of action pending in a non-bankruptcy court. He is a named plaintiff there, and other named plaintiffs in the action are corporations of which he is sole owner. With permission of this Court, any right to the "proceeds" of that cause of action have been assigned to two creditors of the Debtor in exchange for their reducing their claims against this Chapter 7 estate. Those assignee/creditors were not, however, assigned the power to control the prosecution of the litigation, and their legal representative in this Court indicated no desire to control the litigation. (The Court presumes that the assignee/creditors expect to be paid from sources apart from that litigation, as described below.)

The Code contemplates that if the Debtor has "only legal title and not an equitable interest," then that is all that becomes "property of the estate." See 11 U.S.C. § 541(d). The defendant in the lawsuit wishes to purchase all of the "Debtor's right, title and interest" in the

lawsuit. Although the equitable or beneficial interest in the lawsuit was assigned, the Debtor is still able to control the prosecution of the lawsuit, and that is what is for sale. If control had been assigned, the Court would readily approve the sale, to the defendant, of the Debtor's "bare legal title" to the cause of action. Doing so would accomplish nothing because the assignee/creditors could readily substitute themselves for the plaintiffs as the true parties in interest in the action if they wished.

But it appears from the arguments in open court that there is one other true party in interest whose rights are being dealt with here, given the assignee/creditors' lack of control over the prosecution of the cause of action. That other party in interest is the Debtor's non-bankrupt spouse. She too wishes to purchase the Debtor's right, title and interest to the lawsuit (i.e., the right to prosecute it) even though any proceeds therefrom would be paid over to the two assignee/creditors. The reason she wishes to do so is because she too is obliged to those creditors.[1] The consequence of sale to the defendants of not only the Debtor's title as "Plaintiff," but the right to control the prosecution of the lawsuit, would be to extinguish her right to attempt (by funding her husband's efforts) to develop proceeds therefrom that would pay down her obligation to those assignees.

Counsel for the defendants in the lawsuit argues that in light of the assignment, selling the Debtor's interest in the cause of action is a way for creditors of the Chapter 7 estate to

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[1]The assignee/creditors' apathy toward the lawsuit suggests that they consider it irrelevant to their prospects for payments, either because they think little of the merits of the suit, they do not want to incur any costs to proceed with the action, or because the co-obligors on the debt (which include the Debtor's wife) are solvent.

obtain further value from this lawsuit (beyond the reduction of the assignee/creditors' claims). This is undoubtedly true. And it is certainly true that a bidding war between the defendants and the Debtor's non-debtor spouse would enhance distribution to creditors even more.

But just because the Trustee has succeeded to the Debtor's right to something does not mean that it is always proper for the Bankruptcy Code to be utilized to sell those rights, to the extinguishment of the rights of innocent third parties. The sale of the Debtor's right, title and interest to the lawsuit seems innocuous enough, but what is really being sold (if it is sold to the defendants) is the opportunity for the non-debtor spouse to see her obligation to the assignee/creditors reduced by prosecuting the lawsuit to money judgment, and recovering thereon.[2] And that right is not property of the estate. Consequently, it may not be freely sold by the Trustee.

Viewed in these terms, it might appear that the nature of the interest that the Trustee seeks to sell her has many similarities to the type of interest dealt with at 11 U.S.C. § 541(b)(1), which provides that "Property of the estate does not include . . . any power that the debtor may exercise solely for the benefit of an entity other than the debtor . . . ." That provision, of course, is meant to address such powers as "powers of appointment" and "power of attorney."

[2]So long as the control of the prosecution of the lawsuit remains in the hands of the Debtor or his wife or the corporations wholly owned by the Debtor, the prosecution of the lawsuits may be funded by any of them. (In the case of the Debtor, it would have to be funded with post-petition assets or exempt assets.) It is not clear to the Court whether the corporate plaintiffs owned by the Debtor have assets. Whatever value the corporations might have had to the estate was part of the consideration in the transaction, joined in by the Chapter 7 Trustee and approved by the Court, for the assignee/creditors willingness to reduce their claims against the Chapter 7 estate.

But once the right to "proceeds" from the cause of action was assigned to the assignee/creditors (creditors to whom the Debtor's wife was also obliged), it would seem logical that the duty to act in good faith might oblige the Debtor (and consequently the Trustee) not to exercise the power to control the litigation in a way that would defeat the right of the assignee/creditors to proceeds or that would defeat the indirect interest in the litigation that was possessed by his co-debtor/spouse.

But the Court prefers to rest on a different, similar theory. 11 U.S.C. § 725 was enacted specifically to give the bankruptcy court "flexibility to meet the circumstances, . . . permitting disposition of property subject to a co-ownership interest." See H Rept. No. 95-595 to accompany H.R. 8200, 95th Congress, 1st Session (1977) pages 383, 384. Under the unusual, seemingly unique, circumstances of this case, although the non-debtor spouse could not prosecute the state court action in her own name, the Court is satisfied that the assignment of the proceeds to the holder of an obligation on which she is a co-obligor gives her a sufficient interest in the outcome of the litigation to deem her to be a "co-owner" thereof.

