Litigation Trusts in Chapter 11 Bankruptcies: A Proposal to Ensure Adequate Representation to Creditors Represented by Bankruptcy Trustees

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NOTES

Litigation Trusts in Chapter 11 Bankruptcies

A PROPOSAL TO ENSURE ADEQUATE REPRESENTATION TO CREDITORS REPRESENTED BY BANKRUPTCY TRUSTEES

INTRODUCTION

On December 10, 2008, Bernard L. Madoff’s Ponzi scheme\(^1\) collapsed.\(^2\) On December 15, 2008, the Securities Investors Protection Corporation (SIPC)\(^3\) obtained an order pursuant to the Securities Investors Protection Act\(^4\) (SIPA) placing Bernard L. Madoff Investment Securities, LLC (BLMIS) under the protection of SIPC and appointing Irving Picard as trustee to liquidate the assets of BLMIS for the benefit of its customers.\(^5\) In furtherance of his mission, Picard filed four actions in the United States Bankruptcy Court for

\(^1\) “A Ponzi scheme’ is [a] fraudulent investment scheme in which money contributed by later investors generates artificially high dividends for the original investors, whose example attracts even larger investments.” Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 343 n.1 (3d Cir. 2001) quoting BLACK’S LAW DICTIONARY 1180 (7th ed.1999).

\(^2\) SEC v. Madoff, No. 08-CV-10791, 2008 WL 5197070, at *6 (S.D.N.Y. Dec. 11, 2008). Money invested with Madoff had been deposited into a single bank account at J.P. Morgan Chase Manhattan Bank (JPM), which was used as a slush fund “solely to enrich Madoff and his inner circle.” SEC v. Bernard L. Madoff Inv. Sec., LLC (In re Madoff), 424 B.R. 122, 129 (Bankr. S.D.N.Y. 2010).

\(^3\) SIPC is a nonprofit corporation created pursuant to the Securities Investor Protection Act that liquidates securities broker dealers when they are financially troubled. A trustee returns investors’ cash and securities to them, and a fund exists to compensate investors for their losses. Securities Investor Protection Corporation, SIPC Mission, available at http://www.sipc.org/about-sipc/sipc-mission.


\(^5\) In re Madoff, 424 B.R. at 126; see also Picard v. JPMorgan Chase & Co. (In re Bernard L. Madoff Inv. Sec. LLC), 721 F.3d 54, 59 (2d Cir. 2013) (succinctly describing the role of a SIPA trustee).
the Southern District of New York\textsuperscript{6} alleging that “numerous major financial institutions aided and abetted [Madoff’s] fraud, collecting steep fees while ignoring blatant warning signs.”\textsuperscript{7} Picard accused these entities of enabling Madoff’s fraud by funneling billions of dollars to him from new investors through the creation of feeder funds, selling derivative products based on BLMIS, and lending their “prestigious name[s]… to legitimize and attract money to Madoff’s fraud.”\textsuperscript{8} The entities were also accused of knowing or strongly suspecting Madoff’s fraud yet continuing to funnel money to him to continue collecting fee income.\textsuperscript{9}

At first blush, the benefits of litigating such claims would seem obvious. Former BLMIS customers could enjoy an enhanced recovery, possibly up to the full amount of their claims. SIPC could recoup some of the approximately $800 million it advanced to pay customer claims.\textsuperscript{10} Finally, the lawsuit could not only provide a strong incentive for financial institutions to distance themselves from or even report suspected fraud but also satisfy a retributive urge felt toward Madoff and his accomplices.\textsuperscript{11} It may therefore come as some surprise to a casual observer to learn that almost all of the claims asserted by Picard were dismissed for failure to state a claim.\textsuperscript{12}

\textsuperscript{6} Under SIPA, once a brokerage firm is put into receivership and a trustee is appointed, “the [district] court shall forthwith order the removal of the entire liquidation proceeding to the court of the United States in the same judicial district having jurisdiction over cases under [the Bankruptcy Code].” 15 U.S.C. § 78eee(b)(4). The Bankruptcy Court then has “all of the jurisdiction, powers, and duties conferred by this chapter [on the district court].” \textit{Id.} Under Fed. R. Bankr. P. 7001(1), when proceedings are brought to recover money or property, they are filed in the bankruptcy court and styled as an “adversary proceeding,” which proceeds similarly to a lawsuit in a District Court. Fed. R. Bankr. P. 7002 specifically incorporates a number of rules from the Federal Rules of Civil Procedure.

\textsuperscript{7} \textit{In re} Bernard L. Madoff Inv. Sec. LLC, 721 F.3d at 57. The suits were filed “against JPMorgan Chase & Co., UBS AG, UniCredit Bank Austria AG, HSBC Bank plc, and affiliated persons and entities.” \textit{Id.} at 59.

\textsuperscript{8} \textit{Id.} at 59-62 (citations omitted) (quotation marks omitted).

\textsuperscript{9} \textit{Id.} at 59-62.

\textsuperscript{10} \textit{Id.} at 58. Much like FDIC insurance, SIPC maintains a fund that is used to pay the claims of customers who lost money in the failure of a broker-dealer, for a maximum of $500,000 for securities and $250,000 for cash. 15 U.S.C. § 78fff-3(a).

\textsuperscript{11} See DIANA B. HENRIQUES, THE WIZARD OF LIES xx (2011) (describing Madoff’s victims as feeling that he deserves to be imprisoned in something comparable to a “Vietcong [sic] tiger cage;” see also Stephanie Strom, Elie Wiesel Levels Scorn at Madoff, N.Y. TIMES (Feb. 26, 2009) \url{http://www.nytimes.com/2009/02/27/business/27madoff.html} (where Elie Wiesel believed that Madoff deserved to be kept in solitary confinement and forced to watch a screen showing the faces of his victims for at least five years).


\textsuperscript{13} Picard’s suit against UBS, JPM, and other affiliated entities was heard by Judge McMahon of the United States District Court for the Southern District of New York, see \textit{Picard v. JPMorgan Chase & Co.}, 460 B.R. 84, while Picard’s suit against
“lacked standing, under any theory, to assert [the claims].”\textsuperscript{14} and the Second Circuit summarily affirmed the dismissals.\textsuperscript{15}

The purpose of this note is to examine attempts by bankruptcy trustees such as Picard\textsuperscript{16} who try to recover losses suffered by a debtor’s creditors by imposing liability on third parties that allegedly aided and abetted the debtor’s demise. This issue has become increasingly important for three reasons. First, unsecured creditors are often left with little to compensate them for their losses. This is especially true in the case of fraud.\textsuperscript{17} But even in more typical bankruptcy cases, most of the debtor’s assets will be subject to claims by secured creditors.\textsuperscript{18}

Second, while the scope of Madoff’s fraud may have been unprecedented, the outcome of the litigation surrounding Picard’s attempts to impose creditor losses on allegedly culpable third parties is not. Typically, “a series of formalistic bars prevents [a] trustee from going after . . . deep-pocketed third parties . . .”\textsuperscript{21} In particular, the doctrine of \textit{in pari delicto}

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\textit{HSBC and UniCredit Bank Austria was heard by Judge Rakoff of the same court, see Picard v. HSBC Bank PLC, 454 B.R. at 28.}
\textsuperscript{14} Trustee’s Seventh Interim Report for the Period Ending March 31, 2012 at 27; Picard v. Bernard L. Madoff Inv. Sec. LLC, No. 08-01789 (BRL) (Bankr. S.D.N.Y. Apr. 25, 2012), ECF No. 4793; see also Picard v. HSBC Bank PLC, 454 B.R. at 37-38; see also Picard v. JPMorgan Chase & Co., 460 B.R. at 90 (concurring with Judge Rakoff’s analysis of the suits).
\textsuperscript{15} Picard v. JPMorgan Chase & Co. (In re Bernard L. Madoff Inv. Sec. LLC), 721 F.3d 54, 58, 77 (2d Cir. 2013).
\textsuperscript{16} Although Picard was a SIPA trustee, SIPA trustees have similar powers to bankruptcy trustees. See 15 U.S.C. § 78fff-1(a) (2012).
\textsuperscript{17} In the case of a collapsed Ponzi scheme such as Madoff’s, the schemer has generally already squandered what was invested with him, either to lure in new investors or on various extravagances. See Nick Axelrod, \textit{Into the Perfect Storm: The Failure of Trustee Actions Against Third Parties}, 68 N.Y.U. ANN. SURV. AM. L. 441, 442-43 (2012). Clawback suits against investors who withdrew more from the Ponzi scheme than they deposited are common, though ultimately this only distributes the losses among the investors rather than generating new funds to pay investor claims. Amy J. Sepinwall, \textit{Righting Others’ Wrongs: A Critical Look at Clawbacks in Madoff-Type Ponzi Schemes and Other Frauds}, 78 BROOK. L. REV. 1, 1-2 (2012) (describing such suits as taking from Peter to pay Paul).
\textsuperscript{19} In a Chapter 11 bankruptcy case, a debtor will typically possess the powers of a bankruptcy trustee. 11 U.S.C. § 1107(a) (2012).
\textsuperscript{21} Axelrod, \textit{supra} note 17, at 443.
prevents the bankruptcy trustee from bringing suit against culpable third parties on behalf of the estate, while the Supreme Court’s holding in the case of *Caplin v. Marine Midland Bank Trust Co.* prevents the bankruptcy trustee from bringing suit on behalf of the estate’s creditors. The result is that individual creditors are left to their own devices.

Third, enterprising bankruptcy trustees have created *ad hoc* solutions to bypass these formalistic bars to net a greater recovery for aggrieved investors. Some trustees have experimented with taking assignment of creditor claims against third parties to get around the holding of *Caplin*. Others have used the Chapter 11 plan confirmation process to engineer the assignment of creditor claims to trusts or limited liability companies, which in turn bring suit against culpable third parties. This note will first describe reasons that litigation trusts have come into being and then argue that in the brave new world where bankruptcy trustees can represent estate creditors in lawsuits against third parties, additional procedural protections should exist for those creditors. As litigation trusts are essentially class action lawsuits, this protection should be derived from Federal Rule of Civil Procedure 23, which governs class action litigation.

Part I of this note will provide a brief background on the so-called “formalistic bars” mentioned above and describe how they were applied in the Madoff case. Part II will explain, drawing on Supreme Court precedent involving class action litigation, why bankruptcy trustees such as Picard cannot adequately represent estate creditors. Part III will describe ways bankruptcy trustees have circumvented the bars described in Part I and discuss them in the context of the adequate representation issues discussed in Part II. Finally, Part IV will argue that because litigation trusts bind non-parties to judgments, procedural protections must exist for those non-parties, and will draw on Federal Rule of Civil Procedure 23 for suggestions.

I. THE DOCTRINES UNDERPINNING THE DISMISSAL OF BANKRUPTCY TRUSTEE SUITS AGAINST THIRD PARTIES

This Part of the note will describe the legal doctrines that support the dismissal of claims by bankruptcy trustees against culpable third parties generally and will discuss the claims asserted by Picard in the Madoff proceedings in particular. First, it will discuss the doctrine of in pari delicto, which forbids a debtor, such as BLMIS, from suing those that
aided and abetted it in fraud, and through that forbids the trustee of such debtor’s bankruptcy estate from bringing these claims. Second, it will describe the holding of Caplin v. Marine Midland Grace Trust Co. of New York, which forbids a trustee such as Picard from representing creditors of the estate for which he is the trustee. Third, it will describe the holding of Williams v. California 1st Bank, which forbids a trustee such as Picard from taking assignment of creditor claims to evade the holding of Caplin. Finally, it will describe the “Wagoner Rule,” which provides that claims for defrauding a corporation with the assistance of its management accrue to the corporation’s creditors rather than the corporation.

A. The Doctrine of In Pari Delicto

The doctrine of in pari delicto is an abbreviation for the Latin phrase in pari delicto potior est condition defendentis, which means “in a case of equal or mutual fault . . . the position of the [defending] party . . . is the better one.” The doctrine rests on the idea that courts should not mediate disputes among wrongdoers, and that their refusal to do so will deter wrongdoing. For example, if Madoff tried to sue one of his accomplices over the

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22 See infra Part I.A.
23 See infra Part I.B.
24 See infra Part I.C.
25 See infra Part I.D.
27 Id. A simple (and perhaps entertaining) example of the application of this doctrine arose in the case of Rose v. National Auction Group, Inc., 646 N.W.2d 455 (Mich. 2002). There, the plaintiffs owned an island in Lake Huron that they hoped to sell for $850,000. Id. at 457-58. They signed an agreement with the defendant broker that permitted the island to be sold at an auction with no guaranteed minimum selling price. Id. at 458. To protect the plaintiffs in the event of a low price, the plaintiffs had the right to withdraw the island prior to its sale. Id. At the auction, one of the plaintiffs became concerned when only five bidders appeared, but when he inquired about withdrawing the island from the auction, the defendant assured him that the price received would be adequate because the defendant could insert a shill bidder to drive up the price. Id.

