PUTTING HUMPTY DUMPTY BACK TOGETHER AGAIN:

Using State Law and Equitable Causes of Action to MAXIMIZE THE VALUE OF A CORPORATE BANKRUPTCY ESTATE

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No tangible assets, plenty of unsecured liabilities. That's what the schedules reflect in your new case. You begin to wonder, why was this case even filed? Did the owner of the business voluntarily file the case to stay ongoing legal proceedings or did creditors file the case so a trustee could be appointed to pursue the recovery of avoidable transfers?

In order to identify viable claims, you conduct the typical due diligence. As the holder of the corporate debtor's pre-petition attorney-client privilege, you also send a letter to the debtor's pre-petition counsel demanding turnover of all communications and documents.[1] Typically, those documents provide a treasure trove of useful information.

As a result of this due diligence, you have identified viable litigation claims and contemplate how to monetize them. Unquestionably, you have standing and authority to pursue turnover of property of the estate and the recovery of avoidable transfers under Bankruptcy Code sections 544, 547, 548, and 550. However, you also likely have standing and authority to assert state law and equitable claims against third parties. Indeed, it is well-settled that causes of action that a debtor could have maintained under state law outside of bankruptcy are considered "legal or equitable interests of the debtor in property" and therefore qualify as property of the debtor's estate."[2] When a cause of action becomes property of the bankruptcy estate, the trustee appointed to administer the estate becomes the sole party with standing to bring suit, unless the cause of action is abandoned by the trustee.[3] The state law causes of action that may be available to a trustee include aiding and abetting, alter ego, breach of contract, breach of fiduciary duty, civil conspiracy, conversion, fraud, negligence/professional malpractice, and tortious interference claims. The equitable claims that may be available to a trustee include constructive trust, equitable lien, reformation, rescission, and unjust enrichment claims.

At the same time, a trustee's right to assert a state law claim may be challenged by a creditor who contends its owns the claim and has the right to pursue it outside the bankruptcy case[4] or by a litigation target who seeks to dismiss the trustee's suit for lack of standing.[5] The determination of the party with the right to prosecute a claim hinges on whether the creditor was caused direct or particularized harm by the defendant's actions or whether such harm was merely derivative of harm suffered by the debtor and, therefore, constitutes generalized harm suffered by all creditors. Stated differently, "a court must look to the injury for which relief is sought and consider whether it is peculiar and personal to the claimant or general and common to the corporation and creditors."[6] The creditor has the right to pursue the claim in the former instance and the trustee has exclusive standing to pursue it in the latter instance.[7]

A case that best illustrates this turf battle between a trustee and creditor in the alter ego context is *Baillie Lumber Co., LP v. Thompson (In re Icarus Holding, LLC)*.[8] *Baillie Lumber* involved competing suits filed by a debtor-in possession in bankruptcy court (alleging that financial irregularities by the debtor's former principal were fraudulent transfers and should be held in a constructive trust) and by a creditor in state court (alleging the former principal was the corporate debtor's alter ego and was therefore personally liable for monies owed to the creditor). After the debtor-in-possession successfully enjoined the creditor's state court suit, the creditor appealed. In the appeal, the Eleventh Circuit held "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." *Id*. at 1321 (citation omitted).

In order to reach a determination on the first factor of this test, the court reviewed the creditor's state court complaint. *Id*. Since the creditor's alter ego action was based on the former principal's looting of corporate assets, the court concluded that such an action could be brought by all of the company's creditors. *Id*. Thus, the creditor "assert[ed] only a general cause of action and no personal damages that [were] unique to them." *Id*. In other words, "[b]y misappropriating corporate assets," the principal "caused direct harm to the corporation and only indirect harm to [the creditor]." *Id*.

In order to reach a determination on the second factor of the test, the court looked "to Georgia law to determine whether [the corporate debtor] is allowed to bring an alter ego action against its former principal, therefore, making it property of the bankruptcy estate and [the creditor's] separate state action subject to the automatic stay." *Id*. at 1319. After the Georgia Supreme Court answered this certified question in the affirmative, the Eleventh Circuit affirmed the district court's decision that the alter ego action constituted property of the corporate debtor's estate and was subject to an automatic stay preventing individual creditors from seeking to pursue the cause of action.[9] Although *Baillie Lumber's* reasoning was sound, other federal courts have reached the opposing conclusion based on divergent state alter ego law.[10] As a result, choice of law principles are of paramount importance in evaluating contemplated alter ego claims.

