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CLASS ACTIONS IN CHAPTER 11 CASES:

“WHOSE CLAIM IS IT: PERSONAL VERSUS DERIVATIVE CLAIMS”

I. CLAIM CLASSIFICATION: ESTATE CLAIMS VS. CREDITOR PERSONAL CLAIMS

- A.** Generally speaking, to distinguish a claim as an estate claim from a creditor personal claim, three general categories of claims are typically noted:

Estate Claims –

- Purely estate claims which the trustee may pursue.
- Claims by individual creditors stemming from a generalized injury to the debtor’s estate.

Creditor Personal Claims –

- Purely individual claims that stem from injuries that are personal to the creditor.

- B.** Stating these categories, however, does not provide guidance for determining whether a particular claim is an estate claim or a creditor claim.

C. GENERAL CONSIDERATIONS PERTINENT TO DETERMINING WHETHER A CLAIM IS AN ESTATE CLAIM OR A CREDITOR CLAIM

1. **Property of the Estate is Broadly Defined.** Section 541 of the Bankruptcy Code expansively defines property of the bankruptcy estate to include “all legal or equitable interests of the debtor in property as of the commencement of the case,” and broadly incorporates all “rights of action,” such as claims based on state or

federal law. 11 U.S.C. § 541; H.R. Rep. No. 595, 95th Cong., 1st Sess. 367-68 (1977); See United States v. Whiting Pools, Inc., 462 U.S. 198, 203-04 (1983).

2. **State Law Governs What Is Property Of The Estate.** Property interests are created and defined by state law. Butner v. U.S., 440 U.S. 48 (1979). If a cause of action, under state law, is an asset of the corporation's creditors, instead of the corporation itself, then those causes of action are not property of the estate under section 541(a). In re Ozark Restaurant Equipment Co., Inc., 816 F.2d 1222, 1225 (8th Cir. 1987).
3. **Claims Enforceable By The Debtor, And Derivative Claims Enforceable By Shareholders, Are Property of the Estate.** Pepper v. Litton, 308 U.S. 295 (1939). A bankruptcy court has broad equitable powers and has the power to prevent injustice or unfairness in the administration of the bankruptcy estate. Fair administration of the bankruptcy estate requires claims which are assets of the bankruptcy estate to be pursued by the bankruptcy trustee. This includes the right of action for breach of fiduciary duty that was enforceable by the corporation or by a shareholder's derivative action before the petition date. Id. at 307.
4. **General Rule.** To determine whether a claim belongs to the bankruptcy estate, the court must examine whether (i) under state law the debtor could have asserted the cause of action at the commencement of the bankruptcy proceedings; and (ii) the nature of the injury alleged, i.e., whether the claim is direct or derivative to the debtor corporation in order satisfy the requirements of Article III of the U.S. Constitution. See, e.g., Matter of Educators Group Health Trust, 25 F.3d 1281, 1283 (5th Cir. 1994).

II. CLAIMS THAT ARE PERSONAL TO A CREDITOR

A. Particularized Injury. Claims are either general or personal in nature. A claimant's cause of action is personal only if the claimant itself is harmed and no other creditor has an interest in the claim. On the other hand, a claim is general when the conduct at issue results in injury to all creditors of the corporation regardless of the personal dealings between the corporate officers and creditor. See, Koch Refining v. Farmers Union Cent Exchange, Inc., 831 F.2d 1339, 1348-49 (7th Cir. 1987).

B. The Estate Cannot Bring the Claims of a Specific Class of Creditors.

1. **Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416 (1972).** In this seminal case, a Chapter X Trustee brought suit against the

indenture trustee, Marine Midland Grace Trust Co. (“Marine”), on behalf of the debtor’s debenture holders. The Trustee alleged that Marine negligently or intentionally failed to prevent the debtor from engaging in transactions that violated the terms of the indenture and submitting fraudulent compliance certificates, which resulted in the debtor suffering great financial losses. The Trustee argued that a reorganization trustee was better poised to bring such claims than the bondholders. In addition, the Trustee asserted that authorizing him to sue on behalf of debenture holders would discourage vexatious litigation and would not deplete the resources of the estate.

Holding: The Trustee had no standing to raise claims on behalf of the debenture holders. Focusing on procedural concerns, the Supreme Court identified three factors that militated against authorizing the Trustee to pursue the lawsuit:

- a. **Congress did not intend for trustees to have standing to assert claims on behalf of creditors.** There was no suggestion in the statutory scheme that Congress intended to give bankruptcy trustees the authority to sue third parties on behalf of creditors. The Bankruptcy Act did not have provisions that authorized trustees to collect money not owed to the estate.
- b. **Debtor had no claim against the indenture trustee.** Whatever damage the debenture holders suffered, the debtor and the indenture trustee were *in pari delicto*¹ in the alleged misconduct.
- c. **A suit by the trustee on behalf of creditors might be inconsistent with any independent actions that they might bring themselves.** The Trustee’s suit would not preempt suits by individual debenture holders who may not agree on the amount of damages to seek, or even on the theory on which to sue. The Court questioned who would be bound by a settlement obtained by the Trustee, which could lead to a proliferation of litigation.
- d. The Supreme Court concluded that it should be left to Congress to decide whether bankruptcy trustees should have standing to sue on behalf of creditors and expressly invited Congress to do so.

