

Second Circuit Rules that Creditors Lacked Standing to Settle Estate Claims

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As more and more companies file for bankruptcy protection, creditors and other stakeholders have increasingly assumed a more active role in the proceedings as a means of both maximizing their recoveries and influencing the outcome. Vehicles for stakeholder participation include the right to participate generally in the main bankruptcy proceeding, intervention in litigation filed during the case, representation and prosecution of stakeholder interests as a member of an officially-sanctioned committee, and, in a chapter 11 case, the right to vote for or against a chapter 11 plan proposed for the debtor.

Another means of pro-active participation — the ability of creditors or committees in a bankruptcy case to act on behalf of the estate by assuming certain powers traditionally reserved for a bankruptcy trustee or chapter 11 debtor-in-possession ("DIP") — has recently attracted a considerable amount of scrutiny. Because unequivocal authority for anyone other than a trustee or DIP to, for example, prosecute avoidance actions belonging to the estate is found nowhere in the Bankruptcy Code, the legitimacy of such "derivative standing" to sue continues to be an unsettled and controversial question. A related issue — whether creditors can settle estate causes of action — was addressed for the first time in a ruling recently handed down by the Second Circuit Court of Appeals. In *Smart World Technologies, LLC v. Juno Online Services, Inc.*, the Second Circuit held that creditors lacked standing to settle claims belonging to the estate.

Right to Be Heard in Bankruptcy

Unlike most ordinary litigation commenced in federal courts, a bankruptcy case generally impacts the substantive rights of a large group of creditors, shareholders and other parties with a stake in the outcome of the case. As a consequence, parties whose rights or remedies are affected by the case are allowed to participate generally in the proceedings by, for example, receiving notification of significant events during the course of the bankruptcy. Where a stakeholder's rights are directly impacted (*e.g.*, if the value of a creditor's collateral is eroding or the debtor continues to use the property during the bankruptcy case), various provisions of the Bankruptcy Code give the stakeholder a right to seek appropriate relief from the court, such as modification of the automatic stay or other measures designed to protect a secured creditor's interest in collateral.

The right to participate in a chapter 11 case is more explicit. Section 1109(b) of the Bankruptcy Code provides that “[a] party in interest, including the debtor, the trustee, a creditors’ committee, an equity security holders’ committee, a creditor, an equity security holder, or any indenture trustee, may raise and may appear and be heard on any issue in a case under this chapter.”

Exactly what "appear and be heard on any issue in a case" means is unclear. Although it is universally understood to encompass the right to inform the bankruptcy court of a stakeholder's position on issues arising in the main bankruptcy case, courts disagree as to whether section 1109 also creates the right to intervene formally in litigation commenced during the case, which in bankruptcy nomenclature is referred to as an "adversary proceeding."

“Case” and “proceeding” have distinct meanings in bankruptcy. The former refers to the main bankruptcy case that began when the debtor filed its bankruptcy petition. Certain kinds of litigation commenced thereafter, including suits to determine the validity, priority or extent of a lien, to subordinate a claim, to recover assets that were preferentially or fraudulently transferred, to obtain injunctive relief beyond the scope of the automatic stay or to object to the discharge of a debt, are classified as adversary "proceedings." These proceedings are governed by substantially the same procedural rules that apply to other federal litigation, including the rules determining when a non-party to the action can intervene because it has a stake in the outcome. Other types of disputed issues that arise in a bankruptcy case that do not qualify as adversary proceedings (*e.g.*, claims objections or stay relief motions) are referred to as “contested matters.”

Section 1109(b)'s express reference to a "case" has led some courts to conclude that the right of a party in interest to participate is limited to the main chapter 11 case. The First, Fourth, Fifth and Tenth Circuits favor this approach. The Second and Third Circuits take the opposite view. For instance, the Second Circuit held in *In re Caldor Corporation* that any party in interest in a chapter 11 case has an unconditional right to intervene in any adversary proceeding. According to the Court of Appeals, the phrase "any issue in a case" is all-encompassing and plainly grants a right to raise, appear and be heard on an issue regardless of whether it arises in a contested matter or an adversary proceeding.

