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## Chapter X Trustee's Standing to Sue - A Pragmatic Approach - Caplin v. Marine Midland Grace Trust Co., The

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# NOTES

## The Chapter X Trustee's Standing To Sue — A Pragmatic Approach — *Caplin v. Marine Midland Grace Trust Co.*

Trustee in reorganization, Caplin, brought an action to recover the amount of the corporation's outstanding debentures from the indenture trustee, Marine Midland Grace Trust Company of New York. The complaint alleged that Marine Trust breached a provision of the trust indenture by not requiring the issuing corporation to maintain an asset-liability ratio of two-to-one. The issuing corporation had sustained losses in every year from 1959 until 1965, when Marine Trust filed a petition for reorganization of the corporation under chapter X of the Bankruptcy Act.<sup>1</sup> Caplin, after discovering that the corporation's asset-liability ratio was less than one-to-four, filed suit in a district court against Marine Trust on behalf of the debenture holders, alleging that Marine Trust had either negligently or willfully failed to fulfill its indenture obligation, and that Marine Trust knew or should have known that the yearly certificates of compliance submitted by the issuing corporation were fraudulent in that they were based on grossly overvalued appraisals of real property. The district court found that Caplin had no standing to sue, and the court of appeals affirmed the decision.<sup>2</sup> *Held, affirmed*: A trustee in reorganization does not have standing to sue an indenture trustee on behalf of the corporation's debenture holders. *Caplin v. Marine Midland Grace Trust Co.*, 406 U.S. 416 (1972).

### I. THE BANKRUPTCY ACT—ITS ORIGIN AND PURPOSE

Prior to statutory codification of the corporate reorganization laws, there were only three established ways of effecting a reorganization:<sup>3</sup> (1) through a voluntary arrangement of debtors and creditors, (2) through a composition and sale of assets under section 12 of the Bankruptcy Act,<sup>4</sup> or (3) through an equity receivership.<sup>5</sup> Although the most prevalent method was the equity receivership, even it had definite problems.<sup>6</sup> It was criticized as providing for little judicial control and giving inadequate protection to widely scattered security holders.<sup>7</sup>

The forerunners of chapter X of the Bankruptcy Act were enacted primarily to establish a fair and effective method of corporate rehabilitation, preventing the necessity of liquidating the corporation when it got into financial straits.<sup>8</sup>

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<sup>1</sup> 11 U.S.C. §§ 501-676 (1970).

<sup>2</sup> 439 F.2d 118 (2d Cir. 1971).

<sup>3</sup> See Levi & Moore, *Bankruptcy and Reorganization: A Survey of Changes. II*, 5 U. CHI. L. REV. 219 (1938).

<sup>4</sup> Act of July 1, 1898, ch. 541, § 12, 30 Stat. 549.

<sup>5</sup> In a voluntary arrangement, the creditors and owners attempt to effect a reorganization without resorting to court action. The composition is made pursuant to former § 12 of the Bankruptcy Act after a petition has been filed. The sale involves simply a purchase of these assets by the reorganizers. The equity receivership interposed a court appointed receiver who took control of the debtor's property and allowed the interested parties to reach an agreement for reorganization before the assets were sold. 6 W. COLLIER, *BANKRUPTCY* ¶¶ 0.02-04 (14th ed. J. Moore 1971).

<sup>6</sup> *Id.* ¶ 0.01.

<sup>7</sup> *SEC v. American Trailer Rentals Co.*, 379 U.S. 594, 603 (1965).

<sup>8</sup> 83 CONG. REC. 8679-82 (1937) (remarks of Senator O'Mahoney).