A trustee should also consider whether any professionals or other third parties aided and abetted torts against the debtor.[11] To assert a claim for aiding and abetting, a plaintiff must allege (1) the existence of an underlying tort; (2) defendant's actual knowledge of the underlying tort; and (3) defendant's provision of substantial assistance in the commission of the underlying tort.[12] Substantial assistance occurs when a defendant does one of three things: (1) affirmatively assists, (2) helps conceal, or (3) fails to act when required to do so, thereby enabling the breach to occur.[13]

Finally, a trustee should consider equitable claims for constructive trust and equitable lien. Both remedies give the plaintiff an interest in the traced asset. The difference between them is that imposition of a constructive trust gives the plaintiff title to the

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About the Author

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In his bankruptcy practice, Robert regularly represents court-appointed fiduciaries in connection with Chapter 7 and Chapter 11 cases stemming from fraud and financial crimes. He has developed a reputation as a thorough and tenacious litigator who prosecutes fraudulent transfer, preference and professional liability claims with the objective of maximizing distributions to creditors. Robert also regularly represents debtors, creditors, creditors' committees and liquidating trustees.

asset whereas imposition of an equitable lien merely gives the plaintiff a lien on the asset.

Where a "a defendant is unjustly enriched by the acquisition of title to identifiable property at the expense of the claimant or in violation of the claimant's rights, the defendant may be declared a constructive trustee, for the benefit of the claimant, of the property in question and its traceable product. The obligation of a constructive trustee is to surrender the constructive trust property to the claimant, on such conditions as the court may direct."[14] In other words, "[c]onstructive trust transfers ownership of specific property from the holder of legal title to a person with a paramount equitable claim. By contrast, equitable lien (as the name indicates) gives the claimant a security interest in property held by the defendant, rather than ownership."[15]

Imposition of an equitable lien merely secures the defendant's obligation to pay money with a lien on an identifiable asset. *Id*. If a defendant is unjustly enriched by a transaction in which the claimant's assets or services are applied to enhance or preserve the value of particular property to which the defendant has legal title, or more generally the connection between unjust enrichment and the defendant's ownership of particular property makes it equitable that the claimant have recourse to that property for the satisfaction of the defendant's liability in restitution, the claimant may be granted an equitable lien on the property in question."[16]

In conclusion, a trustee's tool box contains state law and equitable claims which should not be overlooked or underutilized. A trustee who uses those tool and continues to think "outside the box" will surely be successful in maximizing the value of a corporate debtor's estate.

ENDNOTES:

1 *See Commodity Futures Trading Commission v. Weintraub*, 471 U.S. 343, 358, 105 S. Ct. 1986, 1996, 85 L. Ed. 2d 372 (1985) (holding that trustee of a corporation in bankruptcy owns, controls, and therefore has the power to waive the corporation's attorney-client privilege with respect to pre-bankruptcy communications) and 11 U.S.C. § 542(e).

2 *U.S. v. Whiting Pools, Inc.*, 462 U.S. 198, 205 n. 9 (1983); *In re Wilton Armetale, Inc.*, 968 F.3d 273, 280 (3d Cir. 2020); *Matter of Geise*, 992 F.2d 651, 655 (7th Cir. 1993); *In re Educators Group Health Trust*, 25 F.3d 1281, 1283-84 (5th Cir. 1994); *Hirsch v. Arthur Anderson & Co.*, 72 F.3d 1085, 1093 (2d Cir. 1995); *In re Van Dresser Corp.*, 128 F.3d 945, 947 (6th Cir. 1997).

