

Standing Issues for Liquidating Trusts Bringing Causes of Action on Behalf of the Estate

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I. Overview of Standing

“Causes of action commenced by a trustee on behalf of a debtor estate fall into two broad categories: (1) actions brought by the trustee as successor to the debtor’s interests included as property of the estate under 11 U.S.C. § 541, and (2) actions brought under one of the trustee’s avoidance powers.” *Sender v. Simon*, 84 F.3d 1299, 1304 (10th Cir. 1996).

A. Standing to Bring Debtor’s Causes of Action Under 11 U.S.C. § 541.

All claims and causes of action of the debtor are considered property of the debtor’s bankruptcy estate. 11 U.S.C. § 541; *In re Chappel*, 189 B.R. 489 (B.A.P. 9th Cir. 1995) (“property of the estate” is broad enough to cover all kinds of property, including tangible or intangible causes of action); *In re Ionosphere Clubs, Inc.*, 156 B.R. 141 (S.D.N.Y. 1993), *aff’d* 17 F.3d 600 (2d Cir. 1994) (debtor’s interests in property, including causes of action, are defined by state law, and become assets of estate once bankruptcy petition is filed). The trustee or debtor in possession has standing to pursue such claims. Indeed, when both the trustee and a creditor are entitled to bring a cause of action, only the trustee is allowed to do so, in order to maximize the recovery for all creditors. *See e.g. BRS Associates, L.P. v. Dansker*, 246 B.R. 755, 772 (S.D.N.Y. 2000) (“Where the trustee has standing to sue, the automatic stay prevents creditors or shareholders from asserting the claim notwithstanding that outside of bankruptcy, they have the right to do so.”) (citations omitted).

Determination of trustee standing issues requires the parties and court to analyze defenses as well, since section 541(a)(1) was not intended to expand the rights of the debtor in the hands of the trustee:

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Though [section 541] will include choses in action and claims by the debtor against others, it is not intended to expand the debtor's rights against others more than they exist at the commencement of the case. For example, if the debtor has a claim that is barred at the time of the commencement of the case by the statute of limitations, then the trustee would not be able to pursue that claim, because he too would be barred. He could take no greater rights than the debtor himself had.

H.R. Rep. No. 595, 95th Cong., 1st Sess. (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 82-3 (1978).

Pursuant to the plain language of Section 541(a)(1) and the above-cited legislative history, bankruptcy courts have repeatedly concluded that a trustee in bankruptcy takes the debtor's rights subject to all defenses and other burdens to which such rights were subject immediately prior to the commencement of the bankruptcy case. *See e.g., Sender v. Simon*, 84 F.3d 1299, 1305 (10th Cir. 1996) (“When asserting claims under the authority of 11 U.S.C. § 541 . . . the trustee stands in the shoes of the debtor and can take no greater rights than the debtor himself had.”); *Hayes & Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 885 F.2d 1149, 1154 (3d Cir. 1989) (concluding that the trustee “is subject to the same defenses as could have been asserted by the debtor had the action been instituted by the debtor”). This is even true of equitable defenses, such as *in pari delicto*, discussed below.

B. Standing to Bring Avoidance Actions.

The Bankruptcy Code vests the trustee or debtor in possession as representative of the estate with authority to bring certain avoidance actions that otherwise belong to creditors and not the debtor, such as fraudulent transfer claims under Code § 548 and § 544(b). Actions brought pursuant to § 544(a), including the unique standing problems, are discussed below.

Section 548 provides after the fact protection to the debtor's creditors, by allowing the trustee or debtor-in-possession – standing in the shoes of the creditors – to undo a debtor's transaction in which property was transferred or an obligation was incurred by the debtor, which either (i) had as its purpose an intent to hinder, delay or defraud the debtor's creditor, or (ii) was made while the debtor was in a precarious financial condition, and the transaction did not provide the debtor with a reasonably equivalent value in exchange for the item transferred or the obligation incurred. 11 U.S.C. § 548. The statute of limitations for bringing a Section 548 action under pre-BAPCPA is one year. The statute of limitations under post-BAPCPA cases is two years.

Section 544(b) authorizes the avoidance of “any transfer of an interest of the debtor in property . . . that is voidable under applicable law by a creditor holding an unsecured claim.” That provision essentially acts as a “conduit to assert state law-based fraudulent conveyance actions in bankruptcy.” *Stalnaker v. DLC, Ltd.*, 295 B.R. 593, 601 (B.A.P. 8th Cir. 2003). The claim requires proof of an actual unsecured creditor who

at the time of the bankruptcy filing could have avoided the transfer in question under state law. *Id.* at 601-02. For that reason, the representative bringing the Section 544(b) claim “is subject to any defenses that could be asserted against the unsecured creditor.” *Id.* at 602; *see also Hayes v. Palm Seedlings Partners*, 916 F.2d 528, 534 (9th Cir. 1990) (holding that trustee “stands in the overshoes of the debtor corporation’s unsecured creditors”). A significant advantage of Section 544(b) is the use of the state-law statute of limitations, which is generally longer than the one or two year statute of limitations applicable to Section 548 actions.

C. Standing to Bring Creditor Actions

1. General vs. Particular Creditor Claims

A number of courts have allowed a bankruptcy trustee to pursue a creditor’s cause of action, and considered it property of the estate, if it is a “general claim” common to all creditors. *St. Paul Fire and Marine Insurance Co. v. PepsiCo, Inc.*, 884 F.2d 688, 701 (2nd Cir. 1989) (“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.”); *Kalb, Voorhis & Co. v. American Financial Corp.*, 8 F. 3d 130 (2d Cir. 1993) (same); *Koch Refining v. Farmers Union Century Exchange, Inc.*, 831 F.2d 1339, 1350 (7th Cir. 1987) (“allegations that could be asserted by any creditor could be brought by the trustee . . . a single creditor may not maintain an action on his own behalf against a corporation’s fiduciaries if that creditor shares in an injury common to all creditors and has personally been injured only in an indirect manner”).² *In re Colonial Realty Co.*, 168

² There is some question whether *Koch* remains good law, based on the Seventh Circuit’s decision in *Steinberg v. Buczynski*, 40 F.3d 890, 893 (7th Cir. 1994). In that case, a trustee was denied standing to sue on behalf of creditors because, as Judge Posner wrote:

When a third party has injured not the bankrupt corporation itself but a creditor of that corporation, the trustee in bankruptcy cannot bring suit against the third party. He has no interest in the suit. The claim in such a case is said to be “personal,” not “general.” [citing *Koch*] That is not an illuminating usage. The point is simply that the trustee is confined to enforcing entitlements of the corporation. He has no right to enforce entitlements of a creditor. He represents the unsecured creditors of the corporation; and in that sense when he is suing on behalf of the corporation he is really suing on behalf of the creditors of the corporation. But there is a difference between a creditor’s interest in the claims of the corporation against a third party, which are enforced by the trustee, and the creditor’s own direct – not derivative – claim against the third party, which only the creditor himself can enforce.

A number of courts have since interpreted *Steinberg* as “eviscerating” *Koch*. *See In re Shadduck*, 208 B.R. 1, 5 (Bankr. D. Mass. 1997); *In re Miller*, 197 B.R. 810, 813 n.4 (W.D.N.C. 1996). However, notwithstanding *Steinberg*, courts within the Seventh Circuit continue to treat *Koch* as good law. *See, e.g., In re Ben Franklin Retail Stores, Inc.*, 2000 U.S. Dist. LEXIS 276 (N.D. Ill., Jan. 12, 2000); *Telesphere Liquidating Trust v. Galesi*, 246 B.R. 315 (N.D. Ill. 2000); *Fisher v. Apostolou*, 155 F.3d 876, 879 (7th Cir. 1998) (reaffirming *Koch*).

B.R. 506, 511 (Bankr. D. Conn. 1994) (following *Koch*); *see also In re Buildings by Jamie, Inc.*, 230 B.R. 36, 44 (Bankr. D.N.J. 1998) (holding creditors lack standing because “recovery on the alter ego claim would benefit the bankruptcy estate as a whole, consequently, the alter ego claim is properly characterized as a general claim as to which the trustee alone has standing as a representative of the estate.”); *In re Porter McLeod, Inc.*, 231 B.R. 786, 792 (D. Colo. 1999) (trustee has creditor standing to sue attorney defendants for legal malpractice and aiding and abetting a breach of fiduciary duty pursuant to Section 544).

Under these cases, a claim is “general” “if the liability is to all creditors of the corporation without regard to the personal dealings between such officers and such creditors.” *Koch*, 831 F.2d at 1349. Conversely, “[a] cause of action is ‘personal’ if the claimant himself is harmed and no other claimant or creditor has an interest in the cause.” *Id.* at 1348-49. Thus, so long as the creditor’s claim is “general”, *i.e.* is an injury common to all creditors, it is the trustee who has standing to bring the action. *But see In re Ozark Restaurant Equip. Co.*, 816 F.2d 1222 (8th Cir. 1987) (section 544 does not give trustee authority to assert causes of action on behalf of creditors).