Standing

Closely related to the right to be heard and the right to intervene is the concept of "standing." Standing is the ability to commence litigation in a court of law. It is a threshold issue — a court must determine whether a litigant has the legal capacity to pursue claims before the court can

adjudicate the dispute. In the bankruptcy context, the Bankruptcy Code determines who has the legal capacity to commence litigation concerning claims and causes of action that belonged to the debtor prior to filing for bankruptcy.

These claims become part of a debtor's bankruptcy estate on the petition date. Standing to prosecute estate claims is expressly given by statute to a bankruptcy trustee or DIP. Thus, for example, the trustee may sue to recover estate property preferentially or fraudulently transferred immediately prior to a bankruptcy filing, or can commence litigation seeking to hold officers and directors liable for pre-bankruptcy fiduciary improprieties.

Although the Bankruptcy Code does not expressly authorize anyone other than a trustee or DIP to prosecute claims belonging to the estate, many courts will allow committees or individual creditors to commence litigation on behalf of the estate under certain narrowly defined circumstances. In one of the seminal cases addressing this issue, the Second Circuit Court of Appeals held in *In re STN Enterprises* that, in considering a committee's request for leave to sue a director for misconduct, a court is required to consider whether the debtor unjustifiably failed to initiate suit against the director and whether the action is likely to benefit the debtor's estate. The Second Circuit broadened this doctrine in *In re Commodore International Ltd.*, which involved litigation brought by a creditors' committee against various officers and directors for fraud, waste and mismanagement. Unlike in *STN Enterprises*, the debtor in *Commodore* had not unreasonably refused to bring suit, but agreed to permit the committee to litigate the claims on behalf of the estate. The Court of Appeals ruled that a committee may bring suit even if the debtor does not unjustifiably refuse to do so as long as: (i) the trustee or debtor consents; and (ii)

the court finds that the litigation is (A) in the best interests of the estate and (B) necessary and beneficial to the fair and efficient resolution of the bankruptcy proceedings.

The Second Circuit's approach represents the majority view. Other courts have employed the same or similar standards to permit not only committees to bring suit on behalf of the estate, but individual creditors as well. Still, some courts reject derivative standing as illegitimate based upon the Bankruptcy Code's express reference to a "trustee" (and by inclusion, a DIP) in specifying who has the right to sue on behalf of the estate. The most notorious adherent to this view (albeit temporarily) was the Third Circuit Court of Appeals, which ruled in 2002 in *In re Cybergenics* that, based upon the express language of section 544(b) of the Bankruptcy Code, only a bankruptcy trustee has the authority to commence avoidance litigation that could have been brought by a creditor under applicable state law outside of bankruptcy.

The Court of Appeals did an about face on the issue the following year, vacating its original ruling and concluding that the scope of a bankruptcy court's equitable powers is sufficiently broad to encompass the discretion to delegate standing to a creditor or committee under appropriate circumstances. Despite the Third Circuit's imprimatur of approval, a handful of courts continue to reject derivative standing.

Compromise and Settlement in Bankruptcy

Part and parcel of prosecuting claims is the ability to settle them. Procedural rules implementing the Bankruptcy Code provide a framework for the settlement of claims or causes of action in a bankruptcy case. Rule 9019 provides that "[o]n motion by the trustee and after notice and a

hearing, the court may approve a compromise or settlement.” The purpose of the rule is to allow the trustee and the creditors to avoid the expenses and burdens associated with litigating sharply contested and dubious claims. Rule 9019 is silent, however, on what standard the court should apply in determining whether to grant its approval. This was left to the courts, which devised a number of different tests designed to gauge the reasonableness and fairness of settlements proffered by a bankruptcy trustee or DIP.

Although most courts agree that someone other than a bankruptcy trustee or DIP can be authorized to commence litigation on behalf of the estate, no court had been called upon to consider whether the concept of derivative standing or the broad right of intervention encompass the related right to compromise or settle estate claims, as opposed to litigating them. The Second Circuit became the first court to address the question in *Smart World Technologies*.