At the auction, bidding stalled at $175,000. Id. at 459. During a recess, the plaintiff again had the option to withdraw the island from the auction, but instead authorized the defendants to commence the shill bidding scheme. Id. “[W]hether through bungling or yet more chicanery,” the shill did not bid, and the sale closed at $175,000. Id. The plaintiffs filed suit against the auctioneers seeking reimbursement of commissions and “damages to put them in the place they would have been had the shill performed.” Id. The court refused to grant the plaintiffs relief over an arrangement that unethically sought to impose a minimum price at an auction advertised as lacking this feature. Id. at 467. Instead, the losses suffered by selling the island for $175,000 instead of the expected $850,000 in the scheme devised between the plaintiffs and the defendants were left as they were. Id.
proceeds of the Ponzi scheme, courts would refuse to help him and let the losses fall where they may.\textsuperscript{28}

The application of in pari delicto is rather obvious when a lawsuit is between two individual wrongdoers. However, the doctrine is extended in three important and less-obvious ways. First, where an employee of an entity has engaged in wrongful conduct, that employee’s misconduct will be imputed to that entity.\textsuperscript{29} Therefore, BLMIS, a limited liability company, is considered a wrongdoer simply because its managing member, Bernard L. Madoff, was a wrongdoer.\textsuperscript{30} This is subject to only narrow exceptions involving rogue employees.\textsuperscript{31}

Second, because a bankruptcy trustee stands “in the shoes of the bankrupt corporation,” he is subject to the same limitations the debtor would face in litigation against a third party.\textsuperscript{32} This notion arises out of 11 U.S.C. § 541(a)(1), which provides that estate property consists of “all legal or equitable interests of the debtor in property as of the commencement of the case.”\textsuperscript{33} If the debtor prior to filing for bankruptcy possessed a cause of action subject to the in pari delicto defense, the

\begin{footnotesize}
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\item See Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc., 267 F.3d 340, 361 (3d Cir. 2001) (Cowen, C.J, dissenting) (summarizing the doctrine as “a plaintiff who has participated in wrongdoing may not recover damages resulting from the wrongdoing”) (citations omitted); Kirschner v. KPMG LLP, 938 N.E.2d 941, 950 (N.Y. 2010) (“No court should be required to serve as paymaster of the wages of crime, or referee between thieves. Therefore, the law will not extend its aid to either of the parties or listen to their complaints against each other, but will leave them where their own acts have placed them.”) (citations omitted); see also Picard v. JPMorgan Chase & Co., 460 B.R. 84, 91-92 (Bankr. S.D.N.Y. 2011) (discussing how BLMIS cannot pursue claims against JPM because of the doctrine).
\item Wight v. Bankamerica Corp., 219 F.3d 79, 86-87 (2d Cir. 2000). This was also an underpinning of the holding in Wagoner; since the debtor did not have a claim against Shearson, only the estate’s creditors held a claim. Shearson Lehman Hutton, Inc. v. Wagoner, 944 F.2d 114, 120 (2d Cir. 1991).
\item Picard v. JPMorgan Chase & Co., 460 B.R. at 91-92.
\item Where the agent is acting in his own interest and adversely to those of the corporation, the agent is actually “committing a fraud for his own benefit, [and] is acting outside of the scope of his agency, and it would therefore be most unjust to charge the principal with knowledge of it.” The exception is narrow though and only applies when the agent has “totally abandoned” the principal’s interests. Wight v. Bankamerica Corp., 219 F.3d 79, 87 (2d Cir. 2000) (internal quotation marks omitted). This exception is itself subject to an exception known as the “sole actor” doctrine. Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 359 (3d Cir. 2001). “The general principle of the ‘sole actor’ exception provides that, if an agent is the sole representative of a principal, then that agent’s fraudulent conduct is imputable to the principal regardless of whether the agent’s conduct was adverse to the principal’s interests. The rationale for this rule is that the sole agent has no one to whom he can impart his knowledge, or from whom he can conceal it, and that the corporation must bear the responsibility for allowing an agent to act without accountability.” Id. (citations omitted).
\item In re Mediators, Inc., 105 F.3d 822, 825-26 (2d Cir. 1997).
\item 11 U.S.C. § 541(a) (2012).
\end{enumerate}
\end{footnotesize}
bankruptcy estate has an identical interest in that claim.\(^{34}\) This means that when in pari delicto would bar one person from bringing claims against another, if that first person files for bankruptcy, the bankruptcy trustee will likewise be barred.\(^{35}\) Thus, even though Picard himself was not in pari delicto with any of the financial institution defendants, the defense still applies to lawsuits he brings against such parties on behalf of the estate of BLMIS.

Third, although in pari delicto is typically an affirmative defense in state courts, under federal law it goes further and deprives a trustee of standing to bring the claim at all.\(^{36}\) As a result, when a corporation that has engaged in fraud files for bankruptcy, the in pari delicto doctrine denies the bankruptcy trustee standing to bring claims against those that assisted the debtor in perpetrating the fraud.

In 2010, the New York Court of Appeals decided in one opinion two consolidated cases dealing with the policy implications of the doctrine of in pari delicto and the imputation of fraud to a corporation. These cases arose out of litigation involving losses suffered by Refco, Inc. and American International Group, Inc. (AIG) due to misstatements on their respective financial statements.\(^{37}\) In the Refco case, Refco filed for bankruptcy, and a litigation trust vested with causes of action “possessed by Refco prior to its bankruptcy filing” was created to bring suit against Refco’s corporate insiders and professional services firms, including investment banks, accounting firms, and law firms, that were deemed complicit in Refco’s collapse.\(^{38}\) In the AIG case, stockholders suing derivatively brought a claim on behalf of AIG against its accountants alleging that AIG “sold to other companies insurance policies that did not


\(^{36}\) Picard v. HSBC Bank PLC, 454 B.R. at 29 (citing Wagoner, 944 F.2d at 118).

\(^{37}\) Kirschner v. KPMG LLP, 938 N.E.2d 941, 945, 948-50 (N.Y. 2010).

\(^{38}\) Id. at 946.
involve the actual transfer of insurable risk, with the improper purpose of helping those companies report better financial results . . . resulting in serious harm to AIG.”

In both cases, the plaintiffs urged the New York Court of Appeals to create an exception to the principle that fraud committed by corporate officers is imputed to the corporation and thereby make claims by the corporation, either in a derivative suit or by a litigation trust, susceptible to the in pari delicto defense. The court noted that the “case reduces down to whether, and under what circumstances . . . New York common law [permits] corporations to shift responsibility for their own agents’ misconduct to third parties.” The plaintiffs alleged that where the beneficiaries of such suits are innocent shareholders and creditors, and the goal of such suits is the possibility of deterring third-party professionals in the future from aiding and abetting misconduct or acting negligently, that such suits should be permitted to proceed.

The court rejected these arguments, however, and upheld the imputation doctrine and the concomitant validity of the in pari delicto defense for two reasons. First, the court questioned why the interests of innocent stakeholders of the corporations, here the creditors of Refco and the shareholders of AIG, should “trump those [interests] of the innocent stakeholders of the outside professionals who are the defendants in these cases.” Put into the context of the Madoff case, the court wondered why someone who purchased stock in JPMorgan Chase & Co. (JPM) should have to pay the debts of a person who invested money in BLMIS. This would create “a double standard whereby the innocent stakeholders” of the defendants “are held responsible for the sins of their errant agents while the innocent stakeholders of the corporation itself are not charged with knowledge of their wrongdoing agents.” Put again into the context of the Madoff case, why should the shareholders of UBS AG (UBS), who elect a board of directors that—through diverse means—hired bankers that set up feeder funds to funnel money into BLMIS, pay the claims of those who entrusted their money to Madoff, who then used their money to

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39 Id. at 949. AIG is alleged to have suffered a $3.5 billion loss in stockholder equity and to have been forced to pay $1.6 billion in fines. The accountant is alleged to have failed to properly audit AIG. Id.
40 Id. at 954.
41 Id. at 957.
42 Id. at 957-58.
43 Id. at 958-59.
44 Id. at 958.
45 Id.
pay the claims of old investors and lure new investors into the
scheme, while promising every investor a patently unrealistic
rate of return? This is especially true given that, in the dealings
between people like Madoff and third-party entities like UBS and
JPM, the scheme principal “almost invariably play[s] the
dominant role in the fraud and therefore [is] more culpable than
the outside professional’s agents who allegedly aided and abetted
the insiders or did not detect the fraud at all or soon enough.”46

Second, the court noted that permitting such claims to
go forward against the defendants might not “produce a
meaningful additional deterrent to professional misconduct or
malpractice.”47 The court cited Arthur Andersen, Enron’s former
accountant, as a counterexample to the proposition that the in
pari delicto defense offers third parties a “get-out-of-jail-free
card.”48 The court also cited settlements achieved in the Refco
and AIG cases under the Securities Act of 1933 and the
Securities Exchange Act of 1934 as examples of legislatively
crafted devices to impose liability on third parties.49 In short,
there was already reason for third parties to avoid aiding and
abetting others in fraud, and the judicial creation of yet another
avenue to heap liability onto these parties was not necessary.

B. The Supreme Court’s Caplin Holding

One might think that it is immaterial whether a debtor,
through its bankruptcy trustee, could bring a claim against
those that aided and abetted the debtor in fraud as it is the
creditors of the debtor, or the customers of entities like BLMIS,
that stand to benefit from such suits. The trustee could simply
sue on behalf of these creditors, who were not in pari delicto
with the defendants, rather than the debtor itself and avoid the
entire issue. However, the Supreme Court’s holding in Caplin v.
Marine Midland Midland Trust Co. of New York prohibits this.

In Caplin, Webb & Knap (Webb), a corporation engaged
in real estate transactions, executed in 1954 an indenture with
Marine Midland Trust Company (Marine) providing for the
issuance of five percent debentures with a face value of
$8,607,600.50 To help ensure repayment, the indenture included
a covenant requiring Webb to maintain an asset to debt ratio of

46 Id.
47 Id.
48 Id.
49 Id.
at least two to one.\textsuperscript{51} Webb was also required to file an annual certificate with Marine indicating compliance with all provisions of the indenture, including the asset to debt ratio covenant.\textsuperscript{52} In 1959, Webb began losing money, and in 1965 it filed for relief under the Bankruptcy Act.\textsuperscript{53}

The bankruptcy trustee commenced an investigation of Webb’s affairs and discovered that Webb had been violating the asset to debt ratio covenant for years\textsuperscript{54} and “Marine had either willfully or negligently failed to fulfill its obligations under the indenture.”\textsuperscript{55} The trustee alleged that Marine’s negligence made it responsible for the losses suffered by the debenture holders and filed suit on behalf of those creditors seeking to recover from Marine the full amount of their unpaid claims.\textsuperscript{56} He further argued that because he already had a statutory duty to investigate the debtor’s affairs and was overseen by the court he was the ideal party to press the creditors’ claims.\textsuperscript{57}

The Supreme Court forbade the trustee from bringing the suit and pointed out three problems with the trustee’s strategy. First, the relevant bankruptcy laws commanded the trustee to investigate the affairs of the debtor and to pursue causes of action available to the estate, but did not command or authorize the pursuit of the causes of action of third parties, such as the debenture holders’ right to sue Marine for breaching its duty to them under the indenture.\textsuperscript{58}

Second, a creditor’s claim against Marine would be the difference between what that creditor was owed by the debtor and what it received in distributions from the bankruptcy estate.\textsuperscript{59} As that amount could not be determined until the bankruptcy proceeding was in its advanced stages, the Court did not see a reason for the trustee to represent the debenture holders.\textsuperscript{60} By the time the estate made its final distribution, the trustee’s job would be almost complete and the debenture holders could select their own attorneys in the lawsuits they

\textsuperscript{51} Id. at 418.
\textsuperscript{52} Id.
\textsuperscript{53} Id.
\textsuperscript{54} The trustee discovered that Webb had assets of approximately $21 million and liabilities of approximately $60 million, “plus [additional] contingent tax liabilities” of almost $30 million. Id. at 419.
\textsuperscript{55} The trustee found that Webb breached the indenture from 1958 onward and that its certifications were breached on “grossly overvalued appraisals” of Webb’s real property holdings. Id.
\textsuperscript{56} Id. at 419-20.
\textsuperscript{57} Id. at 428.
\textsuperscript{58} Id.
\textsuperscript{59} Id. at 431.
\textsuperscript{60} Id.
independently brought. Additionally, Marine might have a claim to be subrogated to the debenture holders’ claims. This would mean that Marine could seek to recover from the bankruptcy estate whatever it paid out to debenture holders, subject to the limitation that it would be paid nothing until other creditors were paid in full. As a result, no benefit would accrue from the litigation to the bankruptcy estate; every dollar that came in from Marine to satisfy debenture holder claims would create another dollar in claims against the estate in favor of Marine. The net result would be a simple reprioritization of claims between the debenture holders and Marine.

Third, the trustee admitted that he lacked the ability to bind debenture holders with any judgment he obtained. In other words, while the trustee pursued his suit, nothing prevented debenture holders from filing their own suits against Marine for the same losses. Since the trustee and all the individual debenture holders would be unlikely to “agree on the amount of damages to seek, or even on the theory on which to sue,” there was a substantial risk of inconsistent or duplicative recoveries. The Court therefore concluded that “there is no showing whatever that by giving [the trustee] standing to sue on behalf of the debenture holders” that the amount of litigation would be reduced. Instead, there was “every indication that litigation would be increased, or at least complicated.”

In language bordering on an advisory opinion, however, the Court suggested that the holding “does not mean that it would be unwise to confer such standing on trustees in reorganizations” and noted that Congress could “well decide” to do just that. In 1978, six years after the Caplin decision, Congress passed the Bankruptcy Code. The House of

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61 Id.
62 Id. at 430.
63 See id.
64 See id. Note though that since the estate almost certainly lacked the assets to pay all claims in full, as there would be little reason for the trustee to file the lawsuit or for Marine to contest it if this were not the case. Another way of characterizing the result is the allocation of the debenture holders’ losses to Marine, a party arguably both culpable for their losses and in a superior position to prevent such losses in future cases. Certainly the investors who received payment of their claims in full rather than a pro rata distribution from the estate would see the distinction between effecting and not effecting the trustee’s plan.
65 Id. at 431-32.
66 Id. at 432.
67 Id. at 434.
68 Id.
69 Id. at 434.
70 Mixon v. Anderson (In re Ozark Restaurant Equipment Co.), 816 F.2d 1222, 1227 (8th Cir. 1987).
Representatives considered legislation that would have expanded the powers of bankruptcy trustees and overruled Caplin. But the provision was deleted in a reconciliation of the House and Senate versions of the Bankruptcy Code. As a result, “Caplin is still good law and is the only Supreme Court case” that addresses the issue of when a bankruptcy trustee has standing to assert causes of action on behalf of the creditors of a bankruptcy estate.

Caplin thus stands for the broad proposition that a bankruptcy trustee can only litigate causes of action that belong to the bankruptcy estate and whose benefit therefore accrues to the estate as a whole.

C. The Ninth Circuit’s Holding in Williams v. California 1st Bank

The holding of Caplin has been extended to forbid a trustee from taking assignment of creditor claims in the hope of undermining at least one of the justifications for the holding in that case. In Williams v. California 1st Bank, the debtor ran a business that both distributed Mexican seafood and offered investment contracts with a 10% monthly rate of return. In an unshocking turn of events, the debtor’s seafood/money management business was actually a Ponzi scheme, and it was forced into bankruptcy after the scheme collapsed in 1984. The bankruptcy trustee took a voluntary assignment from 111 of the creditors who had invested money with the debtors of their claims against California 1st Bank (the Bank) for the Bank’s role in aiding and abetting the debtor’s scheme. The creditors that did not assign their claims would not participate in any recovery from the action against the Bank.