¹ *In pari delicto* means “in equal fault” in Latin. The *in pari delicto* common law defense or doctrine holds that parties to a fraud, mutual wrongdoers, cannot recover from one another for harm done as a result of the fraud.

2. **Rochelle v. Marine Midland Grace Trust Co., 535 F.2d 523 (9th Cir. 1976).** In this case, another Chapter X Trustee brought suit on behalf of certain classes of creditors, debenture purchasers and holders alleging that they were defrauded by the debtor's former officers and directors and a certified public accountant. Relying on Caplin, the Ninth Circuit Court of Appeals held that the Trustee did not have standing to assert claims on behalf of any entity other than the debtor corporation.

3. **Trenwick America Litigation Trust v. Ernst & Young, L.L.P., 906 A.2d 168 (Del.Ch. 2006) aff'd at 931 A.2d 438 (Del. 2007).** The litigation trust which had been formed in the reorganization of a subsidiary of a publicly listed insurance holding company following bankruptcy proceedings, brought an action against former directors of holding company, former directors of the subsidiary, and various third-party advisors, alleging claims including breach of fiduciary duties, deepening insolvency, and fraud. The litigation trust contended that it could assert the claims of the subsidiary's creditors. Basing its decision on Caplin and its progeny, the Delaware Chancery Court held that the litigation trust did not have standing to pursue the claims of the subsidiary's creditors. The Court also indicated that even if the litigation trust had standing to pursue claims on behalf of subsidiary's creditors, the breach of fiduciary duty claim against the holding company's directors would fail because under Delaware law, a parent corporation does not owe fiduciary duties to its wholly-owned subsidiaries or their creditors. Id. at 192 citing Anadarko Petro. Corp. v. Panhandle Eastern Corp., 545 A.2d 1171, 1174 (Del. 1988).

4. **The Amendment to Section 544 That Never Was.** When the Bankruptcy Code was ultimately enacted in 1978, Congress decided against giving bankruptcy trustees standing to assert claims on behalf of creditors. However, the House's original proposed version of Section 544 included a subsection (c), which was intended to overrule Caplin. Under the proposed Section 544(c), the trustee was permitted to act as a representative to a class of creditors if the trustee had no other basis on which to recover on the claim involved. However, this provision was expressly deleted from the final version of Section 544. Subsection (c) would have provided as follows:

(c)(1) The trustee may enforce any cause of action that a creditor, a class of creditors, an equity security holder, or a class of equity security holders has against any person, if -

(A) the trustee could not recover against such person on such cause of action other than under this subsection;

(B) recovery by the trustee for the benefit of such creditor or equity security holder or the members of such class will reduce the claim or interest of such creditor or equity security holder or of such members, as the case may be, against or in the estate;

(C) there is a reasonable likelihood that recovery against such person will not create an allowable claim in favor of such person against the estate; and

(D) enforcement of such cause of action is in the best interest of the estate.

(2) If the trustee brings an action on such cause of action -

(A) the court, after notice and a hearing, may stay the commencement or continuation of any other action on such cause of action; and

(B) the clerk shall give notice to all creditors or equity security holders that could have brought an action on such cause of action if the trustee had not done so.

(3) A judgment in any such action brought by the trustee binds all creditors or equity security holders that could have brought an action on such cause of action. Any recovery by the trustee, less any expense incurred by the trustee in effecting such recovery, shall be for the benefit only of such creditors or equity security holders.

H.R. 8200, 95th Cong., 1st Sess. 416-17 (1977).

C. Examples of Claims Held to Be Personal to Creditors.

1. Conspiracy To Defraud, Aiding And Abetting. Highland Capital Management LP v. Chesapeake Energy Corp. (In the Matter of Seven Seas Petroleum) 522 F.3d 575 (5th Cir. 2008). In this recent case, the debtor, Seven Seas, was an oil exploration company that had issued unsecured notes and secured debt. The unsecured notes contained protective covenants preventing the debtor from issuing secured debt in excess of a combination of the company's cash on hand, certain receivables and a percentage of the discounted value of the debtor's oil reserves. After the debtor's exploratory well failed and the bondholders were told that the amount of the secured notes exceeded the company's assets, the bondholders filed an involuntary chapter 7 petition against the debtor which was converted to chapter 11 and a trustee was appointed. The bondholders also filed an action for fraud in the state court against the

geological firm employed by debtor to provide estimates of the debtor's oil reserves, claiming that such estimates were inflated.

