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Property of the Estate and Creditors Rights to Bring Individual Suits

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INTRODUCTION

Once bankruptcy proceedings begin, section 541 of the United States Bankruptcy Code (the "Bankruptcy Code") defines the scope of a debtor's property as including all legal and equitable interests of the debtor.¹ Courts have adopted an expansive interpretation of this section, noting that "every conceivable interest of the debtor, future, nonpossessory, contingent, speculative, and derivative, is within reach of the bankruptcy estate."² As a result, a trustee of the debtor's estate, or a debtor-in-possession, obtains standing to assert general claims which are common to the creditors, and creditors are thus bound by the outcome of the trustee's actions.³

If creditors wish to assert claims independent of the debtor's estate, they must be able to show specific injury which can be directly linked to the conduct of the party they intend to assert their claims against.⁴ Some examples of situations where creditors can show specific injury, and thus obtain standing to bring actions independent of the trustee, are where the defendant violates

¹ 11 U.S.C. § 541(a)(1).

² *Chartschiasa v. Nationwide Mut. Ins. Co.*, 538 F.3d 116, 122 (2d Cir. 2008).

³ *St. Paul Fire & Marine Ins. Co. v. PepsiCo, Inc.*, 884 F.2d 688, 704 (2d Cir. 1989).

⁴ *Id.* at 701.

“an independent legal duty” which it held to the plaintiff, or where a defendant knowingly misleads a plaintiff to purchase securities issued by the debtor.⁵

This memorandum will analyze how these standing principles apply to bankruptcy proceedings involving complex fraudulent schemes, known as Ponzi schemes.

I. Courts Will Not Allow Creditors to Artfully Plead Their Way Out of Bankruptcy Court in an Attempt to Recover Losses Resulting From a Ponzi Scheme.

Courts have repeatedly dismissed claims in which plaintiffs attempt to bring claims which are related to bankruptcy proceedings outside of bankruptcy courts. These types of claims are often prevalent in Ponzi schemes, where creditors may be unsatisfied with their share of the settlement recovered by the trustee of the debtor’s estate.⁶ Courts have noted that where a claim could be asserted by a majority of the creditors, it is a general claim that is the exclusive property of the trustee of the debtor’s estate.⁷ However, if a plaintiff can show that the injury suffered was specific to him or her and could not be asserted by the creditor class, the plaintiff has standing to assert that claim independent of the trustee of the debtor’s estate.⁸

One specific instance in which the court dealt with this type of specific standing issue was in *Ritchie Capital Management, L.L.C. v. General Electric Capital Corporation*. *Ritchie Capital* was litigation that arose as a result of a fraudulent purchase-order financing Ponzi scheme run by Thomas Petters, beginning in 1998.⁹ General Electric Capital Corporation (“GECC”) entered into an agreement with Petters to fund the purchase order business, which

⁵ *In re Johns-Manville Corp.*, 517 F.3d 52, 63 (2d Cir. 2008); *In re Bernard L. Madoff Inv. Sec. L.L.C.*, 740 F.3d 81, 92-93 (2d Cir. 2014).

⁶ See *Ritchie Capital Mgmt., L.L.C. v. Gen. Elec. Capital Corp.*, 121 F. Supp. 3d 321, 326 (S.D.N.Y. 2015).

⁷ See *In re Cabrini Med. Ctr.*, 489 B.R. 9, 22 (S.D.N.Y. 2012).

⁸ *St. Paul Fire & Marine Ins. Co.*, 884 F.2d at 704.

⁹ 121 F.Supp. 3d 321, 326 (S.D.N.Y. 2015).

resulted in \$45 million owed to GECC by October 27, 2000.¹⁰ In their complaint, Ritchie Capital Management (“Ritchie”) alleged that in order to repay GECC, Petters induced other investors to participate in his fraudulent purchase order business, and used the money which he secured in order to pay the debt owed to GECC.¹¹ The complaint further alleged that Petters only engaged in these actions after GECC had confronted Petters on suspicion that the transactions were fraudulent, and in exchange for being repaid in full, GECC remained silent about their knowledge of Petters scheme.¹² Nothing in the complaint alleges any fraudulent dealings directly between Ritchie and GECC, but rather that GECC’s silence after learning of Petters’ scheme enabled future creditors to be defrauded, and amounted to aiding and abetting fraud, as well as civil conspiracy.¹³

Ritchie did not learn of GECC’s involvement in aiding Petters until 2009, during Petters’ criminal trial, which resulted in his conviction and a sentence of 50 years in prison.¹⁴ After Petters’ conviction, the trustee of Petters’ estate filed suit against GECC in a separate action in the Bankruptcy Court in the District of Minnesota, seeking to recover \$300 million resulting from 13 counts of fraudulent transfer.¹⁵ The claim was settled by the parties for \$19 million “in full, final, and complete settlement of all claims that the debtors, Petters Estates, the Trustee or the Receiver have released and not reserved in this Agreement.”¹⁶ After the District Court dismissed Ritchie’s claim on the grounds that they did not have standing to assert the claim, and in the alternative, that they failed to state a claim upon which relief could be granted, Ritchie

¹⁰ *Id.* at 327.