It was important to encourage rehabilitation rather than liquidation because of the increasing number of large, publicly-held corporations. The liquidation of such a corporation had a financial effect on a large number of people, whereas the liquidation of a small business with only a few creditors and owners had a much smaller effect. It was reasoned, therefore, that the liquidation of a large corporation had a potential for affecting the economy as a whole.<sup>9</sup>

Section 77(b) of the Bankruptcy Act,<sup>10</sup> the first real attempt at codifying the reorganization methods, was enacted during the depression.<sup>11</sup> The purpose of section 77(b) was to aid the many corporations which were in financial difficulties at that time,<sup>12</sup> and to correct the defects and abuses in the equity receivership procedures.<sup>13</sup> The new section, although correcting some of the defects in the equity receivership, was still complicated, ambiguous, and confusing, and itself led to some abuses.<sup>14</sup>

Chapter X of the Chandler Bill,<sup>15</sup> later enacted as chapter X of the Bankruptcy Act,<sup>16</sup> was introduced in Congress as a result of a comprehensive study by the Securities and Exchange Commission,<sup>17</sup> which indicated that a revision of section 77(b) would be advisable. This study evaluated the many conflicts of interest and abuses that were incident to the use of the reorganization provisions of the Bankruptcy Act then in force. Additionally, it pointed out the need for a uniform statutory system that would allow a balancing of the competing interests of the parties involved in a reorganization: the investors, creditors, and reorganizers, with primary emphasis placed on protection of the investors and creditors.<sup>18</sup>

Chapter X was intended to give increased protection to creditors and stockholders who were normally not in a position to protect their own interests.<sup>19</sup> The reorganization was structured to protect the investors whose money had been put into the corporation rather than the interests of management or other dominant groups.<sup>20</sup>

## II. THE ROLE OF THE CHAPTER X TRUSTEE

Under section 187 of the Bankruptcy Act,<sup>21</sup> the trustee in reorganization is given the same rights, powers, and duties that section 47<sup>22</sup> gives to a trustee

<sup>9</sup> *Id.* at 8680.

<sup>10</sup> Act of June 7, 1934, ch. 424, § 77B, 48 Stat. 912.

<sup>11</sup> *Id.*

<sup>12</sup> H.R. REP. NO. 1409 ON H.R. 8046, 75th Cong., 1st Sess. 38 (1937).

<sup>13</sup> 83 CONG. REC. 8680 (1937) (remarks of Senator O'Mahoney); see *SEC v. American Trailer Rentals Co.*, 379 U.S. 594, 604 (1965).

<sup>14</sup> See Friendly, *Some Comments on the Corporate Reorganizations Act*, 48 HARV. L. REV. 39 (1934). The equity receivership served to perpetuate those in control who were already in power, there was no control over counsel fees, and it often resulted in personal advantage to some small groups to the detriment of others.

<sup>15</sup> H.R. 8046, 75th Cong., 1st Sess. (1937).

<sup>16</sup> 11 U.S.C. §§ 501-676 (1970).

<sup>17</sup> S.E.C., REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL, AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES (1940).

<sup>18</sup> *Id.*, pt. I, at 1-6, 897-907.

<sup>19</sup> 83 CONG. REC. 8681 (1937); *Hearings on H.R. 6439*, 75th Cong., 1st Sess. 163-64 (1937). Prior to chapter X, reorganization was handled primarily by insiders who restructured the corporation to give themselves maximum benefit.

<sup>20</sup> S.E.C. REPORT, *supra* note 17, pt. VII, at 105-10.

<sup>21</sup> 11 U.S.C. § 587 (1970).

<sup>22</sup> *Id.* § 72.

in bankruptcy, plus all the rights and powers that a receiver in equity would have over the property of the debtor.<sup>23</sup> Section 70 designates which items of "property" the trustee has title to,<sup>24</sup> and section 167 lists still other powers and duties of investigation that the trustee has.<sup>25</sup>

The trustee's power over the debtor's property is vested in him by section 70,<sup>26</sup> which gives the trustee legal title to all of the bankrupt's "property" and certain of the bankrupt's "rights of action."<sup>27</sup> The determination of whether a right of action is properly asserted by a trustee as "property of the debtor," however, requires additional analysis to determine if the right of action clearly fits within the language of section 70.