Although *Koch* and *St. Paul Fire* were alter ego cases, the general/personal claim analysis has been applied to creditor claims for breach of fiduciary duty as well. *See In re Ben Franklin Retail Stores, Inc.*, 1999 U.S. Dist. LEXIS 16645 (N.D. Ill. , Oct. 20, 1999) (trustee has standing to assert unsecured creditors’ claims v. former Ds and Os for breach of fiduciary duty); *Telesphere Liquidating Trust v. Galesi*, 246 B.R. 315 (N.D. Ill. 2000) (same); *The Mediators Inc. v. Manney*, 1996 U.S. Dist. LEXIS 14402 (S.D.N.Y., Sept. 25, 1996) (same); *In re Wieboldt Stores, Inc.*, 94 B.R. 488 (N.D. Ill. 1988) (same); *In re Western World Funding, Inc.*, 52 B.R. 743, 775 (Bankr. D. Nev. 1985) (same); *Solow v. Stone*, 994 F. Supp. 173 (S.D.N.Y. 1998) (throwing out individual creditor’s claim for breach of fiduciary duty because there was no particularized injury; only trustee could assert claim).

2. Section 544(a) – Are the Winds Blowing Southwest or Southeast?

An old standing debate has recently reentered the case law – a trustee’s standing to bring a cause of action as a “hypothetical creditor” under 11 U.S.C. § 544(a). Bankruptcy Code Section 544 is phrased in terms of “rights and powers”. The trustee is endowed with “the rights and powers of” (1) a judicial lien creditor that extended credit on the petition filing date, whether or not such a creditor actually exists, (2) a creditor that extended credit on the filing date and holds an unsatisfied right to execution on the debtor’s assets, whether or not such a creditor actually exists, and alternatively (3) a bona fide purchaser of the debtor’s real property who has perfected the property transfer on the filing date, whether or not such a creditor exists.³

³ The § 544(a) issue is much more than an academic debate. Assuming § 544(a) can be used to assert creditor claims, the trustee asserts those claims “without regard to any knowledge of the trustee or of any creditor.” This lack of “knowledge” impacts a number of other issues. For example, the statute of limitations may never start to run to the extent the “discovery rule”

Two courts came to very different conclusions last year as to the meaning of that phrase. An Arizona bankruptcy court held that Section 544(a) gives a trustee the right to bring affirmative causes of action belonging to this hypothetical creditor, including breach of fiduciary duty claims. *Collins v. Kohlberg & Co. (In re Southwest Supermarkets, LLC)*, 325 B.R. 417 (Bankr. D. Ariz. 2005); see Robert H. McKirgan and Scott K. Brown, *Strong-Arm On Steroids—Applying Or Injecting “Rights and Powers” Under 11 U.S.C. § 544(a)?*, Norton Advisor, September 2005. In the *Southwest* case, the trustee brought claims for breach of fiduciary duty and actual fraudulent transfer. The defendants moved for dismissal on the basis that the trustee’s claims were barred by the statute of limitations. The court disagreed for a number reasons, one of which was that Section 544(a)(2) gave the trustee authority to bring the actions in the shoes of a hypothetical creditor, and that as a hypothetical creditor the trustee was not charged with the actual or constructive knowledge of the debtor or any creditor. Thus, the trustee’s actions were not subject to the statute of limitations or to many of the other defenses raised in this type of case, such as *in pari delicto*.

The analysis in *Southwest* was rejected by a Colorado bankruptcy court later that year. *In re Greater Southeast Hospital Corp.*, 333 B.R. 506 (Bankr. D. Col. 2005). Noting the split in authority, the *Southeast Hospital* court said:

The key question is whether the phrase “rights and powers” encompasses the ability to file any claim that a creditor with a judicial lien or creditors' bill against the property of the estate might possess as opposed to only those rights that are attained by virtue of the hypothetical status of a judicial lien creditor or an execution creditor. A handful of courts have held that it does. See *Sender v. Porter (In re Porter McLeod, Inc.)*, 231 B.R. 786, 792-93 (D. Colo. 1999); *Raleigh v. Schottenstein (In re Wieboldt Stores, Inc.)*, 131 B.R. 655, 668 (N.D. Ill. 1991) *Collins v. Kohlberg & Co. (In re Southwest Supermarkets, LLC)*, 325 B.R. 417, 426-27 (Bankr. D. Ariz.2005); *Henderson v. Buchanan (In re Western World Funding, Inc.)*, 52 B.R. 743, 773-75 (Bankr. D. Nev. 1985). Other courts, including most circuit courts to have considered the issue, have reached the opposite conclusion. See, e.g., *Shearson Lehman Hutton, Inc. v. Wagoner*, 944 F.2d 114, 118 (2d Cir.1991); *E.F. Hutton & Co., Inc. v. Hadley*, 901 F.2d 979, 985-86 (11th Cir.1990); *Mixon v. Anderson (In re Ozark Rest. Equip. Co., Inc.)*, 816 F.2d 1222, 1226-30 (8th Cir.1987); *Sigmon v. Miller-Sharpe, Inc. (In re Miller)*, 197 B.R. 810, 812-15 (W.D.N.C.1996); *Rodolakis v. Shadduck (In re Shadduck)*, 208 B.R. 1, 2-5 (Bankr.D.Mass.1997). The basis for these latter decisions is usually continued deference to *Caplin*.

Id. at 518.

applies. Second, *in pari delicto* may not apply since the trustee has stepped into the shoes of the creditor and is “without knowledge.” Finally, the trustee may avoid the “insured v. insured” exclusion in typical D & O policies as he has stepped into the shoes of the uninsured creditor.

The *Southeast* court sided with the “circuit” courts, holding: “[T]he statute [Section 544(a)] vests the trustee with the ability of a judgment lien creditor to attach or seize both tangible and intangible property transferred by the debtor to a third party prior to filing for bankruptcy, but it does not transform the trustee into a ‘super creditor’ with the ability to raise causes of action separate from those possessed by the estate.”

Even more recent decisions have come out of the District of Colorado. In *Hill v. Gibson Dunn & Crutcher, LLP (In re ms55, Inc.)*, 338 B.R. 883 (Bankr. D. Colo. 2006) the bankruptcy court agreed with *Southeast*, did not discuss the *Southwest* case, and disagreed with the *Porter McLeod* case on the point about a trustee’s standing to bring an action under 11 U.S.C. § 544(a) as a “judgment creditor”. It said:

The Trustee makes no argument in support of his contention that he is proceeding under section 544(a) other than merely citing *In re Porter McLeod* and *Anstine v. Alexander*. To the extent these cases interpret Colorado law as allowing judgment creditors standing to sue on any cause of action belonging to the judgment debtor, this Court must disagree. Such a misinterpretation of Colorado creditors’ rights law would arm a bankruptcy trustee with subrogation powers that are unknown to decades of application of the bankruptcy fiduciary’s “strong-arm” powers under section 544(a) of the Bankruptcy Code or its predecessor in the Bankruptcy Act of 1898. The United States District Court’s expansive interpretation of judgment creditor’s rights under Colorado law in *Porter McLeod*, is, in fact, at odds with the Tenth Circuit in *Sender v. Simon*. Similarly, the Colorado Court of Appeals’ recent ruling in *Anstine v. Alexander* cannot be reconciled with the ruling of a different panel of that Court in *Sender v. Kidder Peabody*.

Id. at 897, n. 6 (full citations omitted).

The *ms55* decision was surprising, not only because it disagreed with the Colorado District Court decision in *McLeod*, but because it was at odds with a Tenth Circuit decision, *Zilkah Energy Co. v. Leighton*, 920 F.2d 1520 (10th Cir. 1990). There, the court held:

To understand the full import of § 544, one must first understand the power of a bankruptcy trustee to stand in the shoes of an hypothetical creditor of the debtor to effect a recovery from a third party. Simply stated, from the reservoir of equitable powers granted to the trustee to maximize the bankruptcy estate, Congress has fashioned a legal fiction. Not only is a trustee empowered to stand in the shoes of a debtor to set aside transfers to third parties, but the fiction permits the trustee also to assume the guise of a creditor with a judgment against the debtor. Under that guise, the trustee may invoke whatever remedies provided by state law to judgment lien creditors to satisfy judgments against the debtor. *See*

generally 4 *Collier on Bankruptcy* ¶ 544.01 (15th ed. 1990).