The chapter 11 trustee commenced an adversary proceeding against Chesapeake (a holder of secured notes) and the other secured note holders to recharacterize the secured debt as equity and asserted tort claims against Chesapeake for breach of duties to the debtor and interference with the debtor's fiduciary duties. The trustee reached a settlement with Chesapeake as part of the plan whereby Chesapeake agreed to relinquish some of its collateral in exchange for a complete release of claims by the estate.

Two months after the plan was confirmed and Chesapeake was dismissed from the trustee's adversary proceeding, the bondholders amended the complaint in their state court action to add Chesapeake as a defendant to claims of conspiracy to defraud and aiding and abetting fraud. Essentially, the bondholders claimed that the issuance of the secured notes was part of a common plan by the secured note holders to defraud the bondholders by decreasing the assets available to them. The mechanism for achieving this fraud was an inflated reserve estimate which allowed the debtor to issue secured debt notwithstanding the protective covenants in the unsecured notes.

Chesapeake filed a motion to dismiss the complaint against it arguing, among other things, that the claims were property of the estate and had been released under the plan. The bankruptcy court granted Chesapeake's motion to dismiss finding that the harm alleged was "generalized to all creditors" and the trustee could and did raise such claims against Chesapeake. The district court affirmed without considering whether the bondholders' state court action constituted property of the estate.

Holding: The Fifth Circuit vacated the bankruptcy court's order dismissing the bondholders' claims against Chesapeake. Although recognizing the nexus between the bondholders and Chesapeake to Seven Seas and its bankruptcy proceeding, the Fifth Circuit stated that "the existence of common parties and shared facts between the bankruptcy and the bondholders' suit does not necessarily mean that the claims asserted by the bondholders are property of the estate." *Id.* at 585. The Court examined the nature of the specific injuries alleged by the bondholders to determine whether the claims were "merely derivative of an injury" to the debtor. The Fifth Circuit found that because the bondholders' claims did not derive from harm to the Debtor and were unique to their specific situation, their claims were personal and not property of the estate.

2. **False and Misleading Information.** King v. Sharp, 63 F.R.D. 60 (N.D. Tex. 1974). Trustee did not have standing to pursue an action on behalf of a class consisting of all shareholders and certain other creditors alleging, *inter alia*, a conspiracy by defendants to issue materially misleading financial statements and press releases. Principally, the Court found that the debtor did not suffer the same injury as that suffered by the individual class members which resulted from reliance on false and misleading information. The debtor's injury was founded on corporate mismanagement by the defendants that controlled the debtor.

3. **Fraudulent and Negligent Misrepresentation and Non-Disclosure.** In re The 1031 Tax Group, LLC, 397 B.R. 670 (Bankr. S.D.N.Y. 2008). Creditors did not violate the automatic stay in a state court lawsuit that asserted claims of fraudulent and negligent misrepresentations and nondisclosure regarding the type of accounts in which the creditors' funds were to be held and the intended disposition of such funds because such claims were the direct and personal claims of the creditors and resulted in particularized injuries.

4. **Claims Under State Consumer Protection Act.** In re The 1031 Tax Group, LLC, *supra*. Creditors did not violate the automatic stay in a state court lawsuit that asserted claims for deceptive practices under Colorado's Consumer Protection Act because the deceptive practices were aimed specifically at the creditors and therefore personal to the creditors.

5. **Breach of Fiduciary Duty Arising from Broker/Dealer Relationship.** In re I.G. Services, Ltd., 2008 WL 783551 (Bankr. W.D.Tex. 2008). Breaches of fiduciary duties arising from a broker/dealer relationship with investor/creditors were held to be direct claims belonging to the individual creditors.

D. Assignment of Claims By Creditors Does Not Create An Estate Claim. Williams v. California 1st Bank, 859 F.2d 664 (9th Cir. 1988). Chapter 7 Trustee solicited assignments of claims against the Bank from among the class of investors. The Trustee filed suit against the Bank on behalf of the Debtor's estate and the investors, alleging securities fraud arising from the Bank's involvement in the debtor's "Ponzi" scheme. The Trustee was to distribute the net proceeds only to those investors who had assigned their claims. **Holding:** The Ninth Circuit held that the Trustee lacked authority to bring suit on the claims. The court reviewed the three Caplin factors (e.g., no independent grant of standing, no independent claim, and suit by trustee could lead to inconsistent results) and found them to apply with equal force to the facts in Williams.

