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# Can the Claims of Individual Creditors Be Assigned to a Litigation Trust?

***Part One of a Two-Part Article***

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Consider this familiar fact pattern: A small group of bondholders believe that they were misled by a debtor's management about the company's financial situation shortly before the company filed for bankruptcy, and no class action has yet been filed for securities fraud or related claims. The debtor quickly sells its assets and agrees with the creditors committee to file a plan that creates a litigation trust to litigate possible causes of action for the benefit of the creditors. Can the plan provide that the securities claims — which are not estate causes of action because they belong to the bondholders individually, not to the company — will be assigned to the trust so that the trust can efficiently litigate these claims and distribute the proceeds thereof to the bondholders?

Until recently, the answer certainly would have been "no"; several cases have held that a plan can not vest a litigation trust with the claims of individual creditors and instead is limited to litigating and collecting claims that belong to the estate. However, recent decisions from the Second and Fourth Circuits as well as dicta in a recent opinion from the Third Circuit suggest that the answer now is "maybe." This article explores the history, the more recent case law and the open issues, which could be important in structuring a plan in future cases.

## The Supreme Court Sets the Stage in *Caplin*

The issue can be traced back to the Supreme Court's decision in *Caplin v. Marine Midland Grace Trust Co.*, 406 U.S. 416 (1972). In *Caplin*, a bankruptcy trustee under the now superceded Bankruptcy Act sought to assert claims against an indenture trustee on behalf of the estate's bondholders. The Court held that the trustee lacked standing to do so. The Court found no statutory authority that would permit a trustee to assert creditor claims without creditor consent. *Id.* at 428. From a pragmatic standpoint, the Court noted that allowing a trustee to sue on behalf of creditors could lead to unnecessary complications such as inconsistent results with actions brought by individual creditors. For example, would the trustee's lawsuit preempt individual actions by the creditors, and if not, could an individual creditor and the trustee both sue on the claim simultaneously? *See Id.* at 431-32 (trustee arguing that his lawsuit on behalf of creditors would not preempt individual creditor lawsuits, and instead assumed that such individual lawsuits would be extremely unlikely). Moreover, given that the debtor in *Caplin* was potentially *in pari delicto* with the indenture trustee, it was possible that the indenture trustee would become subrogated to the debtor for the amount of any recovery, in which case the trustee's lawsuit would result in no net benefit to the estate. *Id.* at 429-30. The Supreme Court held that for these three reasons the bankruptcy trustee lacked standing to sue on behalf of estate creditors.

## Later Courts Extend *Caplin* Beyond Its Initial Holding

Although *Caplin* was decided under the Bankruptcy Act, it is still good law today. *See, e.g., Mixon v. Anderson* (*In re Ozark*), 816 F.2d 1222, 1228 (8th Cir. 1987). In fact, not only is it still good law, but courts have extended its holding to conceptually different settings. It started innocuously enough: The Eighth Circuit in *Ozark* extended *Caplin* to Chapter 7 trustees ("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 causes of action, such as the alter ego claim, on behalf of the bankruptcy estate's creditors.") (emphasis in original). *Ozark* at 1228. The *Ozark* court found this Congressional message in the legislative history of the Code, which originally contained a proposed § 544(c) that would have overruled *Caplin* and allowed the trustee to bring creditor causes of action even in the absence of their consent. H.R. 8200, 95th Cong., 1st Sess. 416-17 (1977). Section 544(c) was never enacted, which the *Ozark* court took to mean that Congress ultimately approved of *Caplin* and its applicability to all trustees.

Soon after *Ozark*, other courts began to extend *Caplin* even farther to apply not only to Chapter 11 (formerly Chapter X) trustees (*Caplin*) or Chapter 7 trustees (*Ozark*), but also to state law trustees of liquidation trusts created pursuant to a confirmed plan of reorganization. *See, e.g., Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 191 (Del. Ch. 2006); *Torch Liquidating Trust v. Stockstill*, No. 07-133, 2008 WL 696233 at *6 n.4 (E.D. La. Mar. 13, 2008). In the Ninth Circuit case *Williams v. California 1st Bank*, a Chapter 7 trustee sought to take on a role very similar to that of a state law liquidating trustee, which is vested by contract with certain rights of action, by moving the bankruptcy court for permission to solicit and accept assignments of direct causes of action from certain creditors. *Williams v. California 1st Bank*, 859 F.2d 664, 665 (9th Cir. 1988). The bankruptcy court approved the motion and the trustee sent a letter to certain creditors offering to prosecute assigned claims on their behalf and to distribute proceeds directly to them (with none going to non-assigning creditors). Over one hundred creditors assigned their claims to the trustee, who then asserted them against a bank

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for allegedly participating in a Ponzi scheme. *Id*.

The bank challenged the trustee's standing to assert the creditors' claims against it, notwithstanding that the creditors formally assigned their claims to the trustee. The Ninth Circuit agreed: "Although we are mindful that, unlike *Caplin*, the creditors here assigned their claims to the Trustee, 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 for a different result." *Id*. at 666. The court placed great weight on the fact that the trustee would distribute the proceeds of the claims only to the assigning creditors and not to all creditors of the estate. It reasoned that the assigning creditors remained the true parties in interest, since only they received the proceeds. The estate realized no benefit from the trustee's pursuit of assigned claims on behalf of the assigning creditors, and thus, like in *Caplin*, the trustee was collecting "money not owed to the estate." *Id*. at 667.