In Oklahoma, judgment lien creditors have a right to look to “any equitable interest” of a judgment debtor for satisfaction of the judgment. Okla.Stat. Ann. title 12, § 841 (1988). Thus, employing the power granted in 11 U.S.C. § 544(a)(1), an Oklahoma trustee in bankruptcy could file an appropriate action to enforce the creditor’s right granted by Okla.Stat. Ann. title 12, § 841 (1988). For that reason, the court incorrectly concluded § 544 was inapplicable to this case.

Id. at 1523.

Accordingly, the District Court of Colorado overruled *ms55* on appeal and brought it into accord with the *Zilkah*. *In re ms55, Inc.*, 2007 U.S. Dist. LEXIS 65791 (D. Co. 2007). The District Court agreed with the Second, Fifth, and Seventh Circuits and held that the language of §544(a) grants a trustee powers beyond that of mere avoidance. *Id.* at *34. The court held that “section 544(a) does not prohibit Trustee from bringing certain damages actions against third parties on behalf of creditors.” *Id.* at *44-45.

The District Court then relied on *Zilkah* to limit the powers of a trustee to those powers allowed by state law. *Id.* According to the district court, state law must recognize the cause of action for the trustee to have standing to sue. *Id.* at *44.

II. *Caplin* – The Seminal Trustee Standing Case

In *Caplin*, the United States Supreme Court held: “[A] reorganization trustee under Chapter X has no standing under the [old] Bankruptcy Act to assert, on behalf of the holders of the debtor’s debentures, claims of misconduct against a third party” *Caplin v. Marine Midland Grace Trust Co.*, 406 U.S. 416, 434 (1972).

The Court identified three factors militating against finding standing:

- First, nowhere in the statute did the Court find any provision enabling the trustee “to collect money not owed to the estate.” *Id.* at 428.
- Second, the Court noted that the debtor had no claim against the indenture trustee. At the most, then, the trustee’s claims described a situation where the debtor and the indenture trustee were *in pari delicto*. *Id.* at 429-30. Since it appeared that the indenture trustee would be entitled to be subrogated to the position of the debenture holders against the debtor, the Court saw no advantage to giving the trustee standing to sue. *Id.* at 430.
- The third problem troubling the Court was the possibility that the trustee’s suit on behalf of debenture holders could be “inconsistent with any independent actions that they might bring themselves.” *Id.* at 431-32. The Court

saw no reason to believe “that by giving petitioner standing to sue on behalf of the debenture holders we would reduce litigation.” *Id.* at 434. The Court accordingly affirmed the appellate court’s conclusion that the trustee lacked standing, noting that such a grant of standing was a decision “that only Congress can make.” *Id.* at 435.

Caplin was decided prior to the enactment of the Bankruptcy Code. When drafting the Bankruptcy Code, the House of Representatives Committee of the Judiciary included a subparagraph to section 544 that would have allowed the trustee to enforce a claim that any individual creditor or class of creditors had against a third party. *See* H.R.Rep. No. 95-595, 95th Cong. 1st Sess. 370-71 (1977). This was added in response to the Supreme Court’s comment in *Caplin* that Congress should decide the standing of a trustee in bankruptcy reorganizations to bring claims against an indenture trustee on behalf of debenture holders. In explaining this history, one circuit court observed:

As originally proposed by the House, Section 544 was to contain a subsection (c), which was intended to overrule *Caplin*. It is extremely noteworthy, however, that this provision was deleted before promulgation of the final version of Section 544. Because subsection (c), as a part of Section 544, would have applied to both reorganization and liquidation trustees, and because Congress refused to enact subsection (c), we believe Congress’ message is clear--no trustee, whether a reorganization trustee as in *Caplin* or a liquidation trustee as in the present case, has power under Section 544 of the Code to assert general causes of action, such as the alter ego claim, on behalf of the bankrupt estate’s creditors.

See In re Ozark Restaurant Equipment Co. Inc., 816 F.2d 1222 (8th Cir. 1987) (emphasis in original); *see also Williams v. California 1st Bank*, 859 F.2d 664 (9th Cir. 1988); *In re Adam Furniture Industries, Inc.*, 191 B.R. 249 (Bankr. S.D. Ga. 1996); *see also* Gerald K. Smith, “Avoiding Powers of Trustee,” in *Practicing Under the Bankruptcy Reform Act 113* (Hon. George Brody et al eds., CRR Publishing Co. 1977). Mr. Smith’s historical analysis does not indicate in any way that a trustee could assert affirmative actions on behalf of hypothetical creditors under Section 544(a).

III. Frequently Asserted Causes of Action

This section discusses various causes of action that often involve standing issues.

A. Alter Ego Claims Are Debtor Claims in Some States, and Creditor Claims in Others

Courts analyzing a trustee’s standing to bring alter ego claims generally focus on whether it is a cause of action held by the debtor entity under state law. When courts conclude it is a creditor claim, however, they generally find it is a cause of action general to all creditors. In those jurisdictions where common creditor claims may be asserted by the trustee, standing to pursue an alter ego cause of action has been allowed.

1. Alter Ego as a Debtor Cause of Action

In *In re Davey Roofing, Inc.*, 167 B.R. 604 (Bankr. C.D. Cal. 1994), the court held that under California law, the corporation may pierce its own corporate veil. Accordingly, the court found that the alter ego claim belonged to the debtor and was therefore property of the estate pursuant to Section 541.

Other courts have expressly rejected this cause of action. *See e.g. In re Elegant Homes, Inc.*, 2007 U.S. Dist. LEXIS 35564 (D. Ariz. 2007). The court in *Elegant Homes*, concluded that a Arizona corporation may not pierce's its own veil. *Id.* at *6. According to the court, only third parties who deal with the corporation can bring veil piercing actions. *Id.*

Thus, whether an alter ego claim is a cause of action of the estate depends on the applicable state law. If a corporation can pierce its own corporate veil under state law, then the claim is property of the estate per 11 U.S.C. § 541.

2. Alter Ego as a General Creditor Claim

Courts of appeal in many circuits have held that trustees have standing to bring alter ego claims alleging general injury to a corporation, so long as state law characterizes the injury as general to all creditors. Some of the older circuit court opinions are *Koch Refining v. Farmers Union Cent. Exch., Inc.*, 831 F.2d 1339 (7th Cir. 1987) (trustee had standing to assert alter ego claims under Illinois and Indiana law); *In re S.I. Acquisition*, 817 F.2d 1142, 1153 (5th Cir.1987); *Steyr-Daimler-Puch of America Corp. v. Pappas*, 852 F.2d 132, 136 (4th Cir.1988); and *St. Paul Fire & Marine Ins. Co. v. PepsiCo, Inc.*, 884 F.2d 688, 700-05 (2^d Cir.1989).

One of the more recent cases is from the Eleventh Circuit, *In re Icarus Holding, LLC*, 391 F.3d 1315, 1321 (11th Cir. 2004). There, the court said: "Like many courts that have addressed this issue, we hold that in order to bring an exclusive alter ego action under section 541, a bankruptcy trustee's claim should (1) be a general claim that is common to all creditors and (2) be allowed by state law." Citing *Koch*, the court held that it was a general claim common to all creditors, but was unable to determine whether it was allowed by state law. It certified the question for the George Supreme Court, which subsequently answered that the claim was allowed by state law. *Baillie Lumber Co. v. Thompson*, 279 Ga. 288, 612 S.E.2d 296 (2005).

Lower courts have followed this general approach, including some in the Ninth Circuit where they have had to distinguish the *Williams* case, discussed below.

However, other courts take the opposite view of *Koch* and its progeny. For those courts, "no trustee . . . has power under Section 544 of the Code to assert general causes of action, such as the alter ego claim, on behalf of the bankrupt estate's creditors." *In re Ozark Restaurant Equip. Co.*, 816 F.2d 1222, 1228 (8th Cir. 1987); *see also In re*

Shadduck, 208 B.R. 1, 5 (Bankr. D. Mass. 1997) (rejecting *Koch* and *St. Paul Fire* “because the trustee’s difficulty in these cases is lack statutory authority to bring any creditor claim, whether the claims is held by some or all creditors”); *In re Miller*, 197 B.R. 810, 814-15 (W.D.N.C. 1996) (same); *Sender v. Kidder Peabody & Co.*, 952 P.2d 779, 781 (Colo. Ct. App. 1997) (“A bankruptcy trustee cannot assert the claims of creditors or third parties but stands in the shoes of the debtor and may properly assert claims belonging to the debtor.”).