71 Id. at 1227 n.9 (citing H.R. 8200, 95th Cong., 1st Sess. 416-17 (1977)). The provision would have permitted a trustee to bring a cause of action on behalf of creditors or equity security holders if the trustee could not bring the case under any other provision of the Bankruptcy Code, the recovery would reduce the creditor or security holder’s claims against the estate, the suit would “not create an allowable claim in favor of the defendant against the estate, and the suit was “in the best interest of the estate.”
72 Id. at 1228 n.10.
73 Id. at 1228.
74 859 F.2d 664 (9th Cir. 1988).
75 Id. at 665. Although hindsight is 20/20, it is hard to see how people were not more wary of a fishmonger offering to double their money every eight months.
76 Id.
77 Id. The trustee “alleg[ed] state and federal securities law violations arising from the Bank’s participation in, knowledge of, or approval of the debtor’s ‘Ponzi’ scheme.” Id.
78 Specifically, the trustee planned to use any recovery from the Bank to pay administrative and priority claims of the bankruptcy estate, both of which are entitled to a higher priority under the Chapter 7 distribution scheme than the claims of general unsecured creditors. The trustee would then use the remaining funds to make a pro
The Ninth Circuit rejected this proposition and held that “Caplin and its progeny control this case” and “the mere fact of assignment . . . [does not] . . . sufficiently distinguish[] this case [from Caplin] to allow . . . a different result.”79 First, it noted that the creditors were the true party in interest, and the trustee could not bring suit for anything other than to collect money owed to the estate.80 The creditors thus “assigned their claims only for purposes of bringing suit.”81 Second, as in Caplin, the defendant might have a claim of equitable subordination against the estate, meaning that no benefit would accrue to the estate from the trustee’s actions.82 Third, since the trustee did not obtain assignment of all claims, there was a heightened risk of inconsistent results between the assigned and unassigned claims.83 Finally, Congress amended the Bankruptcy Code in 1978, six years after Caplin was decided, and could have amended the Code had it been displeased with the holding of Caplin.84 The court interpreted congressional inaction as a sign of approval.85

Williams thus stands for the proposition that a trustee cannot get around the holding of Caplin, which states that a trustee can only litigate claims that belong to the estate by rata distribution to assigning creditors. Further, the trustee would request that the court forbid non-assigning creditors from receiving any funds from the funds recovered from the Bank. Id. 79 Id. at 666. 80 Id. at 666-67. 81 Id. at 667. 82 Id. As in Caplin, the court ignored the fact that since the bankruptcy estate likely lacked the funds to pay all creditors in full, this would have the effect of imposing a disproportionate amount of the difference between the debtor’s assets and its liabilities on the Bank. However, apparently assuming that the investors could obtain judgments for both their losses and their costs in a state or federal court, the court concluded that “the investors’ total judgments will not be affected by the ultimate division of liability between the estate and [the Bank], it is as difficult here as it was in Caplin to see ‘what advantage there is in giving [the trustee] standing to sue[,]’” Id. (quoting Caplin v. Marine Midland Grace Trust Co. of N.Y., 406 U.S. 416, 430 (1972)). 83 Id. The reasoning on this point has been criticized since “[t]he potential for conflict between the trustee’s pursuit of the assigned claims and the pursuit of the unassigned claims by the creditors who retained them is no greater than, and is probably less than, the potential for such conflict that existed among all of the creditors prior to the assignment.” Collins v. Kohlberg & Co. (In re Sw. Supermarkets, L.L.C.), 315 B.R. 565, 570 n.10 (Bankr. D. Ariz. 2004). Since this explanation was given in Caplin, “perhaps the Ninth Circuit felt itself bound by that rationale even if it made little sense.” Id. 84 Williams v. Cal. 1st Bank, 859 F.2d 664, 667 (9th Cir. 1988); see also Mixon v. Anderson (In re Ozark Restaurant Equipment Co.), 816 F.2d 1222, 1227 (8th Cir. 1987). 85 Williams, 859 F.2d at 667. The Eighth Circuit reached the same conclusion in a similar case. In re Ozark Restaurant, 816 F.2d 1222 (where the trustee sought to sue the directors and officers of the bankrupt corporation under § 544 of the Bankruptcy Code, but the court reasoned that § 544 was not on point and Caplin forbid any contrary holding).
having the estate take assignment of those claims. It also stands for the notion that even if trustees could take assignment of creditor claims, they should not do so where they represent less than all of the creditors with such claims.

D. The Wagoner Rule

The scope of Caplin’s application has also been enhanced by the Wagoner Rule, derived from the case of Shearson Lehman Hutton v. Wagoner, which provides that claims against a third party for defrauding a corporation with the assistance of the corporation’s management accrue to the corporation’s creditors, not to the corporation. In that case, an individual named Herbert Kirschner formed a corporation to engage in stock trades. He funded his investment activities by having his corporation take out loans and issue notes to members of his church. However, because he was neither licensed nor registered as a broker or investment adviser, the trades he made with these funds were illegal.

Kirschner conducted his stock trades through accounts his corporation opened with Shearson/American Express (Shearson), and Shearson took a commission on each trade. Shearson became suspicious that Kirschner’s corporation was illegally trading with borrowed funds, but took no action following representations from Kirschner to the contrary. After Kirschner suffered significant losses in the stock market, he put his company into bankruptcy. The bankruptcy trustee filed suit against Shearson on behalf of the debtor alleging that Shearson facilitated the corporation’s risky investments to earn itself commissions and thus bore responsibility for those losses. Although the logic behind Shearson’s liability was similar to that of Marine’s in Caplin, here the trustee was suing on behalf of the debtor rather than the debtor’s creditors.

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86 944 F.2d 114 (2d Cir. 1991).
87 Id. at 116.
88 Id.
89 Id.
90 Id.
91 Id. at 116-17.
92 Id. at 117-18. Although Shearson may have been unduly credulous with Kirschner, the in pari delicto defense does not seem to be on point as this was not a dispute between two wrongdoers. However, there remains some confusion as to the scope of the Wagoner Rule as compared to the scope of the in pari delicto defense. See Kirschner v. KPMG LLP, 15 N.Y.3d 446, 458, (2010); see also id. at 478 n.1 (Ciparick, J. dissenting).
The court held that a claim against a third party for defrauding a corporation with the assistance of the corporation’s management accrues to the corporation’s creditors, not to the corporation or its bankruptcy estate.\(^{94}\) As a result, under the so-called Wagoner Rule, even though Shearson’s actions caused harm to the corporation by depleting its assets, only the corporation’s creditors had standing to bring claims against Shearson.\(^{95}\) This made it a case where the trustee was suing on behalf of the estate’s creditors. Thus, the Caplin holding barred the claims.\(^{96}\)

The Wagoner Rule has been applied to a wide variety of conduct,\(^{97}\) and when a trustee files suit on behalf of a debtor, the rule can be used by defendants as a means of “scor[ing] an early knock-out by moving to dismiss . . . on the grounds that the trustee, standing in the shoes of the . . . debtor, lacks standing to sue on such claims.”\(^{98}\) As late as 2010, the New York Court of Appeals applied the Wagoner Rule and reinforced the proposition that trustees lack standing even if they are assigned the claims by creditors.\(^{99}\)

E. The Application of These Doctrines in the Madoff Case

To make clear how these concepts operate, this section will describe how they were applied in the Madoff proceedings. As noted in the introduction, Irving Picard filed suits against four large financial institutions and their affiliates\(^{100}\) alleging that they knew of and were complicit in Madoff’s fraud, and were thereby liable to BLMIS customers. This section will describe the claims Picard made against three of these

\(^{94}\) *Wagoner*, 944 F.2d at 120.

\(^{95}\) In a more typical bankruptcy case, a bankruptcy trustee can sue for any causes of action that the debtor possesses and such causes of action do not accrue to another party. *Id.* at 118.

\(^{96}\) *Id.* at 119-20; Official Comm. of Unsecured Creditors of Grumman Olson Indus., Inc. v. H.I.G. Capital LLC (In re Grumman Olson Industries), 329 B.R. 411, 424 n.5 (Bankr. S.D.N.Y. 2005) (referring to Wagoner as the “Wagoner Rule” and explaining that while quite similar to in pari delicto, the latter is an affirmative defense while the Wagoner Rule is an issue of standing).


\(^{98}\) *Id.* at 4.


\(^{100}\) Picard v. JPMorgan Chase & Co. (In re Bernard L. Madoff Inv. Sec. LLC), 721 F.3d 54, 59 (2d Cir. 2013) The financial institutions were JPMorgan Chase & Co., UBS AG, UniCredit Bank Austria AG, and HSBC Bank plc.
financial institutions\textsuperscript{101} and how the legal concepts described in Part I defeated the suits.

1. Claims Made Against JPMorgan Chase Bank N.A.
and Affiliates

J.P. Morgan Chase & Company and three affiliates\textsuperscript{102} were first accused of maintaining a checking account into which Madoff deposited “hundreds of billions of dollars of customer money,” paying JPM “an estimated half billion dollars in fees, interest payments, and revenue . . . .”\textsuperscript{103} In his complaint, Picard alleged dozens of reasons why JPM should have determined from monitoring Madoff’s checking account that Madoff was not running a legitimate investment advisory business.\textsuperscript{104} These included “repeated transactions with the same parties, often on the same days, with no obvious purpose,” $84 billion transferred to just four customers, and suspicious spikes in activity.\textsuperscript{105} JPM thus “had everything it needed to unmask and stop [Madoff’s] fraud . . . .”\textsuperscript{106} In addition, JPM was accused of enabling Madoff’s fraud by selling approximately $250 million in structured products that invested in BLMIS.\textsuperscript{107} JPM also extended approximately $145 million in credit to BLMIS.\textsuperscript{108}

\textsuperscript{101} A discussion of the suit against UniCredit S.p.A. was omitted as the facts are substantially similar to those in the UBS and HSBC suits.

\textsuperscript{102} These three affiliates were JPMorgan Chase Bank, N.A., J.P. Morgan Securities LLC, and J.P. Morgan Securities Ltd. Picard v. JPMorgan Chase & Co., 721 F.3d at 59 n.4.

\textsuperscript{103} Id. at 59-60.


\textsuperscript{105} Id. at 71.

\textsuperscript{106} Id. at 2; see also Picard v. JPMorgan Chase & Co., 721 F.3d at 60. Picard’s complaint also details a multitude of examples where JPM personnel were either discussing or performing due diligence on BLMIS and mentioned the strong possibility that Madoff was a fraud. See, e.g., JPM Complaint at 33-36 (discussing concerns that arose while JPM assessed the risks surrounding structured products that invested in BLMIS). Picard’s complaint also details various regulatory measures to prevent fraud and money laundering that JPM violated in connection with Madoff’s bank account. See, e.g., JPM Complaint at 61-62 (discussing how JPM ignored irregularities in reports BLMIS filed with the SEC).

\textsuperscript{107} JPM Complaint at 121. In a structured product, an investor would put up a sum of money, say $100, while JPM would lend them additional money to leverage this initial investment, say $200, and the total would be invested in BLMIS. The return on the investment is split between the bank and the investor. The investor gets a return on his investment based on a multiple of his initial investment (e.g. 6% of $300 rather than $100), while the bank gets fee and interest income and the returns above and beyond what the investor has contracted to receive (e.g. the investor contracted for 6% but BLMIS pays out 9.5%). Id. at 29.

\textsuperscript{108} Id. at 78-81. Given that a Ponzi scheme should not have much by way of operating expenses, one could presume that this money was used to fund redemptions
Although Picard filed suit against JPM for 28 causes of action, the first 20 were for preferential and fraudulent transfers under §§ 544, 547, and 548 of the Bankruptcy Code. The heart of Picard’s complaint are six of the final causes of action, which sought damages under state common law for (1) knowing participation in a breach of trust, (2) aiding and abetting fraud, (3) aiding and abetting breach of fiduciary duty, (4) conversion, (5) aiding and abetting conversion, and (6) fraud on the regulator. These causes of action alleged that JPM either knew or was willfully blind to Madoff’s fraud and its failure to take action “proximately caused the fraud that resulted in billions in damages to customers, creditors, and/or BLMIS.” In particular, Picard alleged in the conversion claim that all money Madoff deposited into the JPM bank account, which was “[f]rom 1986 on, all of the money that Madoff stole from his customers,” was converted and JPM was liable both for this conversion and for aiding and abetting same. In total, the trustee sought $19 billion in damages for these causes of action.

2. Claims Made Against UBS AG and Affiliates

Two hedge funds known as Luxalpha SICAV and Groupement Financer Ltd. together invested approximately $2 billion with BLMIS. UBS AG and three affiliates served as “sponsor, manager, administrator, custodian, and primary banker” for these two funds. Although this would have typically involved imposing substantial responsibilities on UBS, in actuality UBS simply outsourced all of these responsibilities by customers. Had the credit not been extended, Madoff may have been forced to confess his fraud at an earlier date.