III. THE ESTATE MAY ASSERT CLAIMS OF THE DEBTOR, AND CLAIMS ARISING FROM A GENERALIZED INJURY TO THE ESTATE'S CREDITORS

A. Derivative Claims

1. Breach of Fiduciary Duty, Negligence and Aiding and Abetting.

- a. In re The 1031 Tax Group, LLC, 397 B.R. 670 (Bankr. S.D.N.Y. 2008). Chapter 11 Trustee moved for a preliminary injunction to prevent participants in like kind property exchanges (for which debtors had acted as qualified intermediaries) from pursuing a state court action against the debtor's employees for a variety of claims including negligence and breach of fiduciary duty. Looking to Colorado law and 10th Circuit's decision in Delgado Oil Co., Inc. v. Torres, 785 F.2d 857 (10th Cir. 1986), the court held that the breach of fiduciary duty and negligence claims were derivative and could have been asserted by the debtor on the petition date. The Court also found that claims for aiding and abetting conversion were derivative claims because the conversion at issue involved funds which were property of the estate. Thus, the injury suffered was generalized to all creditors.
- b. In re Healthco International, Inc., 208 B.R. 288 (Bankr. D. Mass 1997). Holding that the Trustee could bring any suit the debtor would have brought, including suits against directors and controlling shareholders for breach of fiduciary duty. The Court explained, "in complaining that directors authorized a transaction which unduly weakened Healthco, the Trustee is not asserting the claim of creditors. He alleges Healthco was the victim of poor management causing damage to the corporation which necessarily resulted in damage to its creditors by diminishing the value of its assets and increasing its liabilities." 208 B.R. at 300 (footnotes omitted).
- c. In re Flagship Healthcare, 269 B.R. 721 (Bankr. S.D. Fla. 2001). Chapter 7 Trustee brought an adversary proceeding against the debtor's prepetition financial advisor and its employees for their alleged negligence in valuing service oriented companies acquired by the debtor. The financial advisor filed a motion to dismiss based on lack of standing,

lack of proximate cause and lack of damages. The court ruled that the trustee had standing by alleging damage to the company not the creditors and the complaint satisfactorily described the financial deterioration of the company.

2. **Derivative Claims Do Not Become Personal Claims When A Corporation Enters the Zone of Insolvency.** In re I.G. Services, 2008 WL 783551 (Bankr. W.D. Tex. 2008). The Trustee of the Investor Claims Trust established in the debtors' cases asserted claims against the debtors' former officers for breach of their fiduciary duties to the debtors' investor/creditors. The gist of this argument was that the defendants owed fiduciary duties (as officers) and "that those duties were ultimately owed to the investors in their capacity as creditors of corporate debtors once the debtors entered the 'zone of insolvency'." Id. at *2. Relying on Delaware law, the Court rejected this argument stating that "those sorts of claims are still essentially derivative claims and may only be asserted by shareholders or creditors *on behalf of* the corporate debtors." Id.

3. **The Trustee Does Not Have Standing When the Debtor's Management Collaborates in the Wrongdoing: The Wagoner Rule and Suits Against Third Party Professionals.** Shearson Lehman Hutton, Inc. v. Wagoner, 944 F.2d 114 (2nd Cir. 1991). In Wagoner, the Trustee brought an action against the debtor's broker for aiding and abetting the debtor's sole shareholder in defrauding the debtor. The Second Circuit held that the Trustee lacked standing to assert a claim against the broker because "[a] claim against a third party for defrauding a corporation with the cooperation of management accrues to the creditors, not to the guilty corporation." The Second Circuit determined that where a debtor's management and a third party collaborate in a fraudulent scheme, a trustee can sue **only** if the trustee can establish that the damage to the debtor-corporation occurred separate and apart from the damage to the debtor's creditors. Thus, when the Wagoner Rule applies, the trustee will not have standing to assert claims on behalf of the debtor. Notably, the Wagoner Rule would not affect the standing of creditors to assert claims against the third party assuming the creditors could show a direct injury.
 - a. **Relationship to the *In Pari Delicto* Doctrine.** The logic underpinning the Wagoner Rule is "the fundamental principle of agency that the misconduct of managers within the scope of their employment will normally be imputed to the corporation." Although Wagoner made no specific mention of the *in pari delicto* defense, the Wagoner Rule is

essentially grounded on the common law *in pari delicto* defense. *In pari delicto* is an equitable defense, while the Wagoner Rule is a standing issue. This distinction aside, other courts have used the *in pari delicto* defense and the Wagoner Rule interchangeably. Global Crossing Estate Rep. v. Winnick, 2006 WL 2212776, FN. 16. (S.D.N.Y., 2006); cf. In re Promedicus Health Group, LLP, 359 B.R. 45, 50 (Bank. W.D.N.Y. 2006) (“It is also important to note that although the *Wagoner* Doctrine and the ‘*in pari delicto*’ doctrine have some elements in common, they are not the same. *Wagoner* addresses ‘standing’ in the context of the ‘case or controversy’ limitation on the exercise of Article III power under the Constitution, and the powers of a Chapter 7 Trustee are indeed a ‘federal question.’ Such a dispute over ‘standing’ is not to be conflated with an eventual trial on the merits of an affirmative defense.”)