In *Ozark*, the court held that a Chapter 7 bankruptcy trustee did not have standing to bring an alter ego action against the principals of the debtor corporation. The court reached its conclusion by relying on *Caplin*. The *Ozark* court found the legislative history on this issue – which did not overrule *Caplin* -- compelling evidence that no trustee has power under Section 544 to act on behalf of the bankruptcy estate’s creditors. *Ozark*, 816 F.2d at 1227-28.⁴

3. Alter Ego as Particular Creditor Claim

In a subsequent opinion to *Koch*, the Seventh Circuit prevented a trustee from bringing an alter ego action because the claim was personal to the individual creditor and not general. See *Steinberg v. Buczynski*, 40 F.3d 890, 893 (7th Cir.1994). In *Steinberg*, the bankruptcy trustee brought an alter ego suit against the debtor corporation's primary shareholders in an attempt to obtain money not paid to an employee pension fund. See *id.* at 891. The court found no evidence that the shareholders directly harmed the corporation itself by taking unreasonably high salaries or “looting” the corporate assets. *Id.* at 892. Only the pension fund was harmed directly. See *id.* Thus, the court held that an alter ego claim by the corporation itself would be improper because the injury was to the pension fund and not the corporation and creditors in general.

The Third Circuit has followed *Steinberg*. See *Board of Trustees of Teamsters Local 863 Pension Fund v. Foodtown, Inc.*, 296 F.3d 164, 171 (3rd Cir. 2002). There, a pension fund sued the former corporate principals of an insolvent corporation to recover \$9.3 million in withdrawal liability that the corporation incurred when, after filing for bankruptcy, it ceased paying contributions to the fund. *Id.* at 167. The court found the plaintiff had standing to pursue the action because defendant's withdrawal liability was not part of the bankruptcy estate and resulted in an injury personal to the plaintiff. *Id.* at 170.

The Ninth Circuit has, in dicta, expressly agreed with *Ozark*. In *Williams v. California First Bank*, 859 F.2d 664 (9th Cir. 1988), a Chapter 7 trustee received assignments from some (but not all) creditors of their claims against a bank for violating state and federal securities laws by participating in the debtor’s Ponzi scheme. The

⁴ Many courts note that in *Caplin* the trustee brought claims on behalf of only certain creditors that would not be distributed throughout the estate. Thus, those courts view *Caplin* as holding “that a bankruptcy trustee may not bring a cause of action if the damages flowed to specific creditors rather than all creditors as a group.” *In re Colonial Realty Co.*, 168 B.R. 506, 511 (Bankr. D. Conn. 1994). Of course, that is entirely consistent with *Koch*.

trustee solicited these claims by promising to disburse proceeds from those claims only to those creditors who provided an assignment. Having received these assignments, the trustee then sued. The defendant moved to dismiss, arguing the trustee lacked standing. The Ninth Circuit, relying on *Caplin* agreed.

Specifically, the *Williams* court held first, that the money the trustee sought to collect was not money owed to the estate; second, the bankruptcy estate itself had no independent claim against the defendant for securities violations; and third, that there was a risk of inconsistent judgments between the trustee's suit on behalf of certain creditors and any independent actions brought by those creditors who did not assign their claims. Consequently, the court dismissed the trustee's claim on behalf of the creditors. However, in doing so, the court went on to state the following:

We agree with the Eighth Circuit that Congress' express decision not to overrule *Caplin* is "extremely noteworthy." [citing *Ozark*] We also share that court's certitude that "Congress' message is clear – no trustee, whether a reorganization trustee as in *Caplin* or a liquidation trustee, has power under the Code to assert general causes of action, such as an alter ego claim, on behalf of the bankrupt estate's creditors."

Id. (quoting *Ozark*, 816 F.2d at 1228) (emphasis in original; citations omitted). This dicta has caused considerable issues for courts within the Ninth Circuit.

For example, in *In re Davey Roofing, Inc.*, 167 B.R. 604 (Bankr. C.D. Cal. 1994), the debtor in possession sought to pierce its own corporate veil. Defendant argued that an alter ego claim belongs to the creditors and that, under *Williams*, debtor lacked standing. The court disagreed, holding that "Ninth Circuit law does not prevent a bankruptcy estate from asserting an alter ego claim where such a claim belongs to the corporation under state law." *Id.* at 606 (citing *Kalb, Voorhis & Co.*, 8 F.3d 130 (2d Cir. 1993), where the court held that *Williams* does not prevent a debtor from asserting alter ego claims). In distinguishing *Williams*, the court noted that "the trustee was not suing on behalf of the bankrupt estate, but rather on behalf on [sic] certain investors, and the trustee did not plan to distribute the proceeds to non-assigning investors, or to any other creditors of the estate. If the trustee had argued that the claims belonged to the bankruptcy estate, then the usual rules and priorities for distribution of property would have applied." *Id.* at 607.

Similarly, in *In re Towe*, 195 B.R. 137 (D. Mont. 1996), the defendants argued that under *Williams* a bankruptcy trustee in the Ninth Circuit has no standing to bring an alter ego action. Again the court disagreed, distinguishing *Williams* as a case in which the trustee "was pursuing claims that were personal to the investor/creditors in the suit." *Id.* at 140. Conversely, the trustee in *Towe* had standing because the alter ego claim he asserted was an asset of the bankruptcy estate. *Id.* at 141 ("Because the assets of an alter ego are essentially the assets of the bankruptcy estate, it is fair to allow the trustee to pursue those assets.") (citing *Pepper v. Litton*, 308 U.S. 295, 307-08 (1939) as evidence of the Bankruptcy Court's broad equitable powers).

In *Daily v. Title Guaranty Escrow Serv., Inc.*, 178 B.R. 837 (D. Haw. 1995), the court was again confronted with a challenge to a trustee's alter ego standing based on *Williams*. The trustee countered by citing the analysis of *Kalb, Davey Roofing* and *Towe*. The court, however, chose to rely on *Williams* and held the trustee lacked standing. "[T]his court is not inclined to dismiss the Ninth Circuit's analysis as dicta. . . . Absent a clear statement from the Ninth Circuit, it is imprudent for this court to simply ignore *Williams*." *Id.* at 843.

The issue of *Williams* was most recently addressed in the Ninth Circuit by *In re Folks*, 211 B.R. 378 (B.A.P. 9th Cir. 1997). There, again, the defendant argued the trustee lacked standing to bring an alter ego claim in light of *Williams*. The court, after examining *Davey Roofing, Towe, Williams, Ozark, Kalb* and *Koch*, found that *Williams* was "consistent with the principles enunciated in *Davey Roofing, . . . Towe* and *Koch*." *Id.* at 386. The court then adopted *Koch's* personal/general analysis for determining if a creditor's claim is property of the estate. Based on that analysis, the court concluded that the alter ego claim was a generalized claim of all the creditors, with no particularized harm to any one creditor, was therefore property of the estate, and thus conferred standing on the trustee.

4. Some Courts Hold That the Bankruptcy Code Prohibits a Trustee From Bringing an Alter Ego Claim.

Some opinions do not analyze whether a claim is general or particular to creditors. They simply hold that the Bankruptcy Code prohibits the trustee from bringing creditor claims. *See e.g., In re Green Valley Seeds, Inc.*, 27 B.R. 34 (Bankr. D. Or. 1982) ("The purpose of the alter ego doctrine is to allow recovery for the creditors of the corporation from other parties. The fact that third parties, the officers of the corporation, may have a liability to creditors does not mean that the corporation has a corresponding claim against third party officers. The trustee does not have the right to step into the shoes of an individual creditor and pursue that creditor's claim against an officer."); *In re Morgan Staley Lumber Co, Inc.*, 70 B.R. 186, 188 (Bankr. D. Or. 1986) ("The trustee lacks standing under federal law to bring a collective action against the corporate officers and shareholders to redress individual wrongs based on piercing the corporate veil doctrines or otherwise.").

B. Racketeer Influenced and Corrupt Organizations – RICO

Under RICO, "[i]t shall be unlawful for *any person* employed by or associated with *any enterprise* . . . to conduct or participate . . . in the conduct of such enterprise's affairs through a pattern of racketeering activity or collection of unlawful debt." 18 U.S.C. § 1962(c) (emphasis added). Only persons who have been injured "by reason of" the commission of predicate acts have standing to bring suit under section 1964(c). *Sedima, S.P.R.L. v. Imrex Co., Inc.*, 473 U.S. 479, 496, 105 S.Ct. 3275, 3285, 87 L.E.2d 346 (1985). Interpreting the "by reason of" language, the Supreme Court in *Sedima* noted that "the compensable injury necessarily is the harm *caused by* predicate acts

sufficiently related to constitute a pattern” and that “recoverable damages . . . will *flow from* the commission of predicate acts.” 105 S.Ct. at 3285 (emphasis added).