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109 Id. at iii-v.
110 Id. at v.
111 Id. at 118 (discussing the aiding and abetting fraud claim); see also id. at 122-26 (discussing the aiding and abetting breach of fiduciary duty claim); id. at 132-38 (discussing the same for the fraud on the regulator claim).
112 Id. at 2.
113 Id. at 127.
114 Id. at 145. Note that given the theory of the conversion claim, that JP Morgan converted all money invested with Madoff, it could be liable for all money lost by investors in the scheme.
116 The four entities were UBS AG, UBS (Luxembourg) S.A., UBS Fund Services (Luxembourg) S.A., and UBS Third Party Mgmt. Co. S.A. Picard v. JPMorgan Chase & Co. (In re Bernard L. Madoff Inv. Sec. LLC), 721 F.3d 54, 60 n.6 (2d Cir. 2013).
117 Id. at 60.
to Madoff.118 By acting in these roles, UBS “enabled and perpetuated the Madoff fraud by effectively selling the UBS brand and reputation to Luxalpha and Groupement Financier in order to provide those funds with the appearance of legitimacy.”119 Because UBS’s prior research repeatedly revealed significant issues with BLMIS,120 specifically including fears that Madoff was running a Ponzi scheme,121 Picard alleged UBS took on these roles to earn fees122 and because it protected itself through various indemnity agreements.123

As with JPM, the trustee alleged a multitude of claims, many of which were for preferential or fraudulent transfers under the Bankruptcy Code.124 However, the most important claims against UBS were for (1) aiding and abetting fraud, (2) aiding and abetting breach of fiduciary duty, (3) aiding and abetting conversion, (4) conversion, and (5) knowing participation in a breach of trust.125 Because of UBS’s role, Picard alleged that it was “a proximate cause of the fraud,” and caused billions in losses to BLMIS’s customers and creditors.126 Picard sought at least $2 billion in damages.127

3. Claims Made Against HSBC Bank plc and Affiliates

HSBC Bank plc and 12 affiliates128 were accused of “direct[ing] over $8.9 billion into BLMIS’s fraudulent investment advisory business” through “a labyrinth of hedge

118 UBS Complaint supra note 115, at 40-58. For example, the custodian of a fund is “responsible for both the safekeeping of the fund’s assets and the supervision of the fund.” Id. at 42. UBS delegated this to BLMIS. Id. Similarly, a portfolio manager “assume[s] the responsibility for the active management of the fund’s assets,” but UBS also delegated this task to BLMIS. Id.
119 Id. at 44.
120 See id. at 32-40.
121 See, e.g., id. at 2, 36-37. The UBS Complaint notes that at all times, UBS refused to market funds that invested in BLMIS to its own clients. Id. at 2, 32.
122 UBS is estimated to have made approximately $80 million in fees for the work it performed, or did not perform, as it were, for the two funds. Id. at 1.
123 Id. at 45.
124 Id. at iii-iv.
125 Id. at iv.
126 Id. at 94, 97, 100, 103.
127 Id. at 122.
funds, management companies, and service providers.” As with UBS, HSBC was accused of lending its name and reputation to the hedge funds that fed money to Madoff, providing them with “an air of legitimacy.” As with UBS, HSBC was accused of knowing or being willfully blind at all times to the fact that BLMIS was not a legitimate investment business. However, unlike UBS, HSBC was accused of pushing funds that it invested with Madoff on its own clients. Picard pursued a variety of claims, but the most important ones were for aiding and abetting fraud and aiding and abetting breach of fiduciary duty. Picard requested $6.6 billion in damages against HSBC for these claims.

4. The Dismissal of Picard’s Claims against JPM, UBS, and HSBC

As of late 2013, Picard has only collected approximately $9.5 billion of BLMIS customers’ $20 billion in principal losses, and many of those customers likely hope he can make good on their approximately $67 billion in paper losses. The ability to pursue over $20 billion in claims against three large financial institutions was too good an opportunity to pass up. However, the legal doctrines discussed in Part I made these otherwise valuable claims unviable.

In the first decision issued in these matters, which involved the suit against HSBC, UniCredit S.p.A., and their affiliates, the presiding judge, Jed Rakoff, concluded that “the federal Bankruptcy Code does not itself confer standing on a bankruptcy trustee to assert claims against third

130 Id. at 93.
131 See id. at 52-84.
132 Id. at 107-10.
133 Id. at iii-iv.
134 Picard v. JPMorgan Chase & Co. (In re Bernard L. Madoff Inv. Sec. LLC), 721 F.3d 54, 62 (2d Cir. 2013).
136 Picard’s clawback suits against investors who withdrew more than they deposited with BLMIS have also been extremely controversial. See Anthony Martucci, Advocating for Asset Forfeiture in the Post-Madoff Era: Why the Government, Not a Bankruptcy Trustee, Should Be Responsible for Recovering and Redistributing Assets From Feeder Funds and Net Winners, 63 CASE W. RES. L. REV. 599, 605-07 (2012).
137 In addition to various feeder fund defendants, UniCredit S.p.A. was accused of funneling $2 billion into BLMIS. Picard v. HSBC Bank plc, 454 B.R. 25, 28 (Bankr. S.D.N.Y. 2011).
parties on behalf of the estate’s creditors.”\textsuperscript{138} This meant that pursuant to the holding of \textit{Caplin}, Picard was barred at the outset from bringing any claims that did not belong to BLMIS.\textsuperscript{139} In the next paragraph, the court noted that “a bankruptcy trustee is often barred from bringing claims on behalf of the debtor’s estate because of the common law doctrine of in pari delicto, which generally precludes a wrongdoer like [BLMIS] from recovering from another wrongdoer.”\textsuperscript{140} Because of “these two obstacles,”\textsuperscript{141} which forbade Picard from suing either on behalf of the estate or on behalf of anyone else, including BLMIS’s creditors, Picard was forced to find another legal argument to press these claims. Those tried, which are beyond the scope of this note but were rooted in the text of SIPA, were unsuccessful.\textsuperscript{142}

Similarly, in the second opinion issued, which involved the suits against JPM and UBS, Judge Colleen McMahon noted that \textit{Caplin} and the in pari delicto doctrine barred the trustee’s claims.\textsuperscript{143} Picard’s remaining arguments were either “mere reformulations of those already rejected by Judge Rakoff”\textsuperscript{144} or were otherwise rejected.\textsuperscript{145} Resultantly, the court dismissed the common law claims against JPM and UBS.\textsuperscript{146}

On appeal, the Second Circuit affirmed both decisions.\textsuperscript{147} It noted that claims on behalf of BLMIS were “barred by the doctrine of in pari delicto.”\textsuperscript{148} It then noted that under the \textit{Wagoner} Rule, any claims BLMIS had accrued to BLMIS’s creditors.\textsuperscript{149} Turning to whether Picard could “assert . . . claims on behalf of BLMIS’s [creditors],” it noted that \textit{Caplin} and its progeny control.\textsuperscript{150} In short, because of the above described

\begin{itemize}
\item \textsuperscript{138} \textit{Id.} at 29 (citations omitted).
\item \textsuperscript{139} \textit{Id.}
\item \textsuperscript{140} \textit{Id.}
\item \textsuperscript{141} \textit{Id.}
\item \textsuperscript{142} Picard first argued that he was a “bailee of the property of Madoff Securities’ customers.” \textit{Id.} Picard then argued that he had “standing to bring these claims . . . as enforcer of SIPC’s subrogation rights.” \textit{Id.} at 33. Neither argument was successful and all of the common law claims were dismissed. \textit{Id.} at 38.
\item \textsuperscript{143} \textit{Picard v. JPMorgan Chase \\& Co.}, 460 B.R. 84, 91 (Bankr. S.D.N.Y. 2011).
\item \textsuperscript{144} \textit{Id.} at 92.
\item \textsuperscript{145} The trustee argued that 11 U.S.C. § 544(a) gave him the authority to press these claims, but the court rejected this argument as this interpretation of the statute “would undermine the limitations on trustee standing established by \textit{Caplin} and enforced by courts in this and other circuits for nearly forty years.” \textit{Id.}
\item \textsuperscript{146} \textit{Id.} at 106.
\item \textsuperscript{147} \textit{Picard v. JPMorgan Chase \\& Co. (In re Bernard L. Madoff Inv. Sec. LLC)}, 721 F.3d 54, 58 (2d Cir. 2013).
\item \textsuperscript{148} \textit{Id.} at 63.
\item \textsuperscript{149} \textit{Id.}
\item \textsuperscript{150} \textit{Id.} at 66, 67. The court further noted that nothing in either SIPA or the Bankruptcy Code made this case a special situation. \textit{Id.} at 67-77 (discussing the
doctrines, Picard could not press any claims against the financial institution defendants for the losses they allegedly inflicted or helped to inflict on customers of BLMIS. Although these customers could bring their own suits against the financial institution defendants,\textsuperscript{151} because Picard has already recovered “more than 54% of the currently estimated principal lost in [Madoff’s] Ponzi scheme,”\textsuperscript{152} such individual customers may not have sufficiently large damages to make these suits worth pursuing.

II. AN ANALYSIS OF BANKRUPTCY TRUSTEES AND ADEQUATE REPRESENTATION OF ESTATE CREDITORS

At this point, one might think that all that is standing in the way of a full recovery for creditors in the position of BLMIS customers is the doctrine of in pari delicto and the holding of Caplin. However, this section will argue that as the Bankruptcy Code is currently constructed, even if a judge were willing to lift either or both of these bars, trustees such as Picard should nonetheless not be permitted to proceed, as there is no way these trustees could provide creditors with adequate representation. Specifically, an analysis of the law surrounding class action litigation and the representation of non-parties to a suit demonstrates that trustees who brought suits currently barred by Caplin would be forced to unfairly distribute the proceeds of any judgments obtained.

A. The Due Process Clause Requirements to Bind Non-Parties to Litigation

“It is a principle of general application in Anglo-American jurisprudence that one is not bound by a judgment \textit{in personam} in a litigation in which he is not designated as a party or to which he has not been made a party by service of process.”\textsuperscript{153} The enforcement of a judgment against a person who was not a party to litigation violates the due process application of \textit{Redington v. Touche Ross & Co.}, 592 F.2d 617 (2d Cir. 1978), Picard’s theory under § 544 and \textit{St. Paul Fire & Marine Ins. Co. v. PepsiCo., Inc.}, 884 F.2d 688 (2d Cir. 1989), Picard’s bailment theory, and his theory on standing as the representative of SIPC as subrogee. A discussion of these theories would be beyond the scope of this note even if the Second Circuit had not rejected each one as invalid.

\textsuperscript{151} \textit{Id.} at 76 n.29.
\textsuperscript{152} \textit{Interim Report, supra} note 135, at 5.
\textsuperscript{153} \textit{Hansberry v. Lee}, 311 U.S. 32, 40 (1940) (citing Pennoyer v. Neff, 95 U.S. 714 (1878)).
clauses of the Fifth and Fourteenth Amendments. In 2008, the Supreme Court explicated in the case of *Taylor v. Sturgell* the six exceptions to this concept.

First, non-parties may agree “to be bound by the determination of issues in an action between others.” For example, where a defendant faces identical claims from numerous plaintiffs, one plaintiff may file a “test case,” and other plaintiffs “may agree that the question of the defendant’s liability will be definitely determined” in that proceeding. Second, non-parties may be bound by “pre-existing substantive legal relationship[s],” such as “preceding and succeeding owners of property, bailee and bailor, and assignee and assignor.” Third, “in certain limited circumstances, a nonparty may be bound by a judgment because she was adequately represented by someone with the same interests who was a party to the suit.” This includes class actions and “suits brought by trustees, guardians, and other fiduciaries.” Fourth, a non-party may be “bound by a judgment if [it] assume[d] control over the litigation in which [a] judgment was rendered.” Fifth, a non-party may be bound where it brings suit by proxy, either through a representative or an agent. Sixth, “in certain circumstances a special statutory scheme,” such as “bankruptcy and probate proceedings” may bind non-parties “if the scheme is otherwise consistent with due process.”

A bankruptcy trustee authorized to bring suit on behalf of estate creditors, notwithstanding the holding of *Caplin*, could only do so under the sixth category, pursuant to bankruptcy’s status as a special statutory scheme, or the third category, a suit by a party with the same interests. However,

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154 Id. at 41 (citations omitted).
155 Id. at 880, 893 (2008). In *Taylor v. Sturgell*, the petitioner had filed a Freedom of Information Act lawsuit “seeking certain documents from the Federal Aviation Administration.” A friend of his had previously filed a similar lawsuit seeking the same documents, but the suit was unsuccessful. The lower courts had held that the petitioner was bound by the judgment entered in the prior lawsuit, but the Supreme Court reversed, holding that absent one of the explicated categories of representation, a prior judgment cannot bind a party. Id. at 885-87.
156 Id. at 893 (citations omitted).
157 Id. (citations omitted).
158 Id. at 894 (citations omitted).
159 Id. (citations omitted) (quotation marks omitted) (brackets omitted).
160 Id. (citations omitted).
161 Id. at 895 (quoting Montana v. U.S., 440 U.S. 147, 154 (1979)).
162 Id.
163 Id. (citations omitted).
164 A trustee would not be bringing a test case under the first category, there is no pre-existing substantive relationship under the second category, the creditor would not be assuming control over the suit under the fourth category, and it would not be a suit by proxy under the fifth category.
if and until the Bankruptcy Code provides explicit authorization for a trustee to file suits on behalf of estate creditors, the trustee is only acting under the third category. Thus, for the trustee to bring suit on behalf of estate creditors, he must provide those creditors with adequate representation as defined by case law on the issue.

Adequate representation requires that “the original plaintiffs [understand] themselves to be acting in a representative capacity and that there [are] . . . special procedures to safeguard the interests of absentees.” So for example, in Taylor v. Sturgell the Supreme Court rejected the concept of “virtual representation” for, inter alia, finding that a party’s representation of the interests of a non-party is not adequate if, at a minimum, their interests are not aligned and the non-party’s interests are not protected. The Court further noted that Federal Rule of Civil Procedure 23 safeguards adequate representation in the context of class action litigation. This is meant to ensure that a non-party receives due process. Resultantly, case law on class actions could be especially informative in determining what it would take for a bankruptcy trustee to adequately represent estate creditors in a suit against culpable third parties.

B. Adequate Representation in the Context of Class Actions

The Supreme Court’s most recent case on class actions, Wal-Mart Stores, Inc. v. Dukes, provides the best starting point. In Dukes, three women who had worked for Wal-Mart at various stores throughout the U.S were serving as the lead plaintiffs for a class of 1.5 million female employees alleged to have been denied equal pay or promotions on account of their

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165 See Mixon v. Anderson (In re Ozark Restaurant Equipment Co.), 816 F.2d 1222, 1227 (8th Cir. 1987).
166 Taylor, 553 U.S. at 894-95 (citations omitted).
167 Id. at 897-98 (citing S. Cent. Bell Tel. Co. v. Alabama, 526 U.S. 160 (1999)).
168 For virtual representation to be permissible, the party must meet a seven factor test which requires a showing that a non-party had (1) an “identity of interest” with the party; (2) a “close relationship” with the bound party; (3) participated “in prior litigation by the party”; (4) gained the party’s “apparent acquiescence”; (5) deliberately “maneuver[ed] to avoid the effect of [a] judgment”; (6) “adequate representation”; and (7) “a suit raising ‘public law’ rather than ‘private law.’” Id. at 888 (quoting Tyus v. Schoemehl, 93 F.3d 449 (1996)). Other Circuits had applied their own inconsistent tests and decisions. Id. at 895.
169 Id. at 900 (citing Hansberry v. Lee, 311 U.S. 32, 43 (1940)).
170 Id. at 900-01.
sex in violation of Title VII of the Civil Rights Act. The lead plaintiffs claimed that the harm they suffered was “common to all Wal-Mart’s female employees.”