- b. **The Trustee Can Still Assert Claims Against the Third Party If the “Adverse Interest Exception” to the Wagoner Rule Is Applicable.** In Wagoner, the Second Circuit also held that the acts of the agent will not be charged to the corporation regardless of whether the agent is purportedly acting on behalf of the corporation when the agent is really committing fraud for his own benefit. This “adverse interest” exception, has been applied only where the agent has “totally abandoned” the debtor’s interests. See, e.g., In re Mediators, Inc., 105 F.3d 822, 827, (2nd Cir. 1997). Under this exception, management misconduct is not imputed to the debtor if the officer or other controlling party acted entirely in his own interests and adversely to the interests of the debtor. The adverse interest exception has not been found applicable where the agent acts for both his or her own benefit and for the benefit of the debtor. See, e.g., Securities Investor Protection Corp. v. BDO Seidman, LLP, 49 F. Supp. 2d 644, 650 (S.D.N.Y. 1999) aff’d, 245 F.3d 174 (2nd Cir. 2001).
- c. **The Adverse Interest Exception Is Not Available and the Trustee Is Without Standing When the Debtor and Its Agent Are One and the Same: The “Sole Actor” Rule.** Where the debtor and its agent are really one and the same, the “sole actor” rule applies. See, e.g., In re Bennett Funding Group, Inc., 336 F.3d 94, 100 (2nd Cir. 2003); Mediators, 105 F.3d at 827 “This rule imputes the agent’s knowledge to the [debtor] notwithstanding the agent’s self-dealing because the party that should have been informed

was the agent itself, albeit in its capacity as [the debtor]." Mediators, 105 F.3d at 827.

B. Alter Ego Claims

1. Koch Refining, 831 F.2d 1339 (7th Cir. 1987). Koch and other oil companies were defendants to a preference action brought by the chapter 7 Trustee which sought declaratory judgment that the debtor's shareholders used the debtor as their alter ego and were jointly and severally liable for the debtor's debts. **Holding:** The Court first determined that Illinois and Indiana law allowed a trustee to bring an alter ego action on behalf of the debtor and, thus, the Trustee had the exclusive right to bring the alter ego claim. The Court pointed out, however, that the Trustee could only bring general claims that were common to all creditors of the debtor and could not assert personal claims of creditors unique or individual to such creditors. Because the injury alleged was not specific to Koch or the oil companies and did not result in loss to them in their individual capacities, the Seventh Circuit determined that only the trustee had standing to assert the alter ego claims. Id. at 1350.
2. S.I. Acquisition v. Eastway Delivery Service (In re SI Acquisition), 817 F.2d 1142 (5th Cir. 1987). At issue in this case was whether an alter ego action brought by Eastway violated the automatic stay. **Holding:** The alter ego action violated section 362(a)(3) of the Bankruptcy Code because the alter ego claim was property of the estate. The Fifth Circuit's ruling was based on the following factors:
 - **The injury complained of provided a right to all creditors under state law.** The remedy of alter ego under Texas law was available to all creditors of a corporation and "does not rest on a particular creditor's dealings with or reliance on the control entity." Id. at 1152.
 - **The "First-Come-First-Served" Problem.** The Court was concerned that allowing Eastway to use the cause of action to pay its individual claim would encourage other creditors to do the same, creating a "multi-jurisdictional rush to judgment." The Court opined claims that are available to all creditors of the corporation should similarly provide a "pool of assets that should be available to all creditors." Id. at 1153-1154.
3. St. Paul Fire and Marine Insurance Co. v. PepsiCo, 884 F.2d 688 (2d Cir. 1989). PepsiCo guaranteed bonds as surety for a wholly owned subsidiary, Lee Way, which PepsiCo later sold to another

company, Banner. Lee Way subsequently filed bankruptcy. The trustee and the committee brought alter ego claims against Banner. PepsiCo sought to bring its own alter ego claim based upon Banner's diversion of Lee Way's assets. **Holding:** The Second Circuit held that only the trustee had standing to bring this claim stating that "if a claim is a general one, with no particularized injury arising from it, and if that claim could be brought by any creditor of the debtor, the trustee is the proper person to assert the claim, and the creditors are bound by the outcome of the trustee's action." Id. at 701. While the Second Circuit also examined ownership of the alter ego claim under Ohio law, it was unable to find any authority directly on point.

4. CBS, Inc. v. Folks (In re Folks), 211 B.R. 378 (9th Cir. B.A.P. 1997). Here, CBS filed a complaint objecting to Folks' discharge under section 727 of the Bankruptcy Code claiming creditor status by virtue of its alter ego claim of diversion of corporate assets against Folks. Folks moved for summary judgment on the grounds that CBS did not have standing to object to his discharge.

Holding: Following Koch, the Ninth Circuit Bankruptcy Appellate Panel first looked to California law (the state in which the debtor entity was organized) to determine ownership of the alter ego claim. California law recognized two types of alter ego claims. The first type alleges "injury to the corporation giving rise to a right of action in it against defendants" and the second type where causes of action belong to each creditor individually. Id. at 385 quoting Stodd v. Goldberger, 73 Cal.App.3d 827, 833 (1977).

Next, the Court cited to an earlier decision by the Central District of California Bankruptcy Court in In re Davey Roofing, Inc., 167 B.R. 604 (Bankr.C.D.Cal. 1994) which stated that under Ninth Circuit law, a chapter 11 debtor had standing to bring a veil piercing claim.