Depending on the nature of the predicate acts, and whether those underlying causes of action support standing in the jurisdiction where the suit is brought, the bankruptcy trustee may be allowed to assert RICO claims. The cases analyzing a trustee’s standing to bring a RICO case can be divided up into the following categories:

1. Some Courts Hold a Trustee Has RICO Standing Under General Principles of Bankruptcy Law

Several circuit courts have held that a trustee does have standing to pursue RICO claims on behalf of the estate. These cases generally do not cite Section 541 of the Bankruptcy Code, although their logic seems to indicate that it is the section they rely upon. *See Wade v. Hopper*, 993 F.2d 1246 (7th Cir. 1993) (“Since Wade Trucking is in bankruptcy, RICO actions, among other actions, are properly brought by the trustee, not by shareholders or the debtor corporation itself.”); *Whale v. Carter*, 954 F.2d 1087, 1092-93 (5th Cir. 1992) (“This Court ruled in *Ocean Energy II [Inc. v. Alexander, Inc.]*, 868 F.2d 740, 744 (5th Cir. 1989) that ‘only the trustee in bankruptcy has standing to bring a RICO claim for monies owed to the bankruptcy estate.’ 868 F.2d at 746. Because the plaintiffs’ claim essentially seeks damages for the fraudulent transfer of assets that belong in the bankruptcy estate of CMH, the district court did not err in finding that the plaintiffs lacked standing to assert RICO claims in their capacities as creditors.”); *Estate of Spirtos v. One San Bernardino County Superior Court Case Numbered SPR 02211*, 2006 U.S. App. LEXIS 8968, *5-7 (9th Cir. 2006) (“plaintiff lacks standing to raise RICO claims on behalf of [the] bankruptcy estate because only the bankruptcy trustee has standing to sue on behalf of the estate” *Id.* at *12); *see also Schacht v. Brown*, 711 F.2d 1343, 1348 (7th Cir. 1983) (where debtor corporation was fraudulently continued in business past the point of insolvency, liquidator had standing to bring RICO claim).

In *Barnett v. Stern*, 93 B.R. 962 (N.D. Ill. 1988), *rev’d in part*, 909 F.2d 973 (7th Cir. 1990), court held that since the debtor was involved in the fraud, a RICO claim was not property of estate under Section 541. It also held that the trustee could not bring the RICO claim under Section 544. But for policy reasons, the court found trustee had standing. Its reasoning was that it wanted to avoid a “race to judgment” by creditors. It relied on alter ego cases as creating an “exception” to *Caplin*.

2. Some Courts Find Trustee Standing Under Section 544

One reported opinion held that a bankruptcy trustee has RICO standing under Section 544. *Lombard v. Maglia*, 621 F. Supp. 1529 (S.D.N.Y. 1985). In *Lombard*, a Chapter 7 trustee of a corporation in bankruptcy joined with the trustee of one of the corporation’s creditors in bringing a RICO action against the company’s principal officers and director. The RICO claim was based upon pre-petition fraudulent conveyances. The *Lombard* court held that the trustee for the debtor corporation had standing to sue third parties for RICO. The defendants raised the argument that the

debtor corporation was involved in the wrongdoing. The court, without much analysis, simply stated “it matters not whether Carla [the debtor corporation] could have maintained a similar claim outside of bankruptcy.” *Id.* at 1541.

Apparently, the court concluded that it was irrelevant that the RICO claim was not property of the estate under Section 541. Rather, the court found RICO standing within Section 544:

Section 544, the “strong arm” provision, provides ample statutory authority for a Chapter 7 trustee’s assertion of creditor’s claims against third parties.

Id. at 1542.

3. Other Courts Hold a Trustee Does Not have Standing or Is Barred by *In Pari Delicto*

Many decisions, including some very recent ones, have held that a trustee does not have standing to pursue a RICO claim or is barred by the *in pari delicto* defense from doing so. See *Official Committee of Unsecured Creditors of PSA, Inc. v. Edwards*, 437 F.3d 1145, 1156 (11th Cir. 2006) (“Because a complaint brought by ETS, outside of bankruptcy, against other members of its RICO conspiracy would have been barred by the doctrine of *in pari delicto*, Laddin is likewise barred from recovery within bankruptcy. Laddin’s complaint is barred because ETS was an active participant in the Ponzi scheme and the application of the defense of *in pari delicto* furthers the policy of the federal RICO statute. The district court did not err when it dismissed Laddin’s claim for treble damages under the federal RICO statute, because his recovery was barred based on the face of his complaint.”).

In *Hirsch v. Arthur Andersen & Co.*, 72 F.3d 1085 (2d Cir.1995), the district court dismissed a bankruptcy trustee’s RICO claim, predicated on mail fraud, against the debtor’s former attorneys and accountants for lack of standing. The district court reasoned that the claims belonged to individual creditors, not the estate. The Second Circuit affirmed, holding that: (1) to the extent the RICO claims were premised upon distributing misleading information to investor creditors, the claims could only be asserted by such investors; and (2) to the extent the RICO claims were premised upon the theory that the bankrupt suffered injuries, the claims could not be asserted by the trustee because “a corporation may not assert RICO claims against its agents for committing illegal actions ‘ostensibly on the corporation’s behalf’ that ultimately redound to its disadvantage.” *Id.* at 1094 (citing *In re American Express Co. Shareholder Litigation*, 39 F.3d 395, 400 (2d Cir.1994)); see also *Lippe v. Bairnco Corp.*, 218 B.R. 294 (S.D.N.Y. 1998) (following *Hirsh*).

In *Kremen v. Black*, 55 B.R. 1018 (D. Md. 1985), the court held that a bankruptcy trustee could not bring a RICO claim against third parties for prepetition fraudulent conveyances. The court’s rationale was contained in the following language:

[A] general creditor without a lien has no legal right or interest in a debtor's property prior to obtaining a judgment of fraudulent conveyance . . . a trustee has no greater interest than an unsecured creditor in property conveyed prior to the debtor's voluntary filing of the bankruptcy petition.

Id. at 1021. Apparently, the court reasoned that because the trustee had no interest in the property fraudulently transferred prior to bankruptcy, there was no injury to the trustee, the estate or the unsecured creditors.

In *Feltman v. Prudential-Bache Securities*, 122 B.R. 466 (S.D. Fla. 1990), a Chapter 11 trustee for a sham corporation and the creditors committee brought a RICO Claim against third parties. The *Feltman* court first addressed whether the trustee could represent a specific class of creditors. Relying on *Caplin*, the court held that the trustee did not have standing to bring claims on behalf of specific creditors. *Id.* at 471.

The *Feltman* court then addressed whether the trustee could assert claims on behalf of all creditors generally. The court analyzed the alter ego cases and recognized that some circuits have distinguished *Caplin* on this basis. The *Feltman* court held that the trustee did not have standing, however, because the trustee had not shown that any creditor would have a RICO claim outside of bankruptcy. Rather, the only thing the trustee had shown was that the creditors in general had been injured derivatively through the broker's stealing of funds from the sham corporation. The court held that this derivative injury to the creditors was not enough to give the trustee standing. *Id.* at 473. The court did not address or refer to Section 544.

Finally, a Texas bankruptcy court likewise held that there was no authority in the Bankruptcy Code for a trustee to bring a RICO suit. *In re Hunt*, 149 B.R. 96 (Bankr. N.D. Tex. 1992). The court based its holding on *Ozark*:

The Independent Trustees' First Amended Complaint and RICO Case Statement specifically allege that the debtors participated in the acts giving rise to the RICO claims. Since they were conspirators in the purported fraud prohibited by RICO, the debtors, on the date of their bankruptcy filings, would have been unable to sue the present RICO defendants (their co-conspirators) for the fraud in question. *Lopez v. Dean Witter Reynolds, Inc.*, 591 F.Supp. 581, 588 n. 4 (N.D.Cal.1984) ("To allow one racketeer to sue another under RICO does not further the statute's objective of eradicating organized crime.").

Id. at 102 (citations omitted).

The *Hunt* court clarified that its analysis did not preclude a "trustee's maintenance of a RICO action against third parties on behalf of an estate where the debtor, prior to filing his bankruptcy petition, could have maintained the same action – where, for example, the debtor did not participate in the fraudulent acts." *Id.* (citations omitted).

C. Breach of Fiduciary Duty

Breach of fiduciary duty claims are generally brought against the debtor's former officers and directors. The officers and directors owe fiduciary duties to the company, and to its shareholders, under state law, thus endowing the debtor's trustee with standing as a matter of Bankruptcy Code Section 541. But these breach of fiduciary duty claims may be difficult to sustain because of *in pari delicto* defenses, and may be difficult to collect because insurance coverage may be barred due to "insured v. insured" coverage exclusions in D&O insurance policies. Some courts have recognized that once a company is in the "zone of insolvency" its directors and officers owe fiduciary duties to the company's creditors as well. This may justify trustee standing under Section 544, while avoiding some problematic defenses.