Other courts have reached similar results and extended the *Caplin* holding to bar state law litigation trusts created under a confirmed plan from asserting any direct claims of creditors. For example, in *Trenwick*, the Delaware Court of Chancery held that under federal law, a post-confirmation litigation trust lacks standing to assert creditor claims: "federal bankruptcy law is clear that litigation trusts do not have standing to pursue the direct claims of creditors." *Id*. (Citing to *Ozark*). It also cited to *Caplin* for the proposition that "bankruptcy trustees and litigation trusts formed as part of reorganization plans do not have standing to bring claims belonging to creditors under the federal bankruptcy statute." *Id*. Accordingly, the court held that the liquidation trust could not pursue direct claims of creditors and only could pursue derivate claims, *i.e.*, claims that belonged to the estate as a whole. But *Trenwick* involved the assignment of claims to a state law trust, an issue that *Ozark* and *Caplin* never actually addressed — they dealt only with Chapter 7 and Chapter 11 (then X) trustees, whose roles and duties are defined by the Bankruptcy Code, trying to assert creditor claims, not with trustees of state law trusts asserting claims that a plan, voted on by creditors and approved by a bankruptcy court, contemplated that the trust might bring. Despite the fact that *Trenwick's* citations dealt with what appears to be a distinct issue (bankruptcy trustees), other state courts have since followed its holding. *See Torch Liquidating Trust v. Stockstill*, No. 07-133, 2008 WL 696233 at *6 n.4 (E.D. La. Mar 13, 2008) ("prior case law is explicit that Litigation Trusts such as plaintiff do not have standing to pursue the direct claims of creditors") (citing *Trenwick*).

## Distinguishing *Caplin* and Its Progeny

Two recent Court of Appeal decisions have rejected the above courts' increasingly broad application of *Caplin* and have allowed bankruptcy trustees and litigation trustees to sue on behalf of creditors under certain circumstances. *Bankruptcy Servs., Inc. v. Ernst & Young, LLP* (*In re CBI Holdings Co., Inc.*), 529 F.3d 432 (2d Cir. 2008); *Logan v. JKV Real Estate Servs.* (*In re Bogdan*), 414 F.3d 507 (4th Cir. 2005). These cases turned on the fact that the trustee obtained an assignment of creditor claims. Unlike in *Caplin* or *Ozark*, where the trustee was not the assignee of the claims that it sought to assert, in these cases it was, and in most instances that was enough to distinguish *Caplin* and change the result — even though this ground does not distinguish these cases from *Williams*.

In *CBI*, the Second Circuit noted that actual assignment negates several of the *Caplin* concerns. First, although no express statutory authority allows a trustee to assert creditor claims generally without their consent, there arguably is such statutory authority if the creditor chooses to assign its claim to the trustee. Section 541(a)(7), added by the 1978 amendments to the Bankruptcy Act, expands the definition of "property of the estate" to include "any interest in property that the estate acquires *after* the commencement of the case" (emphasis supplied). Thus, upon assignment of a claim, it becomes property of the estate and just like any other estate property, the Bankruptcy Code authorizes the trustee to reduce the property (*i.e.*, the claim) to money on behalf of the estate. Before the addition of § 541(a)(7) (and at the time *Caplin* was decided), property of the estate included only property as of the date of the case's commencement, and thus later assigned claims were excluded from the definition. *In re CBI*, 529 F.3d at 454; *Bogdan*, 414 F.3d at 512.

Second, the recent cases have held that assignment negates the Caplin court's concern about trustees bringing actions inconsistent with actions brought by individual creditors. The concern was that allowing multiple parties to sue simultaneously on one claim — *i.e.*, both the creditor and the trustee — could lead to complications such as a defendant facing two lawsuits for the same claim, or two inconsistent results in the lawsuits. *See Caplin*, 406 U.S. at 432. Or, if only one lawsuit is allowed to proceed, the trustee and creditor could potentially disagree on the best strategy for litigating it. The Fourth Circuit in *Bogdan* held that assignment eliminates these concerns because upon assignment the assigning creditor loses its ability to sue on the claim, and hence only one person can sue (the trustee), thus eliminating the possibility of inconsistent rulings. S*ee Bogdan*, 414 F.3d at 512. The court also stated that assignment eliminates the concern that the trustee and creditor would disagree on how to best pursue a claim, because by the very act of assignment, a creditor affirmatively elects how to best deal with its claim. *Id*. Of course, there still could be a tension between how a non-assigning creditor and the trustee would litigate the case, but that concern is no different than it was before the assignment (two creditors could have had different views about how to conduct such a case) and could counsel in favor of collective actions to the extent possible.

As a result of the foregoing distinctions, the Fourth Circuit held in *Bogdan* that a Chapter 7 trustee had standing to pursue the individual claims that 12 mortgage lenders assigned to him. *Bogdan*, 414 F.3d at 509. Perhaps more interestingly to Chapter 11 lawyers, the Second Circuit in *CBI Holding* held that the "disbursing agent" under a confirmed plan had standing to pursue claims that one creditor assigned to the debtor as part of a compromise contained in the plan, resolving claims that this creditor and the debtor had against on another. *CBI Holding*, 529 F.3d at 441. Additionally, the Third Circuit in *LaSala* noted with approval that a confirmed plan had assigned to a litigation and liquidation trust purchasers' individual causes of action for recission of stock purchase contracts, though no one challenged the disbursing agent's standing so the language about liquidation trusts is dicta. *See Lasala v. Bordier et Cie*, 519 F.3d 121, 127, n.1 (3d Cir. 2008).

*Next month: whether the assignment must benefit the estate — and a look at the policy of flexibility.*