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Emerging Issues in Bankruptcy Litigation: Fraudulent Transfers and Preferences

Parties, Pleadings, Forensics, Proof, Remedies, Final Orders, Coverage, Deep Pockets, and Payoff

PART 2

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I. WHO OWNS THE CLAIM?

The ability of the trustee to bring assets back into the debtor's estate by asserting avoidance actions and claims of the debtor is a key component of the bankruptcy system, in that it can increase the overall amount and equity of distribution to creditors of the estate. In many cases, the trustee will be the obvious—or the only—party to pursue such claims, at least after the filing of the bankruptcy. Sometimes, however, an individual creditor or group of creditors may seek to pursue claims independently, for their own benefit rather than the benefit of the estate, regardless of the bankruptcy proceedings. In such circumstances, the preliminary question must be answered: Who owns the claim?

A. Basics

The Fifth Circuit's relatively recent *Seven Seas* opinion lays out the basic principles of the analysis, beginning with what constitutes the debtor's estate.[1] Under Bankruptcy Code § 541(a)(1),[2] the filing of the bankruptcy petition creates the debtor's estate, which is comprised of, *inter alia*, "all legal or equitable interests of the debtor in property as of the commencement of the case."[3] This phrase is construed broadly and includes "rights of action" such as claims based on state or federal law.[4] The central question is whether a particular claim belongs to the estate—if so, then the bankruptcy trustee has the exclusive right to assert that claim.[5] On the other hand, if a claim belongs solely to the estate's creditors, and so it is not part of the estate, then the trustee has no right to bring the claim.[6]

Whether a particular claim belongs to the bankruptcy estate depends on whether under applicable law the debtor could have raised the claim as of the commencement of the case.[7] Courts look to the nature of the injury for which relief is sought and consider the relationship between the debtor and the injury.[8] The ultimate issues are 1) whether the debtor could have raised the claims as of the commencement of the bankruptcy; and 2) the nature of the injury for which the creditor seeks individual relief:

> If a cause of action alleges only indirect harm to a creditor (i.e., an injury which derives from harm to the debtor), and the debtor could have raised a claim for its direct injury under the applicable law, then the cause of action belongs to the estate. Conversely, if the cause of action does not explicitly or implicitly allege

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[1] *Highland Capital Mgmt. LP v. Chesapeake Energy Corp. (In re Seven Seas Petroleum, Inc.)*, 522 F.3d 575 (5th Cir. 2008)
[2] 11 U.S.C. § 541(a)(1).
[3] *Seven Seas*, 522 F.3d at 584 (quoting *id.*).
[4] *Id.* (citing *Am. Nat'l Bank of Austin v. MortgageAmerica Corp.* (*In re MortgageAmerica Corp.*), 714 F.2d 1266, 1274 (5th Cir.1983); *Schertz-Cibolo-Universal City v. Wright (In re Educators Group Health Trust)*, 25 F.3d 1281, 1283 (5th Cir. 1994)).
[5] *Id.* (citing *In re Educators Group Health Trust*, 25 F.3d at 1284).
[6] *Id.* (citing *See Caplin v. Marine Midland Grace Trust Co.*, 406 U.S. 416, 92 S.Ct. 1678, 32 L.Ed.2d 195 (1972)).
[7] *Id.* (citing *In re Educators Group Health Trust*, 25 F.3d at 1284).
[8] *Id.* (citing *In re Educators Group Health Trust*, 25 F.3d at 1284-85; *see In re E.F. Hutton Sw. Props. II, Ltd.*, 103 B.R. 808, 812 (Bankr.N.D.Tex. 1989) ("The injury characterization analysis should be considered as an inseparable component of whether an action belongs to the [estate] or [creditor].")).

> harm to the debtor, then the cause of action could not have been asserted by the debtor as of the commencement of the case, and thus is not property of the estate.[9]

Despite these seemingly-clear rules of analysis, however, the Fifth Circuit's recent *Moore* decision discussed below suggests that the rules may not be entirely rigid and that there may be some art as well as science in making this determination in certain circumstances.

B. *Seven Seas*

The *Seven Seas* decision provides an interesting example of the type of scenario that can present the who-owns-the-claim question.[10] In *Seven Seas*, a group of the debtor's unsecured bondholders, acting as individual creditors, sued a secured bondholder in state court *after* the trustee had previously sued the same secured bondholder and reached a settlement in the debtor's bankruptcy case. The unsecured bondholders' suit was based on a theory that the secured bondholder, acting in conjunction with the debtor itself, had defrauded and otherwise injured the unsecured bondholders individually. The secured bondholder removed the lawsuit to federal district court, which referred the action to the Bankruptcy Court. The Bankruptcy Court then found that the claims asserted by the unsecured bondholders were property of the estate and so could not be asserted by the unsecured bondholders.[11] The district court affirmed on slightly different equitable grounds, finding that the state-court suit was effectively an attempt to invalidate the confirmed bankruptcy plan.[12]

On appeal, the Fifth Circuit reversed. Although implying some skepticism as to whether the unsecured bondholders' claims might actually have any merit, the court held that the claims were not property of the estate and that the suit should therefore be remanded to state court.

The court began by recognizing that both the unsecured and secured bondholders were "linked in a variety of ways" to the debtor and the bankruptcy" and that the claims ultimately arose from the fact that the unsecured bondholders invested in the unsecured notes issued by the debtor.[13] However, such linking did not of itself decide the question:

> [T]he existence of common parties and shared facts between the bankruptcy and the bondholders' suit does not necessarily mean that the claims asserted by the bondholders are property of the estate. Indeed, . . . it is entirely possible for a bankruptcy estate and a creditor to own separate claims against a third party arising out of the same general series of events and broad course of conduct.[14]

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[9] *Seven Seas*, 522 F.3d at 584 (quoting *In re Educators Group Health Trust,* 25 F.3d at 1284) (citations omitted)).
[10] *See supra* note 1.
[11] *Seven Seas*, 522 F.3d at 582–83. The Bankruptcy Court also found that the unsecured bondholders were estopped from asserting the claims due to having participated in the bankruptcy and having supported the settlement of the trustee's earlier lawsuit, and that allowing the suit to go forward would be permitting the unsecured bondholders to play "fast and loose" with the Bankruptcy Court. *Id.*
[12] *Seven Seas*, 522 F.3d at 583.
[13] *Id.* at 585.
[14] *Seven Seas*, 522 F.3d at 583.

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