¹¹ *Id.*

¹² *Id.*

¹³ *Id.* at 333.

¹⁴ *Id.* at 329.

¹⁵ *Id.*

¹⁶ *Id.* at 330 (quoting No. 08 Bk. 45257 (D. Minn.), Dkt. 1733 (Order Approving Settlement Agreement, June 28, 2012)).

appealed to the Second Circuit.¹⁷ The Second Circuit affirmed on the grounds that Ritchie lacked standing to bring the claim.¹⁸

A. Ritchie Capital's Claims Were the Exclusive Property of the Petters Estate, Therefore Ritchie did not Have Standing to Bring Suit Against GECC.

In appealing the District Court's dismissal on grounds they did not have standing to bring the suit, Ritchie advanced two arguments. The first argument asserted was that the claims Ritchie asserted were in fact particularized to Ritchie, and that the Petters Estate could not bring them on its own, therefore the claims were not property of the Petters Estate.¹⁹ The second argument Ritchie asserted was that even had Petters brought these claims against GECC, they would have been barred by *in pari delicto*, which bars third parties from bringing claims against "partners in crime."²⁰ Adopting the District Court's reasoning, the Second Circuit held that Ritchie had failed to allege a particularized injury, and therefore did not have standing to pursue their claim.²¹

In its standing analysis, the District Court noted previous proceedings, all alleging facts from Petters' Ponzi scheme, which were eventually fatal to Ritchie's claim. Specifically, the court noted the proceeding involving the settlement between Petters' Estate and GECC. The District Court observed that Ritchie's complaint and the action brought by Petters' estate shared six allegations which were at the core of their complaint.²² The Court stated that although the action brought by the Petters Estate contained different elements than the state law claim brought by Ritchie, because the action had "the same focus as a fraudulent conveyance action under 11

¹⁷ *Id.* at 339.

¹⁸ *Ritchie Capital Mgmt., L.L.C. v. General Electric Capital Corp.*, 821 F.3d 349, 352 (2d Cir. 2016).

¹⁹ *Id.* at 351.

²⁰ *Id.*; *Ritchie Capital*, 121 F.Supp. 3d at 337.

²¹ *Id.*

²² *Ritchie Capital*, 121 F. Supp. 3d at 336.

U.S.C. § 548(b),” the actions were the property of the estate and only the trustee had standing to bring them.²³ The Court emphasized that this proceeding not only proved that these claims were the sole property of the Petters Estate to bring against GECC, but that this proceeding showed that these claims were actually brought and settled between the two parties.²⁴ Further damaging Ritchie’s argument, the settlement was approved by the bankruptcy court without objection from Ritchie.²⁵ Because Ritchie had no direct dealings with GECC in the process of being defrauded, the claims he was alleging against GECC could have been pursued by any creditor who was defrauded by Petters, leaving the Petters Trustee as the person who had proper standing to challenge the generalized injuries in court.

B. The Wagoner Rule Does Not Apply in the Case at Hand Because the Petters Estate is not the Party Bringing the Action

The District Court also rejected Ritchie’s arguments that the Petters Trustee was barred from bringing these claims against GECC as a result of the Wagoner Rule and the doctrine of *in pari delicto*.²⁶ As the Court explained, “[t]he thrust of these doctrines is that a bankrupt wrongdoer may be barred from pursuing damages claims against its ‘partners in crime’—third parties who participated in the unlawful conduct.”²⁷ The Court declined to accept Ritchie’s arguments that these arguments barred the Petters Trustee from bringing these claims for several reasons. First, the Court had already decided that the claims brought by Ritchie had belonged to the Petters Estate, and had already been brought before the Bankruptcy Court for the District of Minnesota.²⁸ Second, because *in pari delicto* is an affirmative defense of common law, it must

²³ *Id.* at 337 (citing *Nat’l Am. Ins. Co. v. Ruppert Landscaping Co.*, 187 F.3d 439, 441 (4th Cir. 1999)).

²⁴ *Id.*

²⁵ *Id.*

²⁶ *Ritchie Capital*, 121 F.Supp. 3d at 337.

²⁷ *Id.*

²⁸ *Id.*

be actually pled, and cannot apply hypothetically when the suit is brought by a third-party creditor.²⁹ Similarly, the Court explained that the Wagoner Rule cannot apply when the action is brought by a third party creditor and not the Trustee of the estate, since the Wagoner Rule is a federal rule of standing and the Court cannot hypothetically rule on the Trustee's standing in a suit brought by a third-party creditor.³⁰

In upholding the district court's dismissal of Ritchie's claims, the Second Circuit reaffirmed a policy of ensuring that plaintiffs are not able to artfully plead their way out of bankruptcy courts.

II. Requiring Specific Injury in Order for Creditors to Assert Standing Promotes the Underlying Purpose of the Bankruptcy Code.

