Avoiding Forfeiture of Estate Causes of Action Triggered by Conversion to Chapter 7

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Benjamin Rosenblum

The ability to borrow money during the course of a bankruptcy case is an important tool available to a chapter 11 debtor-in-possession ("DIP"). Often times, the debtor's most logical choice for a lender is one with an existing pre-bankruptcy relationship with the debtor. As a condition to making new loans, however, lenders commonly require the debtor to waive its right to pursue avoidance or lender liability actions against the lender based upon pre-bankruptcy events. Normally, this type of waiver does not prohibit official creditors' committees from bringing these causes of actions, derivatively, on behalf of the estate — but the waiver provision may limit the amount of time that the committee has to bring these claims.

An interesting issue arises when the case does not go as well as planned and converts from a chapter 11 reorganization to a chapter 7 liquidation. Suppose the chapter 7 trustee wants to prosecute an avoidance action against the lender: does the waiver bind the trustee, as the successor to the DIP, or does the trustee succeed to the rights of the creditors' committee? The Tenth Circuit Court of Appeals recently considered this issue in *Hill v. Akamai Tech., Inc. (In re Ms55, Inc.)*. In a matter of first impression for the circuit, the court ruled that the only rights a chapter 7 trustee inherits from a creditors' committee are derivative of the debtor's rights and, therefore, are barred if waived by the debtor.

Avoidance Powers and Standing to Sue

A bankruptcy trustee is endowed with the authority to avoid and recover certain transfers for the benefit of the estate. Among other things, this authority includes the power to bring fraudulent transfer and preference actions. The DIP — a concept that can be characterized as a union of the debtor with the estate — has substantially all of the same powers and rights as a bankruptcy trustee. Accordingly, it is the DIP's role to prosecute avoidance actions, in the first instance. However, in some cases, this task may be shifted to the shoulders of another in keeping with the concept of "derivative standing."

An official committee of unsecured creditors is appointed in almost every large chapter 11 case. Although such a committee has no power under the Bankruptcy Code to bring avoidance actions in its own right, most courts have held that a committee may pursue such actions in the name of the estate where, for example, the DIP or trustee unjustifiably refuses to prosecute colorable claims. Still, in such circumstances, the committee's ability to pursue avoidance claims is merely derivative of the DIP's rights, and any recovery is for the benefit of the bankruptcy estate.

The Bankruptcy Code does not explicitly state when, if ever, a creditors' committee ceases to exist. Nonetheless, most courts conclude that a committee dissolves upon conversion of the case from chapter 11 to chapter 7. Upon conversion, the debtor and the estate are divorced, resulting in two separate and distinct entities: a debtor (now, out of possession) and a chapter 7 trustee. Importantly, however, the chapter 7 trustee is bound by the acts of its predecessor, the DIP, because, as the Eighth Circuit Court of Appeals has stated, "[c]reditors must be able to deal freely with debtors-in-possession, within the confines of the bankruptcy laws, without fear of retribution or reversal at the hands of a later appointed trustee."

Yet this seemingly clear principle blurs when applied to a situation where a DIP waives estate causes of action against a post-petition lender with the reservation that the creditors' committee may still pursue such actions derivatively. This confusion is due, in part, to the fact that this arrangement is somewhat awkward; the DIP, as the representative of the bankruptcy estate, agrees to waive certain estate causes of action, but such actions can still be maintained by another party in the estate's name. Nonetheless, such waivers are routine in DIP financing orders. Accordingly, it is important to know whether a subsequent chapter 7 trustee is bound by the DIP's waiver or whether the trustee can inherit the derivative rights of the creditors' committee.

There is authority that suggests that if a committee files a complaint on behalf of the estate prior to being disbanded, the cause of action may be inherited by a chapter 7 trustee. For example, in *Official Unsecured Creditors' Committee v. Rachles (In re S. Rachles, Inc.)*, a creditor's committee commenced avoidance actions against an individual transferee shortly before the case converted to chapter 7. Although the trustee filed his own complaint seeking to avoid the transfer, a question arose as to whether the trustee's complaint was timely filed, so the trustee sought to be substituted as plaintiff in the adversary proceeding filed by the committee. The court permitted the substitution, emphasizing that the proceeding was commenced by the committee on behalf of the estate.

Suppose, however, the obstacle confronting the trustee was not a statute of limitations, but instead, a waiver on the part of the DIP, and suppose further that the committee was authorized

but failed to commence the action before the case was converted. Could the chapter 7 trustee still succeed to the committee's rights under those circumstances? The Tenth Circuit recently addressed this issue in *Ms55*.

The Tenth Circuit's Ruling in *Ms55*

Ms55, Inc. ("Ms55") filed a chapter 11 petition in July of 2001 in the United States Bankruptcy Court for the District of Colorado. Shortly afterward, Ms55 filed a motion seeking authorization to use its cash on hand, which was subject to security interests held by certain of pre-petition secured creditors, and to incur additional post-petition indebtedness. Akamai Technologies ("Akamai") had previously provided secured financing to Ms55. An official committee of unsecured creditors was appointed in August of 2001. Later that month, the bankruptcy court entered a final order approving Ms55's financing motion. Included in the financing order was a provision that shielded secured creditors, such as Akamai, from "any and all claims," except those that could be brought by the creditors' committee. The financing order contained other provisions confirming