The Supreme Court noted that the crucial issue in the case was commonality under Federal Rule of Civil Procedure 23(a)(2), which requires “a plaintiff to show that there are questions of law or fact common to the class.” The Court noted that “any competently crafted class complaint” can raise common questions. Commonality instead requires a showing that all class members “have suffered the same injury.” This demonstrates “that all of their claims can productively be litigated at once.” A showing that all plaintiffs “suffered a violation of the same provision of the law” does not make this showing. Instead, a class must be able to “generate common answers . . . to drive the resolution of the litigation.” In suing over “millions of employment decisions at once,” the plaintiffs would need to demonstrate “some glue holding the alleged reasons for all these decisions together” which would produce “a common answer to the crucial question [of] why was [each individual plaintiff] disfavored.”

The plaintiffs were unable to identify a company-wide policy or single means by which each of them had suffered

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172 Id. at 2547-48 (one plaintiff claimed to have been demoted and fired in retaliation for invoking internal complaint procedures claiming discrepant treatment from male employees; another claimed to have been frequently disciplined and told to work on her physical appearance; a third claimed to have been denied opportunities to train for management positions).

173 Id. at 2548.

174 Id. at 2550-51 (quoting FED. R. CIV. P. 23(a)(2)). Before the United States District Court for the Northern District of California, the plaintiffs had put forth “statistical evidence about pay and promotion disparities between men and women” at Wal-Mart, anecdotal reports of sexual discrimination from about 120 female employees, and sociological testimony from an expert witness that found a company culture “vulnerable to gender discrimination.” Id. at 2549. The District Court certified the class and the Court of Appeals for the Ninth Circuit affirmed. Id. at 2549-50.

175 Id. at 2551. As examples, the court noted that all plaintiffs worked for Wal-Mart, all Wal-Mart managers had discretion over pay, and discriminating against women is an unlawful practice. Id.

176 Id. (quoting Gen. Telephone Co. of Sw. v. Falcon, 457 U.S. 147, 157 (1982)).

177 Id.

178 Id.

179 Id. (quoting Richard A. Nagareda, Class Certification in the Age of Aggregate Proof, 84 N.Y.U. L. REV. 97, 131-32 (2009)). To do so, the court would want “some glue holding the alleged reasons for those decisions.”

180 Id. at 2552 (emphasis omitted). Since Wal-Mart had an announced policy forbidding sexual discrimination and punished denials of equal opportunity, the plaintiffs had to rely on the expert testimony about Wal-Mart’s corporate culture to show a policy of discrimination. Id. at 2553. Although the expert testified that Wal-Mart’s culture was vulnerable to “gender bias,” he could not calculate with any accuracy how often gender bias played a role in employment decisions. Id.
harm.\textsuperscript{181} “Merely showing that Wal-Mart’s policy . . . produced an overall sex-based disparity” did not suffice for showing that each plaintiff suffered identically under the policy in such a way that they could be joined together as a class.\textsuperscript{182} As a result, class certification was denied, meaning that the three lead plaintiffs could not bring a suit on behalf of all women allegedly harmed by Wal-Mart policies, and each of the 1.5 million women either had to sue individually or form smaller classes that did possess commonality.\textsuperscript{183}

The holding of \textit{Wal-Mart v. Dukes} is more than a mere pleading standard for class action complaints. Instead, it is the Supreme Court’s interpretation of what is required under the due process clause of the Fifth Amendment for non-parties to be bound by a judgment in the context of a class action suit.\textsuperscript{184} Thus, compliance with the concept of “common answers” would be required not only if a bankruptcy trustee were suing on behalf of estate creditors in his capacity as a trustee under the third category explicated in \textit{Taylor},\textsuperscript{185} but would also be required if the Bankruptcy Code, a “special statutory scheme” under the sixth category of \textit{Taylor},\textsuperscript{186} were revised to permit trustees to bring such suits.\textsuperscript{187} This would remain true whether the trustee sued on the creditors behalf, which would require a reversal of \textit{Caplin}, or through the vehicle of the bankruptcy estate, which would require the abrogation of the doctrine of in pari delicto.

\textsuperscript{181} Id. at 2554-55. Since Wal-Mart delegated pay and promotion decisions to local managers, it was quite possible that some managers had engaged in sexual discrimination. Id. at 2555. But showing that some managers did this did not demonstrate that other managers did, and therefore did not show that the entire 1.5 million class members had suffered in this way. Id. at 2554. Moreover, statistical evidence showing that female employees at Wal-Mart may have been discriminated against, based upon pay and promotion data, did not show that each individual employee had been discriminated against in the same way. Id. at 2555. The court noted that at each individual store, managers could claim varying reasons for failing to promote women, such as the number, quality, and ambition of their female employees. Id.

\textsuperscript{182} Id. at 2555-56.

\textsuperscript{183} Id. at 2561.

\textsuperscript{184} Id. at 2559 (noting that in a class action, non-party class members lose their right to sue because the lead plaintiffs litigate for them, so this mechanism must comply with the Due Process Clause); see also \textit{Taylor v. Sturgell}, 553 U.S. 880, 900-01 (2008) (stating that Fed. R. Civ. P. 23 ensures adequate representation in the class action context).

\textsuperscript{185} \textit{Taylor}, 553 U.S. at 895-96.

\textsuperscript{186} Id. at 896.

\textsuperscript{187} See \textit{In re Johns-Manville Corp.}, 600 F.3d 135, 154, 158 (2d Cir. 2010) (holding that bankruptcy’s status as a special statutory scheme does not exempt it from the due process clause in actions \textit{in personam}); see also \textit{DPWN Holdings (USA), Inc. v. United Air Lines, Inc.}, 871 F. Supp. 2d 143, 154 (E.D.N.Y. 2012) (holding that scope of discharge in Chapter 11 cases was subject to Due Process Clause); \textit{In re General Motors Corp.}, 407 B.R. 463, 520 n.143 (Bankr. S.D.N.Y. 2009) (same).
C. A Trustee in Picard’s Position Cannot Provide Adequate Representation to the Estate’s Creditors

Using the Madoff proceedings again as an example, were Picard to represent customers of BLMIS in a lawsuit against culpable third party financial institutions, doing so would bind the non-party customers in personam and would therefore have to provide those customers with adequate representation, which would require a “common answer” to a common question of law or fact. In the case of BLMIS, while each customer has a common question of law or fact, namely that he was defrauded by a Ponzi scheme and has lost money as a result, this no more suffices to form a class of plaintiffs that can be adequately represented than a showing that all female employees of Wal-Mart suffered decreased pay and promotion because of gender discrimination did in Dukes.\(^{188}\) The class of plaintiffs must show a common answer to the problem of having lost money in a Ponzi scheme orchestrated by BLMIS.

At first, it sounds absurd to claim that no common answer exists for the claims of BLMIS customers. Each customer lost a sum of money in a Ponzi scheme, and the common answer to this question of fact would seem to be the return of his funds. There is no requirement in any of the six means under Taylor by which non-parties may be bound by a judgment that each non-party’s claim be of the same amount or accrued at the same time.\(^{189}\) But this conceptualization grossly oversimplifies the issue. The customers may simply want their money back, but a trustee pressing claims under state or federal law against parties culpable in the debtor’s fraud, such as the financial institutions that allegedly aided and abetted Madoff’s Ponzi scheme, encounters a fundamental problem. The accusation is not that these defendants orchestrated a Ponzi scheme, but rather that they recruited investors into the scheme or assisted BLMIS in performing certain transactions at certain times, which created certain customer losses. Just as in Dukes, where the “crucial question” focused on “why [a given Wal-Mart worker] was disfavored,”\(^{190}\) since it was “quite unbelievable that all managers would exercise their discretion in a common way” in disfavoring female employees in pay and promotion,\(^{191}\) it is equally unbelievable that each BLMIS

\(^{188}\) Wal-Mart Stores, Inc. v. Dukes, 131 S. Ct. at 2555 (citations omitted).
\(^{190}\) Wal-Mart Stores, Inc. v. Dukes, 131 S. Ct at 2552.
\(^{191}\) Id. at 2555.
investor invested money in Madoff’s Ponzi scheme as a result of the same acts by culpable third parties.

Consider two people, Alice and Bruce, who invested money in a Ponzi scheme orchestrated by a party similar to BLMIS. Alice invests one million dollars via a feeder fund into the Ponzi scheme, while Bruce invests one million directly into the scheme, perhaps based on a personal relationship with the perpetrator. If a trustee were to sue an entity like HSBC or UBS that aided and abetted the feeder fund for the one million dollars in losses suffered by Alice, the proceeds of any recovery would have to be distributed to both Alice and Bruce on a pro rata basis. Thus, even though the defendants are only liable to Alice, as she was the only investor that utilized the feeder fund the defendant aided and abetted, and Bruce would have no claim against the defendant, Bruce would receive 50% of the money recovered. If Bruce had invested 19 rather than one million, and Alice’s investment remains the same, Bruce would get 95% of the recovery, even though on an individual level, he is entitled to none of it. Concomitantly, Alice, who would have received a 100% distribution on her claim had she sued on her own, will only receive a 5% distribution in the latter hypothetical.

This hypothetical, while obtuse through the use of only two people, rounded off sums of money, and no administrative expenses is actually quite similar to the means by which investors came into BLMIS. One need look no further than two of the more famous investors in BLMIS for proof. Elie Wiesel, the Nobel Peace Prize laureate and Holocaust survivor, lost his life savings and his charity lost $15.2 million after investing

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193 Since both investors put in an equal amount of money, and under this hypothetical there are only two investors, any recovery made on a pro rata basis would be split equally between the two of them. See 11 U.S.C. § 726; 15 U.S.C. §§ 78fff-2(c)(1).

194 Since the claims against the estate would be $20 million, and Bruce’s claim of $19 million is 95% of the total outstanding claims, he would receive 95% of any funds distributed on a pro rata basis.

195 The recovery would be $1 million and Alice’s claim would be for $1 million, yet she would only get 5% of the money, or $50,000.

196 In the latter case, this would in essence impose liability for Bruce’s claims on the defendant, even though outside of bankruptcy the defendant would owe no money to Bruce.
with Madoff after meeting him at two social occasions.\textsuperscript{197} By contrast, Liliane Bettencourt, heir to the L’Oreal fortune and the world’s wealthiest woman, entrusted part of her fortune to BLMIS via Access International, one of the feeder funds that UBS is accused of sponsoring.\textsuperscript{198}

Money came into BLMIS, as with many fraudulent schemes, through as many routes as Madoff could create.\textsuperscript{199} A lawsuit that asserted a cause of action against UBS because of harm suffered by Liliane Bettencourt would have to distribute a share of the proceeds to Elie Wiesel. While this is perhaps palatable in a moral sense, it does not comport with the due process clause and the case law regarding the binding of third parties.\textsuperscript{200} In this situation, Ms. Bettencourt has to give up some of the proceeds of a claim she could fully recover on had the trustee not brought it on her behalf. Yet if Picard, or a similarly situated bankruptcy trustee, were to recover funds from these defendants, the Bankruptcy Code or SIPA would command him to do just this by distributing the proceeds of the lawsuit to customers on a pro rata basis.\textsuperscript{201}

As a result, even if the bars imposed by either \textit{Caplin} or the doctrine of in pari delicto were lifted, Picard’s suit against JPM, UBS, and HSBC still should have been dismissed as Picard was unable to adequately represent BLMIS’s creditors. Where Picard would need to allocate the proceeds from such litigation only to the particular creditors who allegedly suffered harm at the hands of these defendants, the Bankruptcy Code and SIPA would compel that each BLMIS customer share pro rata in the proceeds. Picard’s suits therefore cannot meet the

\textsuperscript{197} Strom, \textit{supra} note 11.
\textsuperscript{199} \textit{See} HSBC Complaint, \textit{supra} note 129, at 10-11. The complaint describes how after Madoff had exhausted his connections in America, “[h]is attention turned to potential investors abroad.” \textit{Id.} at 10. It further describes how various individuals were recruited as “ambassadors” to both set up feeder funds and then recruit victims to invest in BLMIS via these funds. \textit{Id.} at 10-11.
\textsuperscript{200} A proceeding that takes one’s cause of action and litigates it for the benefit of other parties can hardly be said to have adopted “special procedures to safeguard the interests of absentees.” \textit{Taylor v. Sturgell}, 553 U.S. 880, 897-98 (2008) (citing S. Cent. Bell Tel. Co. v. Alabama, 526 U.S. 160 (1999).
\textsuperscript{201} 15 U.S.C. §§ 78fff-2(c) (2012). The same would be true if the case were filed under Chapter 7 of the Bankruptcy Code and a distribution were made according to the Code’s scheme. \textit{See} 11 U.S.C. § 726(a) (2012). This would additionally be offensive by taking away from a creditor an interest in an intangible asset she possesses, here the proceeds from a cause of action. Although not directly akin to depriving a secured creditor of its collateral, it would still offend a general protection of property rights that runs through U.S. bankruptcy law. \textit{See, e.g., In re Treco}, 240 F.3d 148, 159-60 (2d Cir. 2001) (discussing the constitutional importance of secured creditors’ rights in U.S. bankruptcy law).
common answers test of *Dukes* and therefore does not satisfy the due process clause. None of this is to say that the Bankruptcy Code or SIPA could not be amended to provide a trustee with a way to adequately represent creditors in suits against third parties, but until such an amendment is effected, any proposed solution would have to create an independent mechanism to ensure that there is not a “failure of due process” in these cases.  

III. LITIGATION TRUSTS

In a number of recent cases, bankruptcy trustees and the estate’s creditors have side-stepped the doctrine of in pari delicto, the holding of *Caplin*, and the *Wagoner* Rule to allow the trustee to represent the estate’s creditors in suits against third parties alleged to be responsible for the debtor’s failure. This has been done through a variety of means, including selective pleading to allow the estate to sue third parties, having the estate take assignment of creditor claims, and the creation of litigation trusts pursuant to Chapter 11 plans that take assignment of creditor claims and act as the named plaintiff in suits subsequent against these third parties. The trusts are overseen by the bankruptcy trustee and distribute the proceeds of any settlements or judgments obtained to the creditors, who are beneficiaries of the trusts. This part will provide a succinct summary of these stratagems, and note where they have and have not addressed the due process clause concerns raised in the prior part.