Lastly, the Court conducted the generalized versus particularized injury analysis employed in the above cases. CBS' alter ego claim alleged that Folks failed to observe any corporate formalities with respect to his corporation and used bank accounts and funds of the corporation for personal and family expenditures. The Court determined this to be a general claim because all creditors were affected and there was no particularized injury to CBS. Accordingly, the Court concluded that the Trustee had standing to bring the alter ego claims against Folks. Id. at 388-389.

C. But, Alter Ego Claims Are Not Always Property of the Estate: It Is a Question of State Law

1. In re Ozark Restaurant Equipment, 816 F.2d 1222 (8th Cir. 1987). In this case, the Trustee sought to bring alter ego claims on behalf of creditors. The Eighth Circuit Court of Appeals held that under Arkansas law alter ego claims vest in creditors personally and do not become property of the estate under section 541 of the Bankruptcy Code.
2. Steinberg v. Buczynski, 40 F.3d 890 (7th Cir. 1994). Similarly, here, the Trustee sought to bring alter ego claims against the debtor corporation's primary shareholders for diversion of corporate assets in an attempt to obtain money not paid to an employee pension fund. **Holding:** Reviewing Illinois corporate law, the Seventh Circuit Court of Appeals held that when a shareholder has injured not the bankrupt corporation itself but a creditor of that corporation, the trustee has no interest in the suit. The Court found no evidence that the shareholders directly swindled the corporation itself by taking unreasonably high salaries or plundering corporate assets. It was only the pension fund that was harmed directly.

IV. CAN ACTIONS BY A CREDITOR AND THE ESTATE COEXIST?

A. In re Van Dresser Corp., 128 F.3d 945 (6th Cir. 1997). Here, a shareholder and guarantor of the debtor brought a suit against an officer of one of the debtor's subsidiaries and the bank and one of its managers alleging that the bank manager and the officer conned the subsidiary to the tune of \$2.7 million. The Trustee had already settled its claim against the bank for \$200,000 and the shareholder did not object to the settlement. The shareholder argued that he had a direct relationship with the bank and this relationship resulted in an injury that was separate and distinct from the injury suffered by the debtors. The bank countered that the claim was the exclusive property of the estate. **Holding:**

1. The Court sided with the bank positing that the critical issue was whether the two claims were preclusive of on another:

The only question is whether both [the shareholder] and [the debtor] could recover on their claims. If a judgment against these defendants by either [the shareholder] or [the debtor] in state court precluded the other from a subsequent recovery, then the claims are not truly independent, and by default the claims are exclusively property of the trustee in bankruptcy. Id. at 947-948.

2. The Court found that the claims of the shareholder and trustee would preclude one another and provided a useful analogy:

The defendants here allegedly took a finite amount of money from [the subsidiaries]. Although they may be liable for additional sums such as attorney fees, costs, and even treble damages, they cannot be required to repay the principal amount of \$2.7 million more than once. If a thief steals a diamond necklace from a married couple, the husband cannot recover the value of the converted necklace from the thief after the wife has already recovered the necklace. Id. at 948.

3. Significantly, the Court recognized that the trustee's settlement did not extinguish the shareholder's claim to recover the costs he incurred in defending actions to collect under guarantees he executed on behalf of the debtor. Id. at 949.

B. In the Matter of Seven Seas Petroleum, 522 F.3d 575 (5th Cir. 2008). This case (discussed in detail above) directly confronted the coexistence of claims issue and held that creditors could continue to prosecute claims arising from the same facts which supported the Trustee's claims for recharacterization and interference with the debtor's fiduciary duties. The lessons to be taken from Seven Seas are as follows:

1. Common parties and shared facts between a debtor's bankruptcy and a lawsuit by creditors do not necessarily mean that the claims asserted by the creditors are property of the estate. As the Fifth Circuit pointed out, "it is entirely possible for a bankruptcy estate and a creditor to own separate claims against a third party arising out of the same general series of events and broad course of conduct."
2. A claim does not belong to the estate, nor is it otherwise only capable of being asserted by the trustee, simply because the claim could be brought by a number of creditors, rather than just one.

V. CAN AN ESTATE REPRESENTATIVE USE CLASS ACTION OR OTHER PROCEDURES TO ELEVATE A PERSONAL CLAIM TO AN ESTATE OR DERIVATIVE CLAIM?

A. Can the Trustee or Debtor-In-Possession Represent the Class?

1. King v. Sharp, 63 F.R.D. 60 (N.D. Tex. 1974). Trustee filed a suit alleging a conspiracy by defendants to have a substantial number

of the debtor's shares issued without required registration under the securities laws and caused the debtor to acquire numerous companies at inflated prices, to borrow beyond its financial ability and to issue materially misleading financial statements and press releases. The Trustee also alleged that the debtor was mismanaged by the defendants to the detriment of the creditors and shareholders. The Trustee then sought leave to proceed on behalf of a class consisting of all shareholders and creditors of the debtor and all others who sustained a loss as a result of the purchase or loan against the common stock of the company.