The Second Circuit's Ruling in Smart World Technologies

Internet service provider Smart World Technologies, LLC filed for chapter 11 protection in 2000 for the purpose of effecting the sale of its most valuable asset — its subscriber list — to a profitable competitor, Juno Online Services, Inc.. The bankruptcy court approved the sale three weeks after the case was filed. Prior to the closing, however, relations between Juno and Smart World soured because of a dispute concerning the number of qualified internet subscribers and the purchase price for the assets.

Juno ultimately commenced an adversary proceeding contending that Smart World had concocted false claims in an effort to extract additional consideration for the sale transaction. The litigation languished for three years, during which the court imposed a standstill based upon

Juno's assurances that a settlement was imminent. Smart World, however, did not participate in settlement negotiations, which Juno conducted almost exclusively with Smart World's creditors based upon its assessment that Smart World had no economic stake in the outcome in light of the estate's insolvency. The bankruptcy judge repeatedly denied Smart World's requests to proceed with the litigation, expressing the view that a settlement was in the best interests of all parties concerned.

In 2003, Juno and Smart World's creditors filed a motion pursuant to Bankruptcy Rule 9019 to settle the adversary proceeding. Under the terms of the settlement, Juno was to pay Smart World's largest creditor, WorldCom Technologies, Inc., \$5.5 million in exchange for a release of all claims. Smart World objected to the settlement, challenging, among other things, the standing of its creditors to pursue a settlement over its objections and claiming that it could not evaluate the reasonableness of the settlement because it had never had an opportunity to conduct discovery. The bankruptcy court approved the settlement, finding that it was in the best interests of all concerned and that Smart World's refusal to endorse it was unreasonable in light of the risks, expense and delay that would be posed by further litigation and the insolvency of the estate. The court also found that various provisions of the Bankruptcy Code giving creditors the right to intervene and endowing the bankruptcy court with broad equitable powers provided an adequate legal basis for conferring standing upon Smart World's creditors to pursue the settlement. The district court upheld this ruling on appeal.

Smart World appealed to the Second Circuit. Examining the language of Rule 9019, the Court of Appeals concluded that the rule explicitly "vests authority to settle or compromise solely in the

debtor-in-possession." This principle, the Court of Appeals explained, is consistent with lawmakers' desire to leave administration of a chapter 11 estate solely in the hands of the DIP and the DIP's statutory duty to manage the estate's legal claims wisely. According to the Second Circuit, "it is the debtor-in-possession who has the legal obligation to pursue claims or settle them, based upon the best interests of the estate."

The Court proceeded to consider whether the doctrine of derivative standing, the broad right of intervention found in section 1109(b) and the bankruptcy court's broad equitable powers can justify construing Rule 9019 broadly to permit settlement of estate claims by creditors. Though refusing to rule out the possibility categorically, the Second Circuit held that such authority was not warranted under the circumstances of the case before it.

First, the Court discussed the doctrine of derivative standing. Observing that "[i]n our view, there is an important difference between pursuing an otherwise neglected claim and settling a claim that the estate is trying to pursue," the Court distinguished the case before it from typical situations where committees are authorized to bring suit against the debtor's principals because the DIP refuses to do so. A DIP pursuing litigation in other contexts, the Second Circuit emphasized, is much less likely to be acting for reasons antithetical to the interests of the estate, such that "a party who seeks to displace the debtor faces a heavier burden."

The Second Circuit did not explain the extent of that burden. Instead, it concluded that Smart World's creditors were not entitled to derivative standing even under the standard applied under ordinary circumstances because the bankruptcy court summarily dismissed Smart World's claims

in the underlying litigation rather than determining the "'likelihood of success' of settlement versus litigation." In fact, the Second Circuit concluded that the bankruptcy court actively prevented Smart World from conducting discovery necessary to establish the merits of its claims, all the while expressing a strong preference for settlement over litigation. It also seemingly "ignored several signs that the interests of the settling parties were in conflict with those of the estate, thereby rendering creditor derivative standing inappropriate."

The Second Circuit did not rule out the possibility that "in rare circumstances derivative standing might be appropriate in the Rule 9019 context." Such circumstances, however, were not present in Smart World's chapter 11 case.