A. Cases Involving Trustees Suing on Behalf of Debtors

The first line of cases that has permitted trustees to bring suit on behalf of creditors sidestepped the *Wagoner* Rule permitting the trustee to file suit against culpable third parties on behalf of the debtor’s estate.  

Because the trustee is bringing suit on behalf of the estate, the holding of *Caplin* is

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203 See Scholes v. Lehmann, 56 F.3d 750 (7th Cir. 1995); Sender v. Mann, 423 F. Supp. 2d 1155 (D. Colo. 2006); Collins v. Kohlberg & Co. (*In re* Supermarkets, L.L.C.), 315 B.R. 565 (Bankr. D. Ariz. 2004); Schnelling v. Thomas (*In re* Agribitech, Inc.), 319 B.R. 207 (Bankr. D. Nev. 2004); Gordon v. Basroom (*In re* Plaza Mortgage and Finance Corp.), 187 B.R. 37 (Bankr. N.D. Ga. 1995); O’Halloran v. PricewaterhouseCoopers LLP, 969 So. 2d 1039 (Fla. Dist. Ct. App. 2007). The *Wagoner* Rule provides that claims that a corporation was defrauded with the assistance of its insiders accrue to the corporation’s creditors, not to the corporation. See supra Part I.D. Thus, the estate would not possess causes of action for the trustee to sue on were the *Wagoner* Rule adhered to.
not implicated. The key for a trustee to have standing to bring such claims was “to allege a claim belonging to the debtor for an injury to the debtor conceptually distinct from the injury to defrauded investors or creditors.”

For example, in *Scholes v. Lehmann*, a receiver overseeing a failed Ponzi scheme had collected about 40% of the investors’ losses by liquidating assets of the debtor. To enhance the recovery, the receiver sought to recover transfers of assets made by the principal to the principal’s ex-wife, an investor, and five charities. The receiver was permitted to bring such claims because he was trying to recover the losses suffered by the corporation from having its assets fraudulently transferred to third parties.

Similarly, in *Plaza Mortgage*, a bankruptcy trustee overseeing another failed Ponzi scheme brought suit against the debtor’s accountants, arguing that they participated in a “fraudulent conspiracy” that depleted the debtor’s assets. The trustee was careful to argue that the damages he was seeking were not the same as the losses suffered by the estate’s creditors, though this argument did not appear to be persuasive. As the *Plaza Mortgage* court summarized, a trustee may bring claims on behalf of investors so long as he is “careful to plead claims belonging to the debtor and injury to the debtor . . . [and] . . . [is] careful not to plead for a recovery based on an injury to the investors/creditors, even though the fraud on the investors will be a part of the background allegations.”

Several issues exist with this approach. First, funds collected by the estate must be distributed pursuant to the Bankruptcy Code, which may result in distributions to creditors who would not otherwise hold a claim against the

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204 *Plaza Mortgage*, 187 B.R. at 42.
205 *Scholes*, 56 F.3d at 752-53.
206 *Id.* at 753.
207 *Id.* at 754. Such an allegation will nonetheless remain subject to an in pari delicto defense. *Id.* at 754-55.
209 *Id.* at 43.
210 *Id.* at 44.
211 In response to an interrogatory on the damages he was seeking, the trustee stated that it would be “the difference between the amount invested in [the debtor’s Ponzi scheme] and the value of the estate on the date the bankruptcy petition was filed.” In other words, damages would be the amount of the creditors’ losses after the estate made a distribution. When the defendants pointed this out, the trustee backpedalled and called this “a preliminary damage analysis” and noted that other formulas may later be used. *Id.*
212 *Id.* The court also warned trustees not to plead damages equal to the amount lost in the Ponzi scheme. Instead, they should be measured on the basis of “funds improperly paid out by the debtor.” *Id.* at 45.
defendants to the detriment of those who did. Second, the approach is generally limited to fraudulent conveyance actions, which are provided for by statute. State common law causes of action of the sort brought in the Madoff case would likely not be eligible. Third, the doctrine of in pari delicto still hangs in the air. While this might not be an issue in a receivership where the Bankruptcy Code is not applicable, or where suits are brought under statutory avoidance actions, it will not work for common law claims such as those brought in the Madoff proceedings.

B. Cases Involving Trustees Taking Assignment of Claims from Creditors

Trustees have also sought to expand the recovery for creditors by taking an assignment of their claims. Trustees could then proceed under the theory that Caplin was not on point because the trustee was only liquidating estate assets rather than directly representing the creditors.

For example in Sender v. Mann, a case involving yet another failed Ponzi scheme, the trustee took assignment of creditors’ claims against the debtor’s lawyers, who were accused of enabling the scheme. The court distinguished these facts from those of Caplin. Similarly, in the Madoff proceedings, Picard has established standing to bring claims on behalf of assigning creditors. These claims were obtained both from customers of BLMIS and from settlement agreements in claims against certain feeder funds.

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213 See supra Part II.B.2.
214 See, e.g., Scholes v. Lehmann, 56 F.3d 750, 753 (7th Cir. 1995).
215 See, e.g., id. (describing how Illinois law provided for a fraudulent transfer cause of action); see also 11 U.S.C. § 548(a) (2012).
216 See, e.g., Plaza Mortgage, 187 B.R. at 45-47; O’Halloran v. PricewaterhouseCoopers, LLP, 969 So. 2d 1039, 1044-47 (2007). In many of these cases, the procedural posture is a motion to dismiss, and because in pari delicto is a fact-based inquiry, the trustee’s complaint could survive such a motion. See, e.g., O’Halloran v. PricewaterhouseCoopers, LLP, 969 So. 2d at 1046-47; Plaza Mortgage, 187 B.R. at 47.
217 See Sender v. Buchanan (In re Hedged-Investments Assoc’s, Inc.), 84 F.3d 1281, 1285 (10th Cir. 1996).
219 See supra Part II.A.
221 Id. at 1160.
222 Id. Since the claims became estate property after the assignment, there was no argument that the Code did not authorize the representation. There was also no risk of inconsistent recovery since the assignors lost the right to sue after the assignment. Id.
224 Id. at *3.
Courts in the Ninth Circuit have had to contend with the *Williams* decision in reviewing claims assignments taken by bankruptcy trustees. In *AgriBioTech*, certain creditors were assigned to the bankruptcy estate claims against the debtor’s directors and officers. The trustee brought suit as the assignee of the creditors’ claims, and the issue was whether the holding of *Williams* barred the assignment. The court noted that in *Williams*, only those creditors that assigned claims would receive a recovery. The court therefore reasoned that the creditors in *Williams* “assigned only the right to bring suit, not the right to recover on those claims.” The trustee there was acting not on behalf of the estate but rather on behalf of the individual creditors. Conversely, in *AgriBioTech* any recovery made on behalf of the assigning creditors would become estate property that would be distributed pro rata to all creditors, including creditors that did not assign their claims. As a result, the holding of *Williams* did not apply.

Given that the assignment of creditor claims was designed as an end-run around the holdings of *Caplin* and *Williams*, it is not surprising to discover several bugs. First, even after the debtor takes possession of the claims, the debtor will still have to overcome the in pari delicto defense. While some courts are forgiving on this point, others may not be.

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225 *Williams* v. Cal. 1st Bank, 859 F.2d 664 (9th Cir. 1988); see also *supra* Part I.C.
227 *Agribiotech*, 319 B.R. at 209.
228 *Id.* at 214.
229 *Id.*
230 *Id.*
231 *Id.* This was true even though the assigning creditors in *Williams* would share pro rata in any recovery, creating a sort of “sub-estate” on whose behalf the trustee was acting. *Williams* v. Cal. 1st Bank, 859 F.2d 664, 665 (9th Cir. 1988).
233 Since the claims and the recovery were estate property, the trustee was merely marshaling and liquidating estate assets, not acting on behalf of individual creditors. There would also be no conflicting results since the assigning creditors lost the right to sue, and conflicting recoveries with non-assigning creditors should not matter. *Agribiotech*, 319 B.R. at 214-15; see also Collins v. Kohlberg & Co. (*In re Sw. Supermarkets, L.L.C.*), 315 B.R. 565, 569-71 (Bankr. D. Ariz. 2004).
234 Scholes v. Lehmann, 56 F.3d 750, 754 (7th Cir. 1995). Judge Posner described corporations under the control of the orchestrator of a Ponzi scheme as “evil zombies” and noted that where the “appointment of the receiver remot[e]s the wrongdoer from the scene” the reasons for the defense no longer remain; see also *Logan* v. JKV Real Estate Services (*In re Bogdan*), 414 F.3d 507, 514 (4th Cir. 2005). The court in Bogdan found that after taking assignment of creditor claims, the trustee had stepped into the shoes of the creditors rather than the debtor. However, this seems to sidestep the issue by letting the trustee have his cake and eat it too. If the trustee represents the creditors, *Caplin* forbids the suit. By taking assignment, he side-steps
Second, if creditors’ claims must be assigned to the bankruptcy estate, any distribution must be made pro rata to all creditors according to the Bankruptcy Code. Creditors that do not assign their claims will receive a distribution from the proceeds of the litigation. Each individual creditor therefore has the incentive to retain their claim and, if they are not paid in full by the estate, to piggy-back on the trustee’s efforts in their own suit. Resultantly, the assignment of creditor claims does little to address the issues raised in Part II.B regarding the issues of adequate representation. The cases are important, however, in the sense that they undermined the holding of Williams and laid the groundwork for litigation trusts.

C. Litigation Trusts in Bankruptcy

A more recent line of cases has allowed bankruptcy trustees to represent creditors of the estate so long as there is a corporate entity serving as a middleman between them. The Caplin holding is avoided because the creditors transfer their claims to an independent entity, usually a limited liability company, and the trustee represents that entity rather than the creditors.


One of the first written opinions on this issue was in the case of Semi-Tech Litigation, LLC v. Bankers Trust Co. The facts of that case are remarkably similar to those of Caplin; the debtor had borrowed $654 million through the issuance of notes Caplin, but he does this by bringing the causes of action into the “shoes” he is wearing as a representative of the debtor’s estate. The trustee cannot claim to be the debtor’s representative on the issue of standing yet claim to be the creditors’ representative on the issue of affirmative defenses.


236 One of the reasons underpinning the decision in Caplin was the idea that creditors should be permitted to decide “whether or not it is worthwhile to seek to recoup whatever losses they may have suffered” through a suit against third parties. Caplin v. Marine Midland Grace Trust Co. of N.Y., 406 U.S. 416, 431 (1972). In this instance, the decision would be premised on a free rider problem rather than any assessment of the merits of the litigation.


pursuant to an indenture agreement between the debtor and Bankers Trust Company.\textsuperscript{239} The indenture contained a list of covenants, including compliance with certain financial ratios.\textsuperscript{240} After the debtor filed for bankruptcy, suit was brought against Bankers Trust alleging that it failed to monitor the debtor’s compliance with the indenture and was unduly credulous in believing the debtor’s assertions of compliance.\textsuperscript{241}

There was one significant difference between \textit{Semi-Tech} and \textit{Caplin}: the plaintiff in \textit{Semi-Tech} was not the debtor or the bankruptcy trustee but a Delaware limited liability company created pursuant to the debtor’s Chapter 11 plan.\textsuperscript{242} Under the debtor’s plan, a lengthy list of causes of action, including those against Bankers Trust, were assigned by each of the creditors to the limited liability company.\textsuperscript{243} The litigation trust then filed suit against Bankers Trust in the United States District Court for the Southern District of New York, and Bankers Trust filed a motion to dismiss.\textsuperscript{244} Bankers Trust argued that “neither a bankruptcy estate nor an entity created by a reorganization or liquidation plan has standing to assert claims of third parties . . . regardless of any assignment by a confirmed plan . . . .”\textsuperscript{245} The court discussed the grounds on which \textit{Caplin}’s holding was based,\textsuperscript{246} but noted that the case was distinguishable because of the employment of the trust.\textsuperscript{247}

Because of the claims assignments, the court also addressed the holding of \textit{Williams v. 1st Bank}\textsuperscript{248} and noted that

\begin{itemize}
\item \textsuperscript{239} \textit{Id.} at 321. Similarly, in \textit{Caplin} the debtor raised $8.6 million through the issuance of debentures subject to an indenture agreement. \textit{Caplin v. Marine Midland Grace Trust Co. of N.Y.}, 406 U.S. 416, 417 (1972).
\item \textsuperscript{240} \textit{Semi-Tech}, 272 F. Supp. 2d at 321. Similarly, in \textit{Caplin} the debtor was subject to certain limitations, including the maintenance of a two to one asset to debt ratio. \textit{Caplin}, 406 U.S. at 417.
\item \textsuperscript{241} \textit{Semi-Tech}, 272 F. Supp. 2d at 321. Similarly, in \textit{Caplin}, the indenture trustee was accused of failing to detect the debtor’s consistent violation of the asset to debt ratio requirement. \textit{Caplin}, 406 U.S. at 417-18.
\item \textsuperscript{242} \textit{Semi-Tech}, 272 F. Supp. 2d at 321.
\item \textsuperscript{243} \textit{Id.} at 322. Each creditor, when voting on the Chapter 11 plan, had the option to elect to assign its claims against the debtor to the trust. However, other language in the plan indicated that each creditor was deemed to have assigned its claims unless it affirmatively rejected assignment. As a result, creditors who left the form blank were deemed to have assigned their claims. \textit{Id.}
\item \textsuperscript{244} \textit{Id.} at 321.
\item \textsuperscript{245} \textit{Id.} at 322. They also pressed other arguments relating to the validity of the assignments that are not relevant here. \textit{Id.} at 323.
\item \textsuperscript{246} The court explicated three reasons for the holding: (1) the Bankruptcy Act did not authorize a trustee to sue on behalf of third parties; (2) individual creditors should get to decide whether they want to sue; and (3) there was a risk of inconsistent results between the trustee’s action and those of individual creditors that the trustee did not represent. \textit{Id.}
\item \textsuperscript{247} \textit{Id.}
\item \textsuperscript{248} \textit{Williams v. Cal. 1st Bank}, 859 F.2d 664 (9th Cir. 1988).
\end{itemize}
“this Court does not find Williams persuasive.”