Holding:

- a. The Trustee did not have standing to represent the class. Relying on the Supreme Court's recent decision in Caplin, the district court concluded that the Trustee had no statutory authority to collect money on behalf of third parties. The Court stated that "[i]f the bankrupt estate has no cause of action in its own right, then the trustee has no authority to institute suits as a class representative or otherwise for the benefit of third parties."
 - b. The Court found that the debtor did not suffer the same injury as that suffered by the individual class members which resulted from reliance on false and misleading information. The debtor's injury was founded on corporate mismanagement by the defendants that controlled the debtor. Because the debtor had no claim in its own right against the defendants, the Trustee had no authority to institute suits as a class representative or otherwise for the benefit of third parties.
 - c. The Court also opined that even if the Trustee did have standing, he would not be an adequate representative for the class because the interests of the class could conflict with the interests of the Trustee. Id. at 64-65. Specifically, if the class action proceeded with the Trustee as the representative, funds from the estate would be expended on behalf of purchasers of the debtor's stock. This expenditure of funds would not directly benefit the estate or its creditors.
2. Morlan v. Universal Guaranty Life Ins. Co., 298 F.3d 609, 619 (7th Cir. 2002). Prepetition, Morlan (the debtor) filed a class action suit as the representative of a class of insurance agents of the defendants, affiliated insurance companies that maintain employee welfare benefit plans. Although the Seventh Circuit was not confronted directly with whether a trustee or debtor could have

standing to pursue claims on behalf of a class, it addressed the problems raised by the issue. Writing for the Seventh Circuit, Judge Posner commented:

What trustee in bankruptcy would think it worthwhile to insert himself in the place of the named plaintiff? We are not surprised to find very few cases in which trustees in bankruptcy have done so. The named plaintiff in a class action usually has only a small stake in the action, and while the stakes for the class as a whole may be large, very few of the benefits of settling the class action or prosecuting it to judgment would be received by the trustee (which is to say the creditors), since he would just be the named plaintiff's surrogate. Most of the benefits would go to the other members of the class and to the lawyers for the class, so that the trustee, as class representative yet having fiduciary obligations exclusively to the estate in bankruptcy, would have a potential conflict of interest. *Id.* at 619.

3. Dechert v. Cadle Co., 333 F.3d 801 (7th Cir. 2003). Chapter 7 Trustee who succeeded to consumer-debtor's Fair Debt Collection Practices Act (FDCPA) claims on commencement of debtor's Chapter 7 case moved for certification of debtor class. **Holding:** Noting the dearth of case law on the issue of whether a trustee could serve as a class representative, the Seventh Circuit (in another decision by Judge Posner) reversed the district court's certification. The Court of Appeal concluded that in light of the Trustee's conflicting duties as representative both of unsecured creditors and of the putative class, the Trustee was not a "fair and adequate" representative for debtor class, which could not be certified as such.
 - a. The Seventh Circuit deliberately refrained from issuing a blanket rule on a trustee's or debtor-in-possession's ability to represent a class positing that, "there may be cases in which the expected recovery of individual class members is substantial and only a fiduciary is available to be the class representative."
4. Dabit v. Merrill, Lynch, Pierce, Fenner & Smith (In re Merrill Lynch & Co., Inc. Research Reports Securities Litigation), 375 B.R. 719 (S.D.N.Y. 2007). Chapter 7 Trustee succeeded to debtor-former broker's interest in prepetition putative securities class action lawsuit brought by debtor against investment banking firm. **Holding:** Citing Dechert and recognizing the issue as one of first impression, the district court held that the Trustee could not be

substituted as the sole named plaintiff. As in Dechert, the decision was motivated by conflict of interest issues.

- a. Specifically, the district court found that the Trustee's dual role as fiduciary for debtor's creditors and as representative of the putative class of plaintiffs would have created an "insuperable and impermissible" conflict of interest, because the Trustee would have to work "both sides of the street" in the case, representing both the interests of Merrill Lynch, which was the creditor with the single largest unsecured claim against debtor, and the interests of the class members. In addition, the court raised concern that the Trustee's obligation to liquidate estate property expeditiously would have conflicted with the class's interest in continuing to prosecute the already protracted lawsuit, and Trustee was not the only available class representative in the case.