Even if a trustee is denied a certain right of action by failure to qualify under section 70, it still may be possible for him to assert the right of action under the broad powers of a receiver in equity.<sup>28</sup> Further, there is authority for allowing a receiver in equity to assert certain rights of action, such as the rights of the corporate creditors, that would ordinarily not be available to the corporation.<sup>29</sup>

In *Clarke v. Chase National Bank*<sup>30</sup> the Court of Appeals for the Second Circuit held that the trustee in reorganization did not have standing to sue a third party on behalf of corporate bondholders. The *Clarke* case involved a diminution in value of the corporation's outstanding debentures resulting from breaches in the terms of the indenture. The trustee in reorganization alleged that the breaches were overlooked by the indenture trustee who should be required to restore to the debenture holders the amount of their losses. In response to this allegation, the court said that such causes of action were "personal to the debenture-holders and have no place in a plan of reorganization.... Moreover, the trustee in bankruptcy has no title to the claims... and is not the real party in interest by whom such claims should be asserted under Rule 17(a) of the Rules of Civil Procedure...."<sup>31</sup>

In several cases the trustee in reorganization was allowed to sue the breaching indenture trustees.<sup>32</sup> However, in none of these cases did the courts actually

<sup>23</sup> *Id.* § 587.

<sup>24</sup> *Id.* § 110.

<sup>25</sup> *Id.* § 567.

<sup>26</sup> *Id.* § 110.

<sup>27</sup> 11 U.S.C. § 110a(5) (1970) gives the trustee title to "property, including rights of action, which prior to the filing of the petition he could by any means have transferred or which might have been levied upon and sold . . ." 11 U.S.C. § 110a(6) (1970) gives the trustee title to "rights of action arising upon contracts, or usury, or the unlawful taking or detention of or injury to his property."

<sup>28</sup> 11 U.S.C. § 587 (1970); see text accompanying note 23 *supra*.

<sup>29</sup> See, e.g., *McCandless v. Furlaud*, 296 U.S. 140 (1935), in which it was held that a receiver may sue to require promoters to account for money fraudulently diverted to the prejudice of the corporate creditors; *Iglehart v. Todd*, 203 Ind. 427, 178 N.E. 685 (1931), holding that the receiver of a corporation represents creditors and can maintain and defend actions which the corporation could not; *Lyons v. Benney*, 230 Pa. 117, 79 A. 250 (1911), holding that when an act has been done in fraud of the rights of the corporation's creditors, the receiver may sue for their benefit, even though the defense set up might be valid against the corporation itself; *State Bank v. Kirk*, 216 Pa. 452, 65 A. 932 (1907), holding that the receiver represents both the creditors of the corporation and the corporation itself. See generally 2, 3 R. CLARK, *THE LAW AND PRACTICE OF RECEIVERS* (3d ed. 1959).

<sup>30</sup> 137 F.2d 797 (2d Cir. 1943).

<sup>31</sup> *Id.* at 800, 801. FED. R. CIV. P. 17(a) provides that "[e]very action shall be prosecuted in the name of the real party in interest."

<sup>32</sup> *Prudence-Bonds Corp. v. State Street Trust Co.*, 202 F.2d 555 (2d Cir.), *cert. denied*,

say that they were allowing the trustee to assert a right on behalf of the corporate bondholders. The closest any court came to saying that the trustee was asserting such a right was in *Central Hanover Bank & Trust Co. v. President & Directors of Manhattan Co.*<sup>33</sup> In this early case the Court of Appeals for the Second Circuit held that a trustee in reorganization had standing to sue a number of breaching indenture trustees, since he had all the power of a trustee in bankruptcy in addition to the power of a receiver in equity. The court found that these powers included the right to sue in certain situations where the reorganized corporation could not. In *Prudence-Bonds Corp. v. State Street Trust Co.*<sup>34</sup> the Court of Appeals for the Second Circuit also allowed a suit against an indenture trustee, but there the suit was brought by the reorganized corporation rather than the trustee.<sup>35</sup> The court made it clear, however, that its decision was based on a reading of chapter X and rule 17 of the Federal Rules<sup>36</sup> together, and indicated that absent such statutory construction the corporation would have no standing to sue.<sup>37</sup> Finally, in *In re Solar Manufacturing Corp.*<sup>38</sup> the Court of Appeals for the Third Circuit allowed a trustee in reorganization to maintain a counterclaim against a breaching indenture trustee for funds that were to be held for certain debenture holders. The court distinguished the earlier *Clarke* case on the basis that the trustee could assert by counterclaim an action that he could not assert by way of an original suit filed against the indenture trustee.