1. Breach of Fiduciary Duty Is an Estate Claim Under Section 541

Several cases have held that a breach of fiduciary duty claim belongs to the estate under Section 541 and is properly asserted by the trustee. *In re R & R Associates of Hampton*, 402 F.3d 257, 264 (1st Cir. 2005) (Claims for alleged legal malpractice and breach of fiduciary duty against attorneys and law firm that represented Chapter 11 debtor-in-possession (DIP) belonged to bankruptcy estate."). On the specific issue of standing, one court explained: "Count I alleges a breach of the fiduciary duty that arose from Pepper and Gagné's attorney-client relationship with SFC. Thus, this is a cause of action that SFC could have brought on its own behalf. Moreover, the Trustee alleges that the conflicts of interest constituting the breach began well before the commencement of the bankruptcy case. Therefore, the Court concludes that the Trustee has standing to bring Count I under 11 U.S.C. § 541(a)(1)." *In re Student Finance Corp.*, 335 B.R. 539, 547 (D. Del. 2005).

Although not specifically referencing Section 541, one bankruptcy court recently held that a trustee does have standing to bring a breach of fiduciary duty claim. It reasoned: "True, a trustee 'does not have standing to pursue the individual claims of creditors or even of creditors as a class' *Id.* Nevertheless, the trustee may 'pursue[] the interests of the bankruptcy estate and derivatively the interests of its creditors' *Id.* In this case, the plaintiff is not seeking recovery on behalf of an individual or even a class of creditors; rather, the plaintiff seeks recovery for the bankrupt corporation itself." *In re Scott Acquisition Corp.*, 344 B.R. 283, 291 (Bankr. D. Del. 2006).

As with any claim asserted by the trustee on behalf of the debtor, there is the possibility that the *in pari delicto* defense will apply, however. See e.g., *In re Verestar, Inc.*, 343 B.R. 444 (Bankr. S.D.N.Y. 2006). The *Verestar* court held: "Since the District Court Complaint itself alleges the facts that give rise to an *in pari delicto* defense, *Leveto v. Lapina*, 258 F.3d 156, 161 (3d Cir.2001) (a claim is subject to dismissal when an affirmative defense appears on the face of the complaint), the Committee's aiding and

abetting and conspiracy claims against the Bear Stearns Defendants must be dismissed under the *Wagoner* doctrine and *in pari delicto*.” *Id.* at 480.

2. Breach of Fiduciary Duty Is a Creditor Claim and Can Only Be Brought By a Trustee if Harm Is General to Creditors

Courts have held that when a debtor enters the “zone of insolvency,” the fiduciary duty of the debtor’s officers and directors shifts from the debtor’s shareholders to its creditors, or at least extends to them. *See e.g., In re Total Containment*, 335 B.R. 589 (Bankr. E.D. Pa. 2005). Assuming the duty shifts, courts must analyze who has standing to assert the breach of fiduciary duty claim. *See e.g., Production Resources Group*, 863 A2d 772, 792 (Del. Ch. 2004) (breach of fiduciary duty is always a derivative claim and when the company is insolvent, creditors have authority to assert the derivative claim); *In re Star Communications*, 2004 WL 2980736 (D. Del.). If it is considered a “creditor” claim, whether by reason of the zone of insolvency or otherwise, the trustee’s standing turns on the same factors described above for alter ego and RICO claims. *See e.g., In re Student Finance Corp.*, 334 B.R. 776 (D. Del. 2005) (“Under 11 U.S.C. § 541, the trustee of a bankrupt debtor may bring any cause of action that the debtor could have brought under state law as of the commencement of the case. Here, the Trustee does not contend that the causes of action in Counts I-V belonged to SFC as of the commencement of the bankruptcy case. Rather, he states explicitly that he is bringing his claims ‘on behalf of... SFC’s creditors.’ Therefore, the Court concludes that the Trustee does not have standing, under § 541 to pursue Counts I-V.”) (citations omitted).

The standing issue is obviously impacted by whether the fiduciary duty shifts to the creditors when the corporation is insolvent or “in the zone of insolvency.” Several courts have recognized this “shifting” of the fiduciary duty. Recent Delaware cases, however, hold that the duty is always owed to the corporation and does not shift to creditors even when the corporation is insolvent. *See North American Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 94 (Del. 2007) (the creditors of a Delaware corporation that is either insolvent or in the zone of insolvency have no right, as a matter of law, to assert direct claims for breach of fiduciary duty against the corporation's directors). Nevertheless, these cases suggest that the creditors of an insolvent corporation may have standing to bring *derivative* claims for breach of fiduciary duty. Of course, in a bankruptcy context, such derivative claims (i.e., claims of the corporation) should vest in the estate per 11. U.S.C. § 541.

3. Section 544 May Give a Trustee Standing to Assert Breach of Fiduciary Duty Even if the Duty Shifted to Creditors.

To the extent breach of fiduciary duty claims are considered claims of creditors, some courts have indicated that a trustee still has standing to assert the claim under 11 U.S.C. § 544. *See e.g., Southwest Supermarkets*, 325 B.R. at 426; *Porter McLeod*, 231 B.R. at 791-92. Not all courts agree. *See In re Student Finance Corp.*, 334 B.R. at 778 (“On the other hand, the Court can find no support for the Trustee's contention that § 544 provides him with standing to pursue the tort claims on behalf of SFC’s creditors.

None of the cases cited by the Trustee supports that contention. In the majority of the cases relied upon by the Trustee, the “general claim” being asserted was either a claim belonging to the bankruptcy estate at the commencement of the case, or an avoidance claim. In none of the cited cases did a court conclude that § 544 empowers a bankruptcy trustee to pursue a tort claim that was not the property of the bankruptcy estate as of the commencement of the case.”).

D. Deepening Insolvency

The theory of deepening insolvency is occupying the time of many scholars and judges. One of the important questions is whether it is separate cause of action or a measure of damages or neither. *See e.g., Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340, 349-52 (3d Cir.2001) (cause of action under Pennsylvania law); *Official Comm. of Unsecured Creditors v. Credit Suisse First Boston (In re Exide Techs., Inc.)*, 299 B.R. 732, 750-52 (Bankr.D.Del.2003) (cause of action under Delaware law); *In re Fleming Packaging*, 2005 WL 2205703 (Bankr. C.D. Ill. 2005) (measure of damages); Sabin Willett, *The Shallows of Deepening Insolvency*, 60 BUS. LAW. 549 (Feb. 2005) (deepening insolvency is neither a cause of action nor an independent measure of damages); *Trenwick America Litigation Trust v. Ernst & Young LLP, et al.*, C.A. No. 157-1 (Delaware Court of Chancery first addressed a cause of action for deepening insolvency and held that “put simply, under Delaware law, ‘deepening insolvency’ is no more a cause of action when a firm is insolvent than a cause of action for ‘shallowing profitability’ would be when a firm is solvent.”); *see also Coroles v. Sabey*, 79 P.3d 974, 983 (Utah Ct.App.2003) (rejecting “deepening insolvency” as a theory of damages because shareholders rather than the corporation suffer harm).

To the extent deepening insolvency is considered a separate cause of action, courts must analyze whether the claim belongs to the debtor or to creditors. The question is whether there is a distinction between injury to the debtor and injury to creditors; in other words is there a “cognizable injury” to the debtor separate and apart from injury to the creditors and investors? *See e.g., Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340, 349-52 (3d Cir.2001) (“In the instant case, the Committee sought recovery of damage to the Debtors’ property from ‘deepening insolvency.’ We see no indication that the Committee is attempting to recover for injuries to the creditors. Therefore, accepting the allegations as true and drawing all reasonable inferences in favor of the Committee, we conclude that the claims here belong to the Debtors, rather than to the creditors.”); *Florida Dept. of Ins.*, 274 F.3d 924, 935 (5th Cir. 2001) (policy holders suffered injury, not the debtor); *In re Flagship Healthcare*, 269 B.R. 721 (Bankr. S.D. Fla. 2001) (allegations in Chapter 7 trustee’s complaint, that as result of negligence of financial advisor in valuing service oriented companies acquired by debtor and of debtor’s reliance on erroneous valuation, debtor had continued with its acquisition strategy and further weakened its financial position, were sufficient, upon “deepening insolvency” theory, to state claim for damage to debtor as distinct from debtor’s creditors, even if debtor was already insolvent when valuation was prepared; accordingly, trustee had standing to pursue this cause of action).

To the extent deepening insolvency is considered a measure of damages, the cause of action is generally analyzed as a breach of fiduciary duty claim. *See e.g., In re Fleming Packaging*, 2005 WL 2205703 (Bankr. C.D. Ill. 2005) (measure of damages) (“Where the target defendant is a director who is alleged to have breached one or more fiduciary duties, a court should determine, based on the allegations of the complaint, whether a cause of action labeled “deepening insolvency” is no different than an ordinary one for breach of fiduciary duty.”).