Co-ownership is addressed not only in 11 U.S.C. § 725, but also in 11 U.S.C. § 363(h)-(j). Subsections 363(h)-(j) provide that the Trustee may sell both the Debtor's interest and the co-owner's interest under some circumstances. Had all of the beneficial interest of the estate not been bargained-away previously in this transaction with the assignee/creditors, the procedures and allocations addressed in § 363(h)-(j) might be appropriate to apply once the wife is viewed as a co-owner of the lawsuit. But with the circumstances of this case, only 11 U.S.C. § 725 is applicable, there being nothing of intrinsic value left to the estate, appearances

notwithstanding.

Indeed, there are many illustrations of assets that might seem to be “property of the estate” even to the point where courts without hesitation will approve their sale for the benefit of the estate, but which in fact do not involve a sale of “property of the estate.” Consider only these two: (1) Often an asset is over-encumbered by a lien. The secured creditor recognizes that liquidating the collateral in the bankruptcy court may be done more quickly, less expensively, and with greater finality, than liquidating it under state law. The secured creditor often will offer to waive a portion of its lien in favor of the Chapter 7 estate if the Trustee will exercise the powers that are available under the Bankruptcy Code to liquidate the collateral for the secured creditor. The true “property of the estate,” in such instances, is merely the Debtor’s naked title to collateral. That is valueless, of itself. What has value, however, are the efficiencies and economies that are available through the bankruptcy process. And so what seems to be sold as “property of the estate” is really property of the secured creditor - a portion of its lien, that it is willing to pay for the use of the bankruptcy processes. There is absolutely nothing inappropriate about this unless one believes that the use of the federal forum for these purposes is not a proper use of federal taxpayers’ money.[3]

(2) A foreclosing mortgagee might attempt to purchase all of the Debtor’s right, title and interest in the real estate being foreclosed, where there is no non-exempt equity in the

[3]The Executive Office of United States Trustees instructs Chapter 7 trustees as to the Executive’s view of this issue, but there is no violation of the Bankruptcy Code or of private rights when Chapter 7 trustees liquidate collateral at a lienor’s expense.

real estate, and where the effect of the sale would be to permit the foreclosing mortgage holder to extinguish all of the Debtor's equitable defenses in the foreclosure proceeding and to extinguish any possibility of the Debtor enjoying whatever homestead exemption the Debtor might be entitled to. This example is very much akin to the case at Bar. In the present Court's view, whatever a Trustee sells that would adversely implicate a debtor's homestead exemption or any equitable defenses that a debtor might have that the Trustee does not actually wish to assert for the benefit of creditors, may be sold by the Trustee only "subject to" the homestead exemption and those equitable defenses.

In sum, then, it is true that where no one objects, the Trustee may sell anything that is ostensibly "property of the estate" to anyone who is willing to pay something for it. But, where the supposed "value" that the Trustee is attempting to administer is a "fabricated" value, a value derived from the rights of an innocent third party who objects, it behooves the Court to determine whether approval of the sale would or would not amount to something approaching "extortion" - a demand of a payment to which the estate is not justly entitled, upon threat of exposing payor to some other economic harm.

Here, if the Debtor's wife were required to outbid the defendant in order to be permitted to fund the prosecution of the State Court action in her own or her husband's name, the Chapter 7 estate will have extracted from her a payment to which it is not entitled. Because she ostensibly has no right to pursue the action in her own name, there can be no more lucid example of the risk to others of Trustees' sales of rights that have no intrinsic value, but have value only

to one seeking to extinguish the right of some innocent third party.

The Trustee shall transfer the estate's interest in the lawsuit to the spouse under 11 U.S.C. § 725. This Court views her, under the circumstances of the case, to be the co-owner thereof, and finds § 363 inapplicable as explained above. She shall pay only the administrative expenses of the present proceeding, to the estate, consisting of Trustee's costs and expenses.

In the alternative, the Trustee may sell said interest to the defendant with the consent of and upon terms acceptable to said spouse and any other party obliged to the assignee/creditors with respect to the debts that were reduced by the assignee/creditors in exchange for, inter alia, the proceeds of the lawsuit.

If the Trustee is able to "broker" a global settlement of the non-bankruptcy lawsuit on terms that might benefit the estate, he may propose same. But he may not fail to transfer his interest to the spouse within 30 days unless she or any other co-obligor requests his involvement.

SO ORDERED.

Dated: Buffalo, New York
April 1, 1999

/s/ Michael J. Kaplan

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Michael J. Kaplan, U.S.B.J.