In all of these cases the courts' decisions revolved primarily around the question of whether the rights of action of the bondholders were the debtor's "property,"<sup>39</sup> thus giving the trustee the right to sue on behalf of the bondholders. The *Clarke* court found that the rights of action of the bondholders did not constitute such "property,"<sup>40</sup> whereas in *Central Hanover Bank, Prudence-Bonds*, and *Solar Manufacturing*, the courts, perhaps indirectly, found that such rights of action did constitute "property" and, therefore, held that the trustee had standing to sue.

### III. CAPLIN V. MARINE MIDLAND GRACE TRUST CO.

Caplin, as trustee, argued that the powers given a reorganization trustee under the Bankruptcy Act were broad enough to allow a suit on behalf of

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346 U.S. 835 (1953); *In re Solar Mfg. Corp.*, 200 F.2d 327 (3d Cir. 1952), *cert. denied*, 345 U.S. 940 (1953); *Central Hanover Bank & Trust Co. v. President & Directors of Manhattan Co.*, 105 F.2d 130 (2d Cir. 1939).

<sup>33</sup> 105 F.2d 130 (2d Cir. 1939).

<sup>34</sup> 202 F.2d 555 (2d Cir.), *cert. denied*, 346 U.S. 835 (1953).

<sup>35</sup> This fact does not affect this case's applicability to the *Caplin* case, since, under § 70 of the Bankruptcy Act, any cause of action that belongs to the corporation also belongs to the reorganization trustee. 11 U.S.C. § 110 (1970).

<sup>36</sup> FED. R. CIV. P. 17.

<sup>37</sup> 202 F.2d at 560. At the time of this case, FED. R. CIV. P. 17(a), 308 U.S. 685 (1939), allowed a party authorized by statute to sue in his own name without joining with him the party for whose benefit the action was brought.

<sup>38</sup> 200 F.2d 327 (3d Cir. 1952), *cert. denied*, 345 U.S. 940 (1953).

<sup>39</sup> See, e.g., *Clarke v. Chase Nat'l Bank*, 137 F.2d 797, 800 (2d Cir. 1943); *Central Hanover Bank & Trust Co. v. President & Directors of Manhattan Co.*, 105 F.2d 130, 132 (2d Cir. 1939).

<sup>40</sup> 137 F.2d at 800. The court found that the claims for breach of the covenants did not derive from the bankrupt estate, but from the alleged tortious action of the indenture trustee.

debenture holders, and that the trustee was, in fact, in a better position to sue than the individual debenture holders. He further contended that this action would not cause an overabundance of litigation. The Supreme Court, however, rejected all of petitioner's theories.

First, the Court found no suggestion in the Bankruptcy Act that the reorganization trustee had the right or responsibility of suing on behalf of anyone other than the reorganization estate.<sup>41</sup> Secondly, the Court rejected the petitioner's contention that the trustee is granted the power for such a suit in section 187 of the Bankruptcy Act,<sup>42</sup> which gives the reorganization trustee the additional rights of a receiver in equity. The Court stated that the case on which the petitioner relied, *McCandless v. Furland*,<sup>43</sup> was inapplicable since it did not involve a suit on behalf of third parties, but one on behalf of the corporation itself.<sup>44</sup> Finally, the Court pointed to the many practical difficulties of allowing such a suit, and suggested that the availability of the class action remedy to the debenture holders eliminated any need for the trustee's suit.<sup>45</sup>

In its haste to solve the problem on the basis of the practical considerations involved, the Court failed either to follow or distinguish the previous case law as it related to the statutes. The Court was concerned that giving the trustee standing to sue would create more problems than it would solve. Further, the Court pointed to the subrogation issue discussed in the lower court,<sup>46</sup> which would mean that even if the trustee were able to recover from Marine Trust, Marine Trust would be entitled to be substituted in place of the debenture holders as claimants to the corporate assets.<sup>47</sup> Thus, the outcome of such a suit would not decrease the corporation's indebtedness, since it would result in the replacement of one creditor with another, and would not leave a larger amount of assets for distribution to the remaining creditors and owners. Without attempting to resolve the merits of the subrogation issue, the Court pointed out that regardless of whether Marine Trust would be entitled to subrogation, the amount of recovery available to the debenture holders from the indenture trustee would be only that amount which the bankrupt estate failed to satisfy. Since this amount is incalculable until the reorganization is almost complete,