The Third Circuit has weighed in on this issue and has specifically held that a trustee may not bring a deepening insolvency cause of action under §544. *In re CitX Corp.*, 448 F.3d 672, 676 n.6 (3d Cir. 2006). The court stated:

Because deepening-insolvency claims are brought on behalf of the debtor corporation...deepening insolvency can only be a claim under Bankruptcy Code § 541 (which deals with property of the debtor's estate). Section 544 implicates instead the trustee's powers to avoid, by stepping into the shoes of certain creditors and purchasers, prepetition transfers of property by the debtor. Therefore,...§ 544 does not authorize a deepening-insolvency tort claim.

Id. (internal citations omitted); *Stanziale v. Pepper Hamilton LLP (In re Student Fin. Corp.)*, 335 B.R. 539, 548-49 (D. Del. 2005) (deepening insolvency is not a §544 claim). The Third Circuit went on to hold that deepening insolvency cannot be sustained by a claim of negligence and deepening insolvency cannot be used as a theory of damages under a negligence cause of action. *CitX*, 448 F.3d at 677-78.

Other courts have questioned the validity of deepening insolvency as a cause of action. The Seventh Circuit found difficulty in finding a duty to “prompt liquidation that would punish corporate management for trying in exercise of its business judgment to stave off a declaration of bankruptcy.” *Fehribach v. Ernst & Young, LLP*, 493 F.3d 905, 909 (7th Cir. 2007). Another court refused to use deepening insolvency as a theory of damages because borrowing money without more does not harm a company. *In re Parmalat*, 501 F. Supp. 2d 560, 574 (D.N.Y. 2007).

IV. Creating Standing

A. Assignment of Creditor Claims

Relying on *Caplin*, the Ninth Circuit in *Williams v. California 1st Bank*, said that “we do not think the mere fact of assignment in order to allow the Trustee to pursue the claims for the creditors sufficiently distinguishes this case to allow of a different result. Evaluating the Trustee’s claim in light of the three concerns that informed the Court’s holding in *Caplin* reveals that substantially the same problems exist.” *Id.* at 666. The Ninth Circuit gave three reasons for its conclusion. First, the investors “plainly remain the real parties in interest in these actions. . . . [T]he Trustee, as in *Caplin*, is attempting to ‘collect money not owed to the estate.’” *Id.* at 666-67. Second, the “bankruptcy

corporation . . . has no claim of its own that it could press against the defendant.” And, third, some of the investors did not assign their claims and, thus, there still remained “the potential for inconsistent actions by those who did not assign.” *Id.* at 667. Thus, “[a]ssignment of creditors’ claims for the purpose of collection for the benefit of creditors does not distinguish this case from *Caplin*. The Trustee lacked authority to bring suit on the claims. The case should have been dismissed.” *Id.*

Some parties have attempted to circumvent *Williams* by having “all” creditors who have standing to sue assign “all” of their claims to the trustee. Although this strategy ignores the first two concerns expressed by the Ninth Circuit in *Williams*, some courts have allowed trustees to pursue those types of assigned claims. In *Bogdan*, for example, mortgage lenders unconditionally assigned their claims to a trustee. *In re Bogdan*, 414 F.3d 507 (4th Cir. 2005). The defendants moved to dismiss, but the Fourth Circuit affirmed the denial of the motion for the following reasons:

[T]he unconditional assignments acquired by Bogdan’s trustee from the mortgage lenders after commencement of this bankruptcy case constitute “property of the estate” that the trustee is authorized to “collect and reduce to money” on behalf of the estate. *See Steinberg v. Kendig (In re Ben Franklin Retail Stores, Inc.)*, 225 B.R. 646, 650 (Bankr.N.D.Ill.1998) (ruling that the creditors’ assignments turned the “causes of action into property of the estates and the Trustee has a duty to marshal those assets for the benefit of the estates”), *aff’d in part and rev’d in part on other grounds*, 2000 WL 28266 (N.D.Ill. Jan.12, 2000) (unpublished). Accordingly, the trustee has the requisite standing to sue Bogdan’s alleged coconspirators “to collect and reduce to money” the causes of action he acquired for the estate from the mortgage lenders after commencement of this bankruptcy case.

Id. at 512.

The Fourth Circuit did not think its decision conflicted with *Williams*. It said that unlike the investors in *Williams*, the mortgage lenders in *Bogdan* “recover, if at all, by sharing from the general assets of the estate on a pro rata basis with all other creditors.” *Id.* at 513. Therefore, “unlike the trustee in *Williams*, Bogdan’s trustee is seeking to collect money it claims the alleged coconspirators owe the trustee as assignee and representative of the estate, not money owed to specific creditors. Accordingly, Bogdan’s estate is the real party in interest in this adversary proceeding.” *Id.* The Court further held that the doctrine of *in pari delicto* had no application because “the trustee is suing on behalf of the estate as assignee of the mortgage lenders. As assignee, the trustee stands in the shoes of the mortgage lenders, thereby assuming all rights and interests that the mortgage lenders have in the causes of action and becoming subject to all defenses that could have been asserted against the mortgage lenders, not Bogdan.” *Id.* 514.

Although it did not discuss the issue in any depth, the *Southwest Supermarkets* case reached the same conclusion about a similar unconditional assignment. 325 B.R. at

424 (“But the Court also concluded that the Trustee can assert claims that were assigned to him by the secured creditors, notwithstanding *Williams*, because the claims were assigned for the benefit of the estate with no special strings attached for the benefit of the assigning creditors. That assignment consisted not only of the debtor and creditor claims the Trustee previously held and had assigned to the secured creditors, but also the claims that the secured creditors had previously held in their own right. Such claims may include breach of fiduciary duty claims.”) (citing previous opinion in *Collins v. Kohlberg and Company (In re Southwest Supermarkets, L.L.C.)*, 315 B.R. 565, 569-71 (Bankr. D. Ariz. 2004) (distinguishing *Williams*).

B. Joining a Creditor as Co-Plaintiff

Another way to create standing is to join as co-plaintiffs those parties who do have standing to bring the claim or claims. However, at least one court has rejected this on the basis that if a trustee does not have standing, it does not have standing -- no matter how many co-plaintiffs it joins that do have standing. *In re R.H.N. Realty Corp.*, 84 B.R. 356, 360 (Bankr. S.D.N.Y. 1988) (“[T]here is not, nor will there be, any indemnification claim by the trustee against the nondebtor defendants. The trustee is simply attempting to collect the deficiency claim against these defendants for the benefit of Rednel [the co-plaintiff].”).

Another court dismissed a complaint because the co-plaintiff, the unsecured creditors committee, lacked standing to bring the claim as well. *See In re Haynie Grain Service, Inc.*, 126 B.R. 208, 212 (Bankr. D. Md. 1991) (“The trustee in bankruptcy lacks standing to bring the instant complaint on behalf of creditors against third parties to recover funds which are not property of the bankruptcy estate. The joinder of the creditors’ committee as co-plaintiff does not alter the result in this case because the committee also lacks standing to sue on behalf of creditors against third parties to recover funds which are not property of the bankruptcy estate.”).

V. In Pari Delicto

The well-used phrase *in pari delicto* is derived from the Latin *in pari delicto potior est conditione defendentis*: “In a case of equal or mutual fault... the position of the [defending] party is the better one.” *Official Comm. Of Unsecured Creditors v. Edwards*, 437 F.3d 1145 (11th Cir. 2006). As stated above, if the trustee is pursuing claims of the debtor pursuant to Section 541, the trustee stands in the shoes of the debtor and is subject to all defenses that could be raised against debtor outside bankruptcy, including *in pari delicto*. *Id.* at 1150 (“If a claim of ETS [the debtor] would have been subject to the defense of *in pari delicto* at the commencement of the bankruptcy, then the same claim, when asserted by the trustee, is subject to the same affirmative defense.”).

A. Standing or Affirmative Defense?

The doctrine of *in pari delicto* has been analyzed by some courts as a matter of standing, unlike other common defenses. *See Baena v. KPMG LLP*, 389 F. Supp. 2d 112,

117-118 (D. Mass. 2005), *aff'd.*, 453 F.3d 1 (1st Cir. 2006) (“[T]he Second Circuit and courts in the First Circuit have viewed [*in pari delicto*] as a standing issue.”) (citing *Breeden v. Kirkpatrick & Lockhart LLP (In re The Bennett Funding Group, Inc.)*, 336 F.3d 94, 99-100, 102 (2d Cir.2003) (finding that if the *in pari delicto* doctrine applies to the corporation, then the Trustee does not have standing to sue); *Nisselson v. Lernout*, No. 03-10843-PBS, slip op. at 7 (D.Mass. Aug. 9, 2004) (holding that the litigation trustee for the new company emerging from the bankruptcy proceeding of L & H had no standing to sue for damages which were sustained by shareholders and was barred by the doctrine of *in pari delicto*); *see also Erricola v. Gaudette (In re Gaudette)*, 241 B.R. 491, 500 (Bankr.D.N.H.1999) (finding that the Trustee lacked standing to sue numerous defendants on grounds that the debtor corporation was a co-conspirator in the fraud); *Goldin v. Primavera Familienstiftung, TAG Assocs., Ltd. (In re Granite Partners)*, 194 B.R. 318, 328 (Bkrcty.S.D.N.Y.1996) (“If *in pari delicto* applies, the trustee cannot sue the third parties for injury that the corporation suffered in connection with the fraudulent scheme.”).