B. Federal Equity Receiver Was An Adequate Class Representative Under FRCP 23(a)(4): Dirks v. Clayton Brokerage Co. of St. Louis, 105 F.R.D. 125 (D. Minn. 1985). Federal equity receiver of corporation for which defendant brokerage firm placed commodity trades sought to serve as a class representative to defrauded investors in a class action. Defendant argued that the receiver was not a proper member of the class or representative under FRCP 23(a)(4) because (1) the receiver was withholding funds from the investors of the receivership corporation to finance litigation which would benefit only investors within the class definition and (2) the receiver could not assert claims of the individual investors under Caplin and its progeny. Id. at 135. **Holding:**

1. The district court disagreed holding that the receiver was a proper member of the class and representative. The court based its ruling on the well-established law that a receiver can assert claims of the corporation itself which amount to grievances similar to the claims of the class members stating that "the fact that the receiver could not himself bring the claims of individual investors does not necessarily require the conclusion that the receiver's interests (i.e., the claims of the corporation) are so different from the investor's interests that the receiver could not serve as one of the class representatives." Id. at 136. Additionally, the court dismissed defendant's argument that the receiver's interests were divergent from the other class members because the receiver represented the entity which "directly damaged the investors." Id.
2. The court also commented that if conflicts of interest arose during the course of the litigation the court had a variety of procedural remedies available in that the court could (a) "direct a notice to

class members inquiring whether they consider their representation fair and adequate;” (b) allow other plaintiffs to become named plaintiffs under Rule 23(d)(2); or (c) decertify the class under Rule 23(c)(1). Id.

C. Trustee Cannot Use Estate Funds to Support Class Action: In the Matter of the Washington Group, Inc., 476 F.Supp. 246 (M.D.N.C. 1979). The Trustee sought authority to expend the debtors’ funds to assist in defraying the costs of maintaining two class actions brought by shareholders and employees against former officers, directors and fiduciaries of the debtors. The Trustee was not seeking to directly bring the suits on behalf of the third parties. Basing its decision on the reasoning in Caplin and King v. Sharp, the Court held that the Trustee did not have authority to use estate funds to help support claims of third party members of a class.

VI. TRUSTEE’S LAW SUITS ON BEHALF OF DEBTORS ARE NOT BARRED BY THE SECURITIES LITIGATION UNIFORMS STANDARDS ACT OF 1998 (“SLUSA”)

A. SLUSA Background. SLUSA preempts certain class actions that allege fraud under state law “in connection with the purchase or sale” of securities. Under SLUSA, such lawsuits cannot be filed in state or federal court. Congress enacted SLUSA in response to the wave of state court “strike suits” filed after it enacted the Private Securities Litigation Reform Act (“PSLRA”) which imposed new restrictions for securities class actions including a heightened pleading standard, damage caps and mandatory sanctions for frivolous litigation.

B. SLUSA Only Applies to “Covered Class Actions”

1. **SLUSA provides for federal preemption and dismissal of state-based securities law claims alleged by a “covered class action.”** 15 U.S.C. § 77p(f)(2)(A). A “covered class action” is defined as:

(ii) any group of lawsuits filed in or pending in the same court and involving common questions of law or fact, in which--

(I) damages are sought on behalf of more than 50 persons; and

(II) the lawsuits are joined, consolidated, or otherwise proceed as a single action for any purpose.

2. **A Trustee Only Counts as One Person Under SLUSA**

SLUSA provides with respect to counting of class members:

For purposes of this paragraph, a corporation, investment company, pension plan, partnership, or other entity shall be treated as one person or prospective class member, but only if the entity is not established for the purpose of participating in the action. 15 U.S.C. § 78bb(f)(5)(D).

- a. Smith v. Arthur Andersen LLP et al., 421 F.3d 989 (9th Cir. 2005). The Plan Trustee for the bankruptcy estate of Boston Chicken and various related entities filed an action alleging a variety of claims. The Trustee later filed motions seeking court approval of settlements reached with certain of the defendants and requesting bar orders enjoining the non-settling defendants from asserting certain claims against the settling defendants. The Ninth Circuit Court of Appeals affirmed the district court's decision to grant the approval motions finding, among other things, that the trustee was "one person" under SLUSA and that his action was not a "single lawsuit" barred by SLUSA.

3. **SLUSA Excludes Actions "On Behalf of a Corporation"**

- a. A trustee's claims "brought on behalf of the corporation" are statutory exceptions to the definition of a "covered class action" under SLUSA which provides that:

the term "covered class action" does not include an exclusively derivative action brought by one or more shareholders on behalf of the corporation. 15 U.S.C. § 78bb(f)(5)(C).

- b. Coykendall v. Kaplan, Fed. Sec. L. Rep. (CCH) ¶ 92, 224 (N.D.Cal. 2002). Shareholder brought a derivative action on behalf of the corporation. Defendants contended that SLUSA barred the Plaintiff's claims because the factual allegations of the derivative action "mirror[ed] those that underlie numerous federal class action . . . to which SLUSA applies." The district court held that SLUSA did not apply to the separate derivative suit.

4. **SLUSA Does Not Cover Misconduct That is Not Directly “In Connection With the Purchase or Sale of Securities”**
 - a. SLUSA includes only allegations of “misrepresentation or omission . . . in connection with the purchase or sale of a covered security.” 15 U.S.C. § 78bb(f) and 77p(b). This is likely outside the confines of most trustee lawsuits.