3 *Parker v. Wendy's Int'l, Inc., 365 F.3d 1268, 1272* (11th Cir. 2004) ("[g]enerally speaking, a pre-petition cause of action is the property of the Chapter 7 bankruptcy estate, and only the trustee in bankruptcy has standing to pursue it"); *Oswalt v. Sedgwick Claims Management Services, Inc.*, 624 F. App'x 740, 741 (11th Cir. 2015) (cause of action which the debtor failed to disclose to the bankruptcy court and which the trustee never abandoned continued to constitute property of the debtor's estate); *Romagosa v. Thomas (In re Van Diepen, P.A.)*, 236 F. App'x 498, 502-503 (11th Cir. 2007); *Baillie Lumber Co., LP v. Thompson (In re Icarus Holding, LLC)*, 391 F.3d 1315 (11th Cir. 2004); *Surf N Sun Apts., Inc. v. Dempsey*, 253 B.R. 490 (M.D. Fla. 1999); *Sidney v. Ragucci (In re Ragucci)*, 433 B.R. 889, 897 (Bankr. M.D. Fla. 2010); *In re Zwirn*, 362 B.R. 536, 539 (Bankr. S.D. Fla. 2007)

4 *See, e.g., Baillie Lumber Co., LP v. Thompson*, 413 F.3d 1293 (11th Cir. 2005).

5 *See, e.g., In re Oaktree Medical Centre, P.C.*, 2022 WL 1160609 (Bankr. D.S.C. Apr. 19, 2022) (summarized in the ABTJ Case Law Update, Vol. 38, Issue 03 (2022).

6 *Koch Refining v. Farmers Union Cent. Exchange, Inc.*, 831 F.2d 1339, 1349 (7th Cir. 1987).

7 *Caplin v. Marine Midland Grace Trust Co.*, 406 U.S. 416, 433-34 (1972).

8 391 F.3d 1315 (11th Cir. 2004).

9 *Baillie Lumber Co., LP v. Thompson*, 413 F.3d 1293 (11th Cir. 2005).

10 *See, e.g., In re RCS Engineered Products Co.*, 102 F.3d 223, 225-26 (6th Cir. 1996) (trustee lacked standing to assert alter ego action because subsidiary corporation does not have standing to sue its shareholders or parent under an alter-ego theory under Michigan law); *Kalb, Voorhis & Co. v. American Financial Corp.*, 8 F.3d 130, 133 (2d Cir. 1993) (trustee had standing to assert alter-ego claim because, a corporation can pierce its own corporate veil under Texas law); *St. Paul Fire and Marine Insurance Co. v. PepsiCo*, 884 F.2d 688, 696-99 (2d Cir. 1989) (trustee had standing to assert alter-ego claim because corporation could pierce its own veil under Ohio law); *Koch Refining v. Farmers Union Central Exchange Inc.*, 831 F.2d 1339, 1346 (7th Cir. 1987) (trustee can assert alter-ego claim under Indiana and Illinois law); *In re Ozark Rest. Equip. Co.*, 816 F.2d 1222 (8th Cir. 1987) (trustee lacked standing to assert alter-ego claim because corporation could not pierce its own veil under Arkansas law).

11 *American Master Lease, LLC v. Idanta Partners, Ltd.*, 225 Cal. App. 4th 1451, 1477-78 (Cal. Ct. App. 2014).

12 *In re Bayou Hedge Funds Inv. Litig.*, 472 F. Supp. 2d 528, 532 (S.D.N.Y. 2007); *ZP No. 54 Ltd. P'ship v. Fid. & Deposit Co. of Md.*, 917 So. 2d 368, 372 (Fla. Dist. Ct. App. 2005); *Becks v. Emery-Richardson, Inc.*, 1990 WL 303548, at *42 (S.D. Fla. Dec. 21, 1990); *In re Caribbean K Line, Ltd.*, 288 B.R. 908, 919 (S.D. Fla. 2002).

13 *Monaghan v. Ford Motor Co.*, 71 A.D.3d 848, 850, 897 N.Y.S.2d 482, 484-85 (2010). Cf. *In re Oaktree Medical Centre, P.C.*, 2022 WL 1160609, at *6 (Bankr. D.S.C. Apr. 19, 2022) (requiring active encouragement or active procurement of the breach of fiduciary duty under a knowing participation standard).

14 Restatement (Third) of Restitution & Unjust Enrichment, § 55 (2011).

15 *Id*. at § 56 cmt. b.

16 *Id*. at § 56(1).