Consistent with U.S. Supreme Court precedent narrowly interpreting the substantive rights created by section 1109(b), the Second Circuit held that the statute does not entitle parties-in-interest to usurp a debtor-in-possession's role as legal representative of the estate. Moreover, the Court of Appeals emphasized, "a distinction can be drawn between the right to intervene in an adversary proceeding, to which [Smart World's creditors] are plainly entitled, and the right to take ownership of the debtor's claims in that adversary proceeding." The Second Circuit explained that intervenors' claims are separate from those of the original parties to a proceeding. According to the Court of Appeals, in drafting section 1109(b), lawmakers could not have intended to override other provisions carving out an exclusive role for the debtor-in-possession as legal representative and fiduciary of the estate.

The Second Circuit also rejected section 105 of the Bankruptcy Code as a basis for authorizing creditors to settle claims belonging to the estate. Even though section 105 gives a bankruptcy court broad equitable powers to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions" of the Bankruptcy Code, the Court of Appeals emphasized, it cannot be used to create substantive rights that do not already exist elsewhere in the statute.

Concluding that sections 1109(b) and 105(a), and, under the circumstances, the doctrine of derivative standing could not serve as a basis for authorizing Smart World's creditors to settle the adversary proceeding, the Second Circuit vacated the orders below and remanded the matter to the bankruptcy court.

Outlook

Smart World reinforces one of the fundamental principles underlying chapter 11 — the DIP, at least in the first instance, is entrusted with directing the course of a case, managing its assets and maximizing the value of the bankruptcy estate for the benefit of all stakeholders. This remains the rule even when the estate is insolvent and creditors may be the only economic parties with a stake in the outcome of the case. Only if the DIP fails to fulfill its statutory mandate are creditors or other stakeholders permitted to seek relief from the bankruptcy court designed to remedy the problem, which may include assuming the mantle of responsibility for prosecuting claims belonging to the estate on behalf of all stakeholders in the case, or proposing a chapter 11 plan.

The Second Circuit's ruling does not erode the validity of the doctrine of derivative standing. The decision merely clarifies the standards governing its use and the purpose for which it is intended, concluding that, under the circumstances of this case, the doctrine cannot be a license for creditors to usurp a DIP's right to prosecute (or not) potentially colorable causes of action. Still, we are left to speculate about the circumstances that would justify deployment of the doctrine as authority for creditors to settle estate claims. Presumably, it would entail some kind of negligence or misconduct by the DIP in pressing claims that are too insubstantial to justify expending estate assets to litigate. Although such conduct by a DIP might not rise to the level of "cause" for the appointment of a chapter 11 trustee, it may be an appropriate case for use of the doctrine of derivative standing in the Rule 9019 context.

Smart World Technologies, LLC v. Juno Online Services, Inc. (In re Smart World Technologies, LLC), 423 F.3d 166 (2d Cir. 2005).

Unsecured Creditors Committee of Debtor STN Enterprises, Inc. v. Noyes (In re STN Enterprises), 779 F.2d 901 (2d Cir. 1985).

Commodore Int'l Ltd. v. Gould (In re Commodore Int'l Ltd.), 262 F.3d 96 (2d Cir. 2001).

Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery, 330 F.3d 548, 579 (3d Cir. 2003).

Canadian Pac. Forest Prods. Ltd. v. J.D. Irving, Ltd. (In re The Gibson Group, Inc.), 66 F.3d 1436 (6th Cir. 1995).

In re Xonics Photochemical, Inc., 841 F.2d 198 (7th Cir. 1988).

Louisiana World Exposition v. Fed. Ins. Co., 858 F.2d 233 (5th Cir. 1988).

In re Fox, 305 B.R. 912 (Bankr. 10th Cir. 2004).

Official Unsecured Creditors' Committee v. Michaels (In re Marin Motor Oil), 689 F.2d 445 (3rd Cir. 1982), *cert. denied*, 459 U.S. 1206 (1983).

Term Loan Holder Committee v. Ozer Group, L.L.C. (In re The Caldor Corporation), 303 F.3d 161 (2d Cir. 2002).