It found that the issue in Williams was “whether assignments should be stripped of legal effect because the assignee is a creature of bankruptcy.”

The court reasoned that because assignees rarely have claims of their own to sue on and the risk of inconsistent results is always present in assignations, there was no reason to treat assignments in bankruptcy differently.

As a result, the litigation trust had standing to pursue claims against Bankers Trust on behalf of the creditors of the bankruptcy estate that had assigned their claims.

On appeal, the Second Circuit affirmed the “insightful and thorough” opinion and adopted it as “the law of this Circuit.”

Further, in a separate suit involving a complaint by the Semi-Tech litigation trust against the debtor’s accountant, a New York state appellate court cited the federal court litigation against Bankers Trust Company in refusing to dismiss the complaint. In affirming the decision below, the court distinguished the case of Barnes v. Schatzkin, which like Williams, held that trustees may not take assignments of

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250 Id.
251 Id. at 324. It is important to note the distinction between this argument on Williams and that put forth in AgriBioTech. The latter case reasoned that Williams was distinguishable because in Williams any recoveries would flow through the trustee to the assigning creditors, and thus those creditors “assigned only the right to bring suit, not the right to recover on those claims.” Schnelling v. Thomas (In re Agribiotech, Inc.), 319 B.R. 207, 214 (Bankr. D. Nev. 2004). Williams was therefore distinguishable in that case because the recovery flowed directly to the bankruptcy estate and all creditors shared pro rata in the proceeds. Id. In Semi-Tech, recoveries made by the litigation trust would be distributed pursuant to the terms of the trust agreement rather than the Bankruptcy Code.
253 Semi-Tech Litig., LLC v. Bankers Trust Co., 450 F.3d 121, 126-27 (2d Cir. 2006). The court did not even discuss the issue of Caplin, merely noting in passing that Caplin “does not deprive [the litigation trust] of standing to assert the claims of the Noteholders.” Id. at 123.
255 212 N.Y.S. 536 (1925), aff’d 242 N.Y. 555 (1926). In Barnes, the debtor purportedly ran a brokerage firm but instead defrauded its customers. Id. at 537. The bankruptcy trustee sued a stock broker that allegedly aided and abetted the debtor on behalf of 164 defrauded former customers of the debtor. Id. The court rejected the idea that a trustee may take assignment of claims from creditors, noting that “[i]f the trustee may take an assignment of these claims he might take an assignment of a claim from any stranger and force the estate into an expensive litigation.” Id. at 538. Since the claims the trustee was litigating did not belong to the debtor and therefore did not belong to the estate, absent statutory authorization to take assignments the court would not imply such a right. Id. at 539.
claims. Because the assignment here was not to the trustee but “to a specially created entity,” the holding was not on point.

2. The Expanded Use of Litigation Trusts: In re CBI Holding Company, Inc.

In 2008, the Second Circuit reaffirmed and expanded the holding of Semi-Tech in Bankruptcy Services, Inc. v. Ernst & Young LLP (In re CBI Holding Company, Inc.). In that case, the debtor was a pharmaceutical company that financed its growth by acquiring other companies. It financed these acquisitions in part by issuing debt and equity instruments to Trust Company of the West (TCW). Like the debtor in Caplin, this financing agreement was subject to certain limitations that the debtor breached through fraudulent misrepresentations. Ernst & Young, the debtor’s accountants, failed to detect this fraud.

Under the debtor’s bankruptcy plan, all equity interests in the debtor were extinguished and an entity called Bankruptcy Services, Inc. (BSI) was appointed to administer the debtor’s estate. Since the debtor’s business operations had ceased, this simply included liquidating the assets of the debtor’s estate as a trustee would. The debtor’s unsecured creditors and TCW assigned all of their rights in any causes of action against any third parties to BSI, and BSI filed suit against Ernst & Young.

The bankruptcy court entered judgment in BSI’s favor, but the district court reversed, finding that “a bankruptcy trustee does not have standing to assert

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256 Semi-Tech, 787 N.Y.S.2d at 236. Barnes was cited in Wagoner for the proposition that assignments to a bankruptcy trustee are invalid. Shearson Lehman Hutton, Inc. v. Wagoner, 944 F.2d 114, 118 (2d Cir. 1991).
257 Semi-Tech, 787 N.Y.S.2d at 236.
258 529 F.3d 432, 456 (2d Cir. 2008) (holding that “federal bankruptcy law permits [the litigation trustee] to press [creditor] claims against” the third party accountants alleged to have contributed to creditor losses.
259 Id. at 439.
260 TCW owned 48% of the equity in the debtor, and was permitted to take control of the company on the occurrence of certain default provisions, which included the failure to maintain certain financial metrics. Id.
261 The debtor engaged in a scheme to inflate the value of its assets through “inventory fraud.” This included entering payments to vendors for shipped goods as pre-payments for future goods, therefore showing them as assets rather than expenses. It also included inflating the amount and value of the debtor’s inventory. Id. at 440.
262 Id. at 440-41.
263 Id. at 441.
264 Id.
265 Id. at 441-42. Since the claim was brought on behalf of TCW, BSI did not need to only plead harm to the debtor as the court in Plaza Mortgage suggested. See Gordon v. Basroon (In re Plaza Mortgage and Finance Corp.), 187 B.R. 37, 44-45 (Bankr. N.D. Ga. 1995).
claims against third parties on behalf of creditors of a corporation, even where the creditors assigned their claims to the trustee.”

The Second Circuit reversed the district court and held that BSI had standing to press the claims against Ernst & Young. Relying on Semi-Tech, the court held that claims assigned to a bankruptcy estate become estate property and may be liquidated by a trustee as he would any other asset. The court was not persuaded by Ernst & Young’s argument that the legislative history of the Bankruptcy Code precluded the holding reached in Semi-Tech, and noted that New York case law does not preclude it either. It further concluded that Congress’s failure to overrule Caplin in 1978 did not indicate a desire to prevent creditors from transferring their claims pursuant to a Chapter 11 plan. The court went on to note that “[a]llowing a debtor’s creditors to assign their claims . . . [gives] bankruptcy courts the flexibility in reorganizing or liquidating a debtor’s assets necessary to achieve efficient administration of the reorganization or liquidation.” It further noted that the holding of Barnes “would unnecessarily hamstring [debtors and creditors] on the basis of an outdated version of the Bankruptcy Code.”

The decision was important because unlike the line of cases discussed in this Part that steered around Williams by having an estate take an assignment of claims, here an independent entity took the assignment. Further, instead of requiring that distributions be made according to the distribution scheme of the Bankruptcy Code, CBI Holdings held that trustees may take assignments without any contingencies. As a result, trustees can litigate assigned claims and distribute the proceeds by a custom method proposed in the Chapter 11 plan.

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266 CBI Holding Co., 529 F.3d at 446-47 (citing Breeden v. Kirkpatrick & Lockhart LLP (In re Bennett Funding Grp., Inc.), 336 F.3d 94, 102 (2d Cir. 2003)).
267 CBI Holding Co., 529 F.3d at 459.
268 Id. at 456-59 (citing 11 U.S.C. § 541(a)(7) (2012) (which makes property of the estate assets acquired by the estate after the filing of the bankruptcy petition)).
269 Id. at 457-58 (discussing the possible repeal of Caplin in 1978).
270 Id. at 458-59. The defendants argued that the holding of P&F Indus. v. Medallion Grp., 476 N.Y.S.2d 928 (2d Dep’t 1984), where a trustee’s attempt to sue third parties on behalf of the estate did not preclude one of those third parties from later bringing suit, conflicted with Semi-Tech. The court noted that there was no conflict here, as no assignment occurred in P&F. Id. at 459.
271 Id. at 458.
272 Id. at 459.
273 Id.

These points became especially relevant when the Seventh Circuit adopted the holding of Semi-Tech. In Grede v. Bank of New York Mellon,274 the debtor, Sentinel Management Group, Inc., was a “futures commission merchant and investment manager or commodity brokers, pension funds, and wealthy persons.”275 Sentinel’s customers believed they were defrauded and that The Bank of New York Mellon (BONY) aided and abetted Sentinel in this.276 To facilitate litigation against BONY, the debtor’s Chapter 11 plan created a liquidation trust that took assignment of the creditors’ claims.277

However, the trustee of the liquidation trust was the same individual that had served as the trustee of the Chapter 11 proceeding.278 Further, under the liquidating trust agreement, only creditors that assigned claims to the estate were eligible to receive a distribution from the funds generated by these claims.279 Because the trust took possession of other assets, it did this by creating a tranche of assets composed of the claims that creditors assigned to it.280 Because all estate property was transferred to the liquidation trust, this had the effect of bifurcating the funds distributed by the trust: all creditors would share pro rata in estate assets but assigning creditors would receive an additional distribution representing their share of the assigned claims.281

Grede therefore effected almost a full abrogation of Caplin. A bankruptcy trustee was permitted to represent creditors of a bankruptcy estate in their claims against third parties, with a distribution to be made not according to the Bankruptcy Code but instead according to the creditors’ claims. All it took to make Caplin ineffective was a limited liability company to serve as a middleman between the bankruptcy trustee and the creditors. In a brief opinion, the Seventh

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274 598 F.3d 899 (7th Cir. 2010).
275 Id. at 900.
276 BONY served as Sentinel’s “clearing bank, lender, and depository for investment pools.” Id.
277 Id.
278 Id.
279 Liquidation Trust Agreement at 3, In re Sentinel Mgmt. Grp., Inc., 398 B.R. 281 (Bankr. N.D. Ill. 2008) (No. 07-14987 (JHS)). The agreement elected to provide for only a pro rata distribution on this tranche, though nothing would preclude more detailed arrangements.
280 Fourth Amended Chapter 11 Plan of Liquidation at 29, In re Sentinel Mgmt. Grp., Inc., 398 B.R. 281 (Bankr. N.D. Ill. 2008) (No. 07-14987 (JHS)).
281 Id. at 26.
Circuit held that the reasons for the Supreme Court’s holding in *Caplin* did not apply to the facts of the case, and therefore *Caplin* “does not apply to the activities of a liquidating trust created by a plan of reorganization (or, for that matter, an ex-debtor operating under a confirmed plan).”

The court’s reasoning for finding that *Caplin* did not apply was also important. The first ground for the holding in *Caplin* was that the Bankruptcy Act did not authorize trustees to take assignment of creditor claims. Whereas other courts had held that claims assigned post-confirmation became property of the estate pursuant to the Bankruptcy Code, the court in *Grede* held that while the Code governs “trustee[s] in bankruptcy, the terms of the plan of reorganization (and of the trust instrument) govern the permissible duties of a trustee after bankruptcy.” In other words, the case could be read to say that *Caplin* does not apply at all to trustees operating post-confirmation according to either a Chapter 11 plan or a trust agreement.

The idea that *Caplin* is limited to the exact facts of the case has now become so commonplace that courts will approve the usage of a litigation trust with little more than a string citation. Moreover, the type of trust created in *Grede*, whereby distributions are made to assigning creditors rather than to all creditors, is becoming the norm. Additionally, rather than asking creditors to affirmatively execute an assignment in favor of the trust, Chapter 11 plans will now indicate that on confirmation of the Chapter 11 plan, creditor claims will be assigned by operation of the law unless the

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282 *Grede*, 598 F.3d at 903; see also *In re Tribune Co.*, 464 B.R. 126, 193 (Bankr. D. Del. 2011) (describing the trustee of a litigation trust as “is not acting as a representative of the Debtors or their estates, so the concerns for statutory trustees expressed in *Caplin* are not raised by this Plan provision”).

283 *Grede*, 598 F.3d at 901.

284 See Bankruptcy Services, Inc. v. Ernst & Young (*In re CBI Holding Co.*), 529 F.3d 432, 446-47 (2d Cir. 2008).

285 *Grede*, 598 F.3d at 902.

286 The court also noted that the issue of subrogation that arose in *Caplin* was immaterial because “the Bank would have had to make such an argument in the bankruptcy court, and it did not.” Id.

Thus, under *Grede*, it would seem that a creditor must object at the debtor’s confirmation hearing to the standing of a trustee taking assignment of claims against it under a Chapter 11 plan rather than waiting until suit is brought. This is a further limitation on the holding of *Caplin*, since in that case, the court made the argument for the benefit of the entire estate and not merely the defendant. See *Caplin* v. Marine Midland Grace Trust Co. of N.Y., 406 U.S. 416, 433 (1972).


creditor takes affirmative steps to “opt out.” Some litigation trusts will even claim causes of action by all creditors with no further steps needed by those creditors.

4. Remaining Opposition to Litigation Trusts: *Mukamal v. Bakes*

While the Second and Seventh Circuits have embraced litigation trusts and the Fourth Circuit and courts within the Ninth Circuit have permitted bankruptcy estates to take assignments of creditor claims so long as no priority is given to assigning creditors, at least one court in the Eleventh Circuit has remained resistant.

For example, in 2007 a lawsuit was brought in the Southern District of Florida by the trustee of a trust fund created pursuant to a Chapter 11 plan. The debtor had run a company into insolvency in circumstances akin to a Ponzi scheme and had incurred substantial additional debt when the debtor’s controlling shareholders tried to sell the company off to turn a profit on their investment. The actions of the debtor’s controlling shareholders, aided and abetted by the debtor’s accountants, not only caused harm to foreseeable

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289 *Id.* at 193.
290 See Order Confirming Chapter 11 Plan, Exhibit A, Third Amended and Restated Joint Chapter 11 Plan of Reorganization for the Lyondellbasell Debtors at 60-63, *In re Lyondell Chemical Co.*, No. 09-10023-REG (Bankr. S.D.N.Y. Apr. 23, 2010), ECF No. 4418 (defining the creditor trust in that case generally); see also *id.* at 8 (defining the “Creditor Trust Beneficiaries” as all creditors of certain classes of claims).
292 See Grede v. Bank of N.Y. Mellon, 598 F.3d 899 (7th Cir. 2010).
293 See Logan v. JKV Real Estate Services (*In re Bogdan*), 414 F.3d 507 (4th Cir. 2005).
296 *Id.* The trust arose from the bankruptcy proceeding of Far & Wide Corporation and its affiliates. The trustee filed suit against the directors and officers of the debtors, the debtors’ accountants, and the debtors’ controlling shareholders. *Id.* at 803.
297 *Id.* The debtor sold “travel related services . . . 60 days before a customer’s departure” on a vacation and paid for those services “45-60 days after” the customer returned. New revenue soon became a source for old expenses. *Id.* at 806.
298 The debtor was financed by $70 million in secured debt and an additional $20 million in unsecured debt. The debtor’s management then began using “false and misleading” financial statements to obtain forbearance from their lenders so they could try to sell the entity “at a price high enough to give [the debtor’s controlling shareholder] a return on [its] initial investment.” Ernst & Young was employed to prepare the allegedly false financial statements. This permitted the debtor to both incur another $20 million in unsecured debt and to continue incurring liabilities to customers and vendors through its Ponzi-like operations. *Id.* at 806-07.
creditors that reasonably relied on the false financial statements but also permitted the debtor to incur additional secured debt “at the expense of [the debtor] and [its] creditors.”