Recognizing that bankruptcy proceedings are typically much more complex than typical two party litigations, Congress took it upon itself to create the Bankruptcy Code and bankruptcy courts. Two of the underlying goals of Congress in enacting the bankruptcy system was to promote judicial efficiency throughout the court system, as well as to ensure that the process be as equitable as possible for all creditors involved. The standing requirement imposed on creditors, requires that they be able to show specific injury, promotes both of those goals.

A. Making Claims the Exclusive Property of the Debtor's Estate Ensures Equity Among all Creditors.

Because of the complex nature of bankruptcy proceedings, especially those involving Ponzi schemes, it becomes especially crucial for courts to ensure that all of the creditors involved have an opportunity to recoup at least some of their losses. Thus, by binding creditors to the results of the litigation brought forth by the trustee of the estate, the bankruptcy proceedings are

²⁹ *Id.* (citing *In re Madoff*, 848 F. Supp. 2d 469, 484 (S.D.N.Y. 2012).

³⁰ *Id.*

able to eliminate a “race to the courthouse,” which would allow creditors to be paid on a first come, first served basis.³¹

The Second Circuit discussed these concerns in *St. Paul Fire & Marine Ins. Co. v. Pepsico, Inc.*³² *St. Paul* rose to the Second Circuit as an appeal of a dismissal of the plaintiff’s third party complaint at the district court level.³³ The Second Circuit affirmed the dismissal, holding that the third-party-complaint was the exclusive property of the estate of the trustee because it was general in nature and would directly affect all the creditors involved.³⁴ The Court pointed to the underlying purpose of this standard being included in the Bankruptcy Code, stating that it “provides creditor protection. Without it, certain creditors would be able to pursue their own remedies against the debtor’s property. Those who acted first would obtain payment of the claims in preference to and to the detriment of other creditors.”³⁵

The Second Circuit’s reasoning in *St Paul* is a consistent theme which runs throughout cases in which plaintiffs attempt to recover outside of bankruptcy proceedings.³⁶ Courts have shown their reluctance to allow these types of claims to be brought outside of the bankruptcy setting, even when brought against a third party, such as the instances in both *St Paul* and *Ritchie Capital*. By repeatedly affirming this standing principle, courts are ensuring that the bankruptcy proceeding maintains its status as the proper venue in these types of cases, as well as eliminating the creditor race to the courthouse that Congress was clearly concerned about.

B. Imposing Stricter Standing Requirements Promotes the Bankruptcy Court’s Goal of Judicial Efficiency.

³¹ See *Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. L.L.C.*, 429 B.R. 423, 430 (Bankr. S.D.N.Y. 2010).

³² 884 F.2d 688.

³³ *Id.* at 690.

³⁴ *Id.* at 701.

³⁵ *Id.* (quoting H.R. Rep. No. 595, 95th Cong., 2nd Sess. 340, reprinted in 1978 U.S.Code Cong. & Admin.News 5963, 6297).

³⁶ See *Ritchie Capital*, 121 F.Supp. 3d at 333.

Due to the often extensive number of parties involved in bankruptcy proceedings, courts maintain a heightened interest in making sure that these proceedings are carried out as efficiently as possible. This concern becomes especially apparent in cases where plaintiffs attempt to circumvent the bankruptcy courts in order to obtain their own relief, separate of the creditor class. In its decision upholding the dismissal of a complaint at the district court level, the Fourth Circuit explained the importance of judicial efficiency in *National American Insurance Co. v. Ruppert Landscapping Co.*³⁷ In maintaining that the plaintiff attempted to plead its way out of bankruptcy court by bringing claims which belonged to the estate, the Court noted that it is the trustee's role to bring these claims.³⁸ By bringing these suits, the trustee "eliminates the many wasteful and individual suits of individual creditors."³⁹ The Court noted that it was not just the individual claims of the parties which were at stake, and to allow plaintiffs to bring these types of suits "would unravel the bankruptcy process and undermine distribution of the bankruptcy estate. The goal of bankruptcy is to consolidate the proceedings and avoid piecemeal litigation."⁴⁰

Conclusion

The ruling in *Ritchie Capital* further solidifies the notion that claims which affect an entire class of creditors are the sole property of the estate of the debtor. If creditors wish to recover independent of the actions of the trustee, they must be able to show that the injury they suffered was specific to them, and could not be brought by the trustee or the debtor. Courts have held that this principle applies even when plaintiffs are attempting to bring suits against third parties.

³⁷ 187 F.3d 439 (4th Cir. 1999).

³⁸ *Id.* at 441.

³⁹ *Id.* (quoting *Koch Ref. v. Farmers Union Cent. Exch., Inc.*, 831 F.2d 1339, 1342-1343 (7th Cir. 1987)).

⁴⁰ *Id.* at 442.

This holding protects many aspects of the bankruptcy process. First, it protects debtors from being subject to liability from numerous creditors in numerous proceedings. Second, it protects creditors' interests by ensuring that an equitable distribution of the available assets will be achieved, as well as avoiding a race to the courthouse by creditors seeking to be the first to recover. Finally, it protects the bankruptcy process as a whole by ensuring that bankruptcy courts retain their authority to issue final rulings, as well as consolidating bankruptcy proceedings in a single forum.