Others recognize it as simply an affirmative defense. *See e.g. Baena v. KPMG LLP*, 453 F.3d 1, 6 (1st Cir. 2006) (“The doctrine is sometimes described (dubiously) as one of standing, *e.g.*, *Shearson Lehman Hutton, Inc. v. Wagoner*, 944 F.2d 114, 120 (2d Cir. 1991), but this usage has nothing to do with Article III requirements. Chemerinsky, *supra* § 2.3.1, at 60. In substance, the doctrine offers a policy-based defense reflecting an obvious but visceral judgment, one echoed in other, somewhat different legal doctrines, *e.g.*, the “unclean hands” defense in equity, *Dobbs, supra* § 2.4(2), at 68-72, and contributory negligence in tort actions, *Prosser & Keeton on Torts* § 65, at 451-62 (5th ed. 1984).”); *see also Lafferty*, 267 F.3d at 346 (“An analysis of standing does not include an analysis of equitable defenses, such as *in pari delicto*.”); *In re Total Containment*, 335 B.R. at 621.

Under 11 U.S.C. § 541, causes of action enter the estate subject to affirmative defenses that would exist outside of bankruptcy. Accordingly, *in pari delicto* applies as an affirmative defense even if the estate is asserting the cause of action to benefit innocent creditors and the wrongdoers will not benefit from any recovery. *Claybrook v. Broad and Cassell, P.A., et al., (In Re Scott Acquisition Corp.)*, 47 B.C.D. 280 (Bankr. Del. 2007).

B. Exceptions to *In Pari Delicto*

1. Section 544(a) Actions

In those jurisdictions where a trustee has standing to bring hypothetical creditor actions under Section 544(a), *in pari delicto* may not be a viable standing argument or defense. *See Southwest Supermarkets*, 325 B.R. at 426 (“[§ 544(a)] may resolve trustees’ *in pari delicto* problem, at least where state law would free a receiver from that defense.”); *Porter McLeod* 231 B.R. at 794 (“In bankruptcy, the doctrine applies only to the trustee in his ‘debtor’ status, not as ‘creditor.’”); *Western World*, 52 B.R. 743, 775 (Bankr. D. Nev. 1985)(“[T]he trustee seeks recovery for injury to the *corporations*, which

injuries creditors only ‘derivatively.’ In pursuing these claims, the trustee does not establish that the corporations are *in pari delicto* in causing their own harm. Therefore, there is no more conflict of interest in the trustee bringing these actions in his creditor capacity as there is in his avoiding preferential and fraudulent transfers. Since all these actions are for the benefit of creditors in general, and may be availed by ‘any’ creditor without regard to his personal dealings with the defendants, the trustee’s action is an appropriate application of his status as a ‘supposed or hypothetical’ creditor under § 544(a).”).

2. Public Policy And Adverse Domination

In pari delicto is generally not a defense that is available to fiduciaries such as directors and officers. This issue was front and center in the *In re HealthSouth Corp.* case, which held:

Scrushy cannot wield the doctrine of *in pari delicto* to escape liability. It is because corporations must act through living fiduciaries such as Scrushy that the application of the *in pari delicto* doctrine has been rejected in situations when corporate fiduciaries seek to avoid responsibility for their own conduct vis-à-vis their corporations. Stated simply, HealthSouth is not at “equal fault” with Scrushy for the material deficiencies in HealthSouth’s financial statements because it was Scrushy who was the ultimate manager responsible for ensuring the integrity of those statements. The reality that HealthSouth itself might be liable to third-parties due to the failure of its managers (under Scrushy’s supervision) to prepare materially accurate financial statements does not mean that HealthSouth has no right to seek recompense from those managers for the harm they caused it. To hold otherwise would be to leave the constituencies of corporate entities – including public stockholders and creditors – with no recourse when their corporation is injured by its managers. Like its equitable counterpart the unclean hands doctrine, the *in pari delicto* defense will not be applied when its acceptance would contravene an important public policy.

845 A.2d 1096, 1107-08 (Del. Ch. 2003) (citing *In re Walnut Leasing Co.*, 1999 WL 729267, at *5 (E.D.Pa. Sept. 8, 1999) (“Vis-à-vis their corporations, insiders cannot avoid the consequences of their own handiwork.”); *In re Granite Partners, L.P.*, 194 B.R. 318, 332 (Bankr.S.D.N.Y.1996) (“*In pari delicto* bars claims against third parties, but does not apply to corporate insiders or partners.”)).

Likewise, a plaintiff may be able to use the adverse domination rule to circumvent an *in pari delicto* attack. That is because wrongful conduct is not imputed to a debtor if wrongful conduct was for the benefit of the actor and not the corporation. *O’Melveny & Myers*. 969 F.2d 744 (9th Cir. 1992), *rev’d in part on other grounds*, 512 U.S. 79 (1994), on remand, 69 F.3d 17 (9th Cir. 1995); *cf. Baena v. KPMG LLP*, 389 F. Supp. 2d 112, 120 (D. Mass. 2005) (“Even when all reasonable inferences are drawn in favor of

plaintiff, the adverse interest exception, styled in Massachusetts as action taken ‘entirely for [the agent’s] own or another’s purposes,’ is inapplicable. There is no allegation in the complaint that the Breaching Managers engaged in the fraud exclusively to further their own purposes, but rather to boost L & H’s revenues and value.”), *aff’d in Baena v. KPMG LLP*, 452 F.3d 1 (1st Cir. 2006).

If the corporation was dominated by a sole actor, the adverse agent exception does not apply and the wrongful conduct is imputed to the corporation. *See e.g. In re Parmalat Securities Litigation*, 421 F.Supp. 2d 703, 714-15 (S.D.N.Y. 2006). Likewise, if all members of management are part of the wrongdoing and there is no “innocent” officer or director, the wrongful conduct may be imputed to the corporation. *See id.*

VI. Drafting the Plan/ Trust Agreement

It is fundamental that jurisdiction cannot be conferred by agreement. Hence, a plan of reorganization, which is a type of contract between a debtor and creditors, cannot create jurisdiction in a plan trustee or any other entity where it would not otherwise exist at law. *See e.g., In re Harrold*, 296 B.R. 868, 873 (Bankr. M.D. Fla. 2003) (citing *Surf N Sun Apts., Inc. v. Dempsey*, 253 B.R. 490, 494-95 (M.D.Fla.1999) (“The bankruptcy court may not, however, unilaterally confer standing upon the creditor to pursue the claim itself. If such authority is to be granted, it must come from Congress and not the Courts.”); *In re Metal Brokers International, Inc.*, 225 B.R. 920, 922 (Bankr. E.D.Wis.1998) (“[A]bsent the appointment of a third party to commence a preference action pursuant to a plan of reorganization under § 1123)(b)(3)(B), no other statutory authority exists to enable [the creditor] to bring such action.”).

However, if a plan and its frequently attached and incorporated trust agreement fail to authorize a plan trustee to pursue causes of action, litigation defendants may assert defenses that careful drafting would avoid. This issue was front and center in the *Rahl v. Bande* case:

In the case at bar, the provision in question is clear. The Trust Agreement transferred and assigned claims only against the Debtors’ former or current debtors [sic]. Although plaintiff maintains that the word “claim” should be given the broadest possible meaning, this does not change the fact that the Trustee was assigned claims only against former or current directors or officers. A broad definition of the term “claim” affects only the types of claims which may be brought and not the identities of the parties against whom they may be brought. Accordingly, plaintiff does not have standing to maintain an action against the corporate defendants unless they are deemed to be former or current directors or officers of Flag, which plaintiff maintains should be done with respect to Verizon and Andersen.

328 B.R. 387, 400-401 (S.D.N.Y. 2005).

VII. Conclusion

Standing in bankruptcy cases is a complicated issue. The case law varies from circuit to circuit and is often in conflict. Bankruptcy practitioners must carefully analyze these issues when putting together a plan of reorganization that provides for the retention and prosecution of causes of action. Bankruptcy litigators must carefully plead their complaints in order to meet the jurisdiction's applicable standing requirements.