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<sup>41</sup> The Court stated that "the statute, 11 U.S.C. § 567(3), gives the trustee the right, and indeed the duty, to investigate fraud and misconduct and to report to the judge the potential causes of action 'available to the estate' . . . . [T]here is nothing in the section that enables him to collect money not owed to the estate." 406 U.S. 416, 428 (1972).

<sup>42</sup> 11 U.S.C. § 587 (1970).

<sup>43</sup> 296 U.S. 140 (1935).

<sup>44</sup> The *McCandless* case involved a scheme by corporate promoters to form a corporation with low capitalization and to have it issue bonds to buy the promoter's land at an inflated price. The court allowed the corporate receiver to recover from the promoters, but the case is not clear as to on whose behalf the recovery is made, the corporation itself or its creditors. The Court did say, however, that the receiver in equity could sue in such a situation, regardless of whether the corporation itself could sue. 296 U.S. 140 (1935).

<sup>45</sup> The Court indicated that such a suit by Caplin might be inconsistent with the independent actions of the debenture holders themselves, and that the debenture holders did not need the trustee to sue in their behalf, since rule 23 of the Federal Rules of Civil Procedure allowed them to avail themselves of the class action remedy.

<sup>46</sup> 439 F.2d 118, 122 (2d Cir. 1971).

<sup>47</sup> 406 U.S. 416, 430 (1972). "Subrogation may be defined as the substitution of another person in the place of a creditor, so that the person in whose favor it is exercised succeeds to the rights of the creditor in relation to the debt." 83 C.J.S. *Subrogation* § 1 (1953). It is viewed as an "equitable remedy," hence the application of equitable doctrines to a person seeking its relief. See, e.g., 406 U.S. 416, 440 (1972).

it presents a problem in deciding the amount debenture holders would be able to recover.<sup>48</sup> Consequently, the Court seems justified in not accepting the trustee's argument that his suit could relieve the corporation of the burden of distributing assets to one class of creditors.

The Court pointed out additional problems which would arise if the trustee was given standing to sue. If the trustee's suit did not preclude independent suits by the debenture holders, it would create further litigation on the same issue. The problem of whether the debenture holders were bound by any out-of-court settlement by the trustee would also arise. These two problems do indeed exist, and will continue to exist, until Congress undertakes to codify the procedure in situations such as this.

Finally, the Court pointed out that rule 23 of the Federal Rules of Civil Procedure, which makes class actions available to the debenture holders, obviated the necessity for a suit by the reorganization trustee and afforded the debenture holders adequate protection.<sup>49</sup> It is the opinion of several writers, however, that the class action is not the panacea that the Court indicates, and that it is not a remedy of which a debenture holder or shareholder may automatically avail himself.<sup>50</sup>

After concluding that the reorganization trustee did not have standing to sue, the Court asked Congress to resolve the point by making a policy decision that it refused to make.<sup>51</sup> The Court did not indicate that it would be unwise to give the trustee standing in this situation, but found no evidence of congressional intent to grant standing to the reorganization trustee.

In a dissenting opinion, Justices Douglas, Brennan, White, and Blackmun asserted that the majority misconstrued the role of a chapter X trustee, and that his power is broad enough under the statute<sup>52</sup> to allow such a suit. This

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<sup>48</sup> Since the corporation's assets will be distributed first to its creditors by virtue of the "absolute priority doctrine" (*see* *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106 (1939)), the debenture holders' loss may not be to the full extent of the outstanding debenture obligation. This point was made in the case of *Clarke v. Chase Nat'l Bank*, 137 F.2d 797 (2d Cir. 1943), in which it was stated that "each creditor, including the debentureholders, can prove the full amount of his claim, and only to the extent that a debentureholder fails to satisfy it from the bankruptcy estate will he suffer a loss which he can assert against the defendant through its failure to enforce the negative covenants." *Id.* at 800.