Given the indicia of fraud in the proceeding, a Chapter 11 trustee was appointed to oversee confirmation of the plan.

The plan created a litigation trust that took assignment of all causes of action belonging to the debtor’s creditors. Additionally, the litigation trustee was not the Chapter 11 trustee of the bankruptcy case but rather an independent party that had experience serving as a bankruptcy trustee. Nonetheless, the court held that “[w]ithout doubt, Caplin and its progeny apply here.” Relying on Bennett, the court noted that Caplin applies even where a creditor has assigned its claims. This was because some creditors could reject the plan and retain the claims for themselves, which would implicate Caplin’s third factor by creating a risk that their recovery would be inconsistent with what the trustee recovered. The court also relied on Williams for the proposition that Caplin’s third

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299 Id. at 807.
300 See Notice Appointing Trustee Alan L Goldberg and Setting of Bond in the amount of $320,000.00, In re Fair & Wide Corp., No. 03-40415(RAM) (Bankr. S.D. Fla. Sept. 8, 2005), ECF No. 1211.
301 See id. at 810.
304 Breeden v. Kirkpatrick & Lockhart LLP (In re The Bennett Funding Grp., Inc.), 336 F.3d 94 (2d Cir. 2003).
305 Mukamal v. Bakes, 383 B.R. at 811. This, however, is not an accurate description of the holding in Bennett. In that case, the trustee sued on behalf of the estate, and was barred under the Wagoner Rule, which notes that claims against third parties for aiding and abetting a debtor accrue to the estate’s creditors, not to the estate since in pari delicto bars the estate’s claims. Breeden v. Kirkpatrick, 336 F.3d at 100. Bennett merely cited Barnes in passing for the proposition that had an assignment occurred, it would not be upheld. Id. at 102. However, the ability of a trustee to take assignment of creditor claims had already been upheld by the Second Circuit, arguably overruling this portion of the Breeden opinion. Semi-Tech Litig., LLC v. Bankers Trust Co., 272 F. Supp. 2d 319, 321 (S.D.N.Y. 2003) aff’d 450 F.3d 121, 123 (2d Cir. 2006). Barnes was also rejected by the Second Circuit a year later. Bankruptcy Services, Inc. v. Ernst & Young LP (In re CBI Holding Co.), 529 F.3d 432, 439 (2d Cir. 2008). Although the Second Circuit cannot overturn a New York Court of Appeals decision, New York case law is also not binding in Florida, and a 2006 federal appeals court decision is arguably more persuasive than a state law case from the early twentieth century.
306 Mukamal v. Bakes, 383 B.R. at 813. This is a completely inaccurate view of Caplin’s third factor. In Caplin, the trustee did not take assignment of the claims, so both the trustee and the creditor could file suit for the same injury but press disparate legal claims. Caplin v. Marine Midland Grace Trust Co. of N.Y., 406 U.S. 416, 431-32 (1972). The Caplin court also feared that a settlement of one claim would not bind the other party, and that litigation for the same claims would proliferate, generating duplicative recoveries. Id. at 432. In Mukamal, only non-assigning creditors would only be able to sue for their individual injuries, and the litigation trust would only be able to sue for the injuries of those creditors that assigned their claims.
307 Williams v. Cal. 1st Bank, 859 F.2d 664 (9th Cir. 1988).
factor was implicated since only those creditors that assigned their claims were eligible to receive a recovery from the proceeds of any litigation.\textsuperscript{308} It concluded that although the Eleventh Circuit had not addressed the interplay of litigation trusts and \textit{Caplin}, it would reject the arrangement.\textsuperscript{309} The court did leave open the question of whether a litigation trust might be upheld if every single creditor with a claim assigned it to the estate, all claims became estate property, and a distribution on the claims was made pursuant to the Bankruptcy Code.\textsuperscript{310} In an unpublished decision, the Eleventh Circuit affirmed the dismissal.\textsuperscript{311}

D. Conclusion: Litigation Trusts As Class Action Lawsuits

Litigation trusts skirt the intent of the \textit{Wagoner} Rule, the holding of \textit{Caplin}, and the doctrine of in pari delicto by having creditors assign their claims for the purpose of bringing suit to an entity that is neither the debtor nor the bankruptcy trustee. As this assignment is increasingly effected through the Chapter 11 plan confirmation process, the bankruptcy court is essentially certifying a class action suit by the debtor’s creditors, with a corporate entity to serve as the lead plaintiff and the bankruptcy trustee to serve as plaintiff’s counsel.

In the context of the Madoff proceedings, there is not a glaringly obvious reason why Irving Picard cannot create a limited liability company, make himself the managing member, and solicit each customer of BLMIS in his capacity as the managing member of that limited liability company to transfer any claims they have against culpable financial institutions to the LLC for prosecution.\textsuperscript{312} Picard could then file precisely the

\textsuperscript{308} Mukamal v. Bakes, 383 B.R. at 811-12.
\textsuperscript{309} \textit{Id.} at 812 (citing E.F. Hutton & Co. v. Hadley, 901 F.2d 979 (11th Cir. 1990)).
\textsuperscript{310} \textit{Id.} at 814 (citing Logan v. JKV Real Estate Services (\textit{In re Bogdan}), 414 F.3d 507, 512-13 (4th Cir. 2005)). In \textit{Bogdan}, the debtor operated a limited liability company that defrauded mortgage lenders by obtaining undercollateralized loans on homes in Baltimore by collaborating with corrupt appraisers, mortgage brokers, and title insurance agents. The trustee brought suit against these accomplices seeking $1 million in actual damages and $500,000 in punitive damages. \textit{Id.} at 509-10. Since the number of mortgage companies was small, and likely their hope of achieving a recovery from possibly insolvent defendants over such a small sum did not make litigation on their part worthwhile, they were willing to assign the claims. A situation where creditors will unanimously assign their claims and waive any individualized right to recovery would likely rarely arise, and therefore this door left open by the court in \textit{Mukamal} is not of much import.
\textsuperscript{311} Mukamal v. Bakes, 378 F. App’x. 890, 899 (11th Cir. 2010).
\textsuperscript{312} One potential issue is the first tenet of \textit{Caplin}: the issue of statutory authority. Bankruptcy trustees in Chapter 11 cases can claim, perhaps weakly, that the Bankruptcy Code offers them flexibility in devising a Chapter 11 plan. \textit{See} 11 U.S.C. § 1123 (2012). This authority has been called into question though. \textit{See} Morris, \textit{supra} note 20, at 600-02.
same complaints as he did in his capacity as the SIPA trustee with precisely the same purpose, albeit this time as the managing member of a limited liability company. This time, the Second Circuit’s holding, grounded in the doctrine of in pari delicto and the holding of Caplin, fall to the wayside, and Picard need not parse the language of SIPA for an alternate basis of standing.\textsuperscript{313}

IV. IMPROVING LITIGATION TRUSTS

Litigation trusts are remarkably similar to class action lawsuits: one party brings suit, a judgment will bind many non-parties, and the proceeds of the judgment will be distributed to those non-parties. As discussed in Part II, when non-parties are bound by litigation in the class action context, procedural protections exist to ensure that they are adequately represented.\textsuperscript{314} This part will draw on Federal Rule of Civil Procedure 23 to provide suggestions for ensuring that litigation trusts adequately represent estate creditors.

First, estate creditors should receive notice of a trustee’s intent to create a litigation trust. While such notice is likely already contained in the debtor’s disclosure statement and Chapter 11 plan, neither of these documents has a reputation for being concise or accessible to a lay reader. In providing creditors with such notice, Rule 23(c)(2)(B) should be instructive. This provision requires that class action claimants get notice of the nature of the action, including such things as the proposed class, the claims, issues, and defenses, and the binding effect that a class action judgment will have on them.\textsuperscript{315} In short, creditors should understand that they can bring their own claims against culpable third parties, but that they are giving up this claim in exchange for a pro rata distribution, less administrative expenses, of what the trustee will recover.

Second, estate creditors should have the ability to opt out of litigation trusts. The right to opt out, and the consequences of opting out, should also be specified in the notice creditors receive.\textsuperscript{316}

Third, litigation trusts should ensure that creditors receive a recovery similar to what they would have received had they brought the claim themselves. In a case where such claims exist, there will be two types of creditors: those who hold claims against third parties for the losses they suffered, and

\textsuperscript{313} For a description of the Second Circuit’s holding, see \textit{supra} Part I.D.
\textsuperscript{314} See Fed. R. Civ. P. 23.
\textsuperscript{315} Fed. R. Civ. P. 23(c)(2)(B).
those who do not. As discussed in Part II, a litigation trustee should ensure that the trust does not distribute funds obtained from assigned claims to creditors that did not possess such claims. But efforts should be made to ensure that creditors with claims against third parties are not subsidized by creditors who do not possess such claims.

To illustrate this point, consider a Ponzi scheme that collapses and leaves four creditors. The first was duped into investing by the scheme's principal, the second invested on the recommendation of a reckless financial advisor, the third invested on the basis of financial statements negligently produced by the schemer's accountant, and the fourth is the schemer's landlord. The debtor owes $1 million to each of these four creditors. Assume further that the trustee seizes the schemer's personal assets, say houses and cars, and generates $2 million in proceeds. Each creditor gets his pro rata share, $500,000, and a litigation trust is created to seek $1 million in damages against the financial advisor and the accountant.

As discussed in Part II, the litigation trust cannot distribute money obtained through settlements with the accountant and financial advisor to the landlord creditor or the creditor who invested through the schemer; these causes of action belong to the other two creditors and allocating the proceeds to others would deny them adequate representation. The litigation trust also cannot seek out more than $1 million in damages; the assigned claims can be no greater than the harm each creditor suffered, and here, each of the two creditors is out only $500,000 after the estate's initial distribution. Resultantly, in a best case scenario, the two creditors with claims against third parties will get paid in full on their claims, whereas the other two creditors will only get a 50% distribution.

However, if in this hypothetical the accountant and financial advisor each had $1 million, settlements with them could have paid the two assigned claims in full, leaving the $2 million in estate assets to satisfy the claims of the third investor and the landlord. In an ideal solution, the bankruptcy estate would withhold distribution to creditors assigning claims against third parties until a distribution on the assigned claims could be made. This in turn would maximize the distribution made to all creditors, and not just those creditors who hold additional claims against third parties.317

317 This hypo seems to illustrate the point made in Caplin that the claims that the litigation trust will sue on will be the difference between what the creditor lost in
Fourth, the claims of litigation trusts should be capped at the damages suffered by creditors who assigned claims to it. This means that no distributions from the trust should be made to non-assigning estate creditors, and that Moore v. Bay\textsuperscript{318} should not become the rule with litigation trusts.\textsuperscript{319}

Fifth, the interests of the creditors who have assigned claims to the trust should be aligned. For example, in Crescent Resources Litigation Trust ex rel. Bensimon v. Duke Energy Corp., a land developer called Crescent Resources engaged in a leveraged buyout in 2006.\textsuperscript{320} Lenders advanced it over one billion in secured loans and this money was distributed to Crescent’s parent corporation.\textsuperscript{321} The loans left Crescent insolvent and it filed for bankruptcy in 2009.\textsuperscript{322} In the case of a leveraged buyout bankruptcy, it is common for trustees to move to vacate the liens secured creditors obtained as fraudulent conveyances.\textsuperscript{323} However, in this case, the litigation trust, which was for the benefit of $279 million in general unsecured creditors and $961 million in claims constituting the unsecured portion of the secured lenders’ claims, fully released the secured lenders from liability.\textsuperscript{324} The litigation trust’s attempts to pursue the former equity holders of Crescent who received the proceeds of the secured loans were predictably unsuccessful.\textsuperscript{325} In the context of dismissing a similar fraudulent conveyance claim against the former equity holders, the court noted the unjust release provision.\textsuperscript{326}

Sixth, the litigation trust should provide, as Rule 23(e) does, that before the trust enters into any settlement, that settlement is reviewed to ensure that it is fair and reasonable.\textsuperscript{327}
Litigation trusts could also provide that if creditors are dissatisfied with the settlement, they are permitted to opt out. 328

Because creditors are assigning viable claims to a bankruptcy trustee through the bankruptcy plan confirmation process and will be bound by any judgments or settlements obtained by that trustee, procedural protections should exist to ensure that these creditors receive adequate representation, and through that due process.

CONCLUSION

Those who invest in Ponzi schemes often have pitiful tales; lured into investing their life savings by a fictitiously safe investment, they are often left with nothing to fend for themselves in retirement. The discovery that there were persons out there that knew of the scheme and could have either limited its impact or prematurely terminated it yet chose to enable and profit from it would certainly be frustrating. One can certainly imagine a knee-jerk reaction toward imposing the losses suffered by the victims onto the negligent or reckless third parties.

This note argues that while it may ultimately prove worthwhile to impose creditor losses on culpable third parties, steps must be taken to ensure that their interests are adequately protected. It is possible that Title 11, which as currently drafted did not envision providing the underpinning for such suits, does not sufficiently protect all creditors. Until these issues are resolved legislatively, courts should hesitate to allow bankruptcy trustees to create ad hoc class action suits solely through the protections offered by the voting procedures of the plan confirmation process. Instead, courts should look to Federal Rule of Civil Procedure 23 to ensure that creditors with claims against third parties are adequately represented.

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† J.D. Candidate, Brooklyn Law School, 2014. I would like to thank John D. Moore, Sabrina M. Bierer, Michael Tse, and the members of the Brooklyn Law Review for their help in the writing process. All errors remain my own.