<sup>49</sup> 406 U.S. 416, 433-34 (1972).

<sup>50</sup> To qualify under rule 23, the member of the class must comply with certain general requirements, the satisfaction of which is a question that is almost entirely within the discretion of the trial judge. The plaintiff must show (1) that the class is too numerous for joinder to be practical, (2) that the rights of the class involve common questions of law or fact, (3) that the claims of the representatives are typical of the class, and (4) that the representatives will adequately protect the interests of the class. After these requirements are met, the class action plaintiff still faces a complex and expensive process of managing the suit. In fact, the determination of whether the action is maintainable as a class action may itself require substantial discovery and extensive litigation. This could leave plaintiff in the position of having spent large sums in preparation, only to have the class action alternative taken from him. *See* Harte & Forde, *Practical Problems in Handling Class Actions*, 15 TRIAL LAW GUIDE 549, 551 (1971). *See also* Note, *Revised Federal Rule 23, Class Action: Surviving Difficulties and New Problems Requiring Further Amendments*, 52 MINN. L. REV. 509 (1967). Finally, even after an action has been designated a class action by the courts, the plaintiff has other requirements to fulfill under rule 23 which may involve onerous, if not prohibitive, expense. For example, if the notice requirement of rule 23 is satisfied to the extreme limits of due process, as defense counsels tend to view as mandatory, vast amounts of expense to the plaintiff will be involved. *See* Pomerantz, *New Developments in Class Actions—Has Their Death Knell Been Sounded?*, 25 BUS. LAW. 1259 (1970).

<sup>51</sup> 406 U.S. 416, 434 (1972).

<sup>52</sup> 11 U.S.C. § 567 (1970).

argument is well taken, as the previous discussion points out. The minority went on to suggest that payment of the amounts outstanding on the debentures would eliminate those creditors from the reorganization, and, therefore, allow the corporate assets to be reallocated among fewer creditors.<sup>53</sup> In making this argument, the minority disagreed with the majority's position on subrogation,<sup>54</sup> stating that the equitable remedy of subrogation would not be available to Marine, since Marine did not have "clean hands" which would allow it to invoke equity jurisdiction.<sup>55</sup> Thus, the dissent would give the reorganization trustee standing to sue by reaching exactly opposite conclusions from the majority. That is, the dissent found that the trustee had the power, and saw no particular practical difficulties involved in letting him use it.

Although a bankruptcy trustee would not ordinarily have the power of an equitable receiver, by giving the reorganization trustee in section 187 all of the powers of a trustee in bankruptcy, in addition to the power of a receiver in equity, it is at least arguable that Congress intended the trustee to continue using the broad powers of the equitable receivership. Consequently, taking these broad powers and superimposing them upon the general ideas and purposes behind the enactment of chapter X, it seems that the Court could have found, as the dissent did, that a trustee in reorganization did indeed have standing to sue on behalf of the debenture holders.

#### IV. CONCLUSION

The many practical difficulties involved in giving the chapter X trustee standing to sue on behalf of debenture holders seem, in this case, clearly to have dictated the outcome. It would not be difficult, however, given a similar fact situation, for a court to distinguish *Caplin* and reach an opposite conclusion. This idea is premised on two points in the *Caplin* Court's analysis.

First, the Court's extreme reliance on the class action remedy of rule 23 of the Federal Rules of Civil Procedure is perhaps unwarranted in light of the many difficulties that are still incident to its use. Secondly, the role and power of the chapter X trustee and his predecessor, the receiver in equity, was probably intended by Congress to be broader than the majority opinion would indicate.

Consequently, each court in the future will have to balance the advantages and disadvantages discussed in *Caplin* and decide which elements have the most importance. The most favorable solution to the problem, of course, would be for Congress to resolve the issue. While enacting an appropriate clarifying statute, it could provide the guidelines to solve the practical difficulties that are necessarily incident to a judicial determination of the matter.

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<sup>53</sup> 406 U.S. at 438.

<sup>54</sup> See text accompanying notes 46-47 *supra*.

<sup>55</sup> 406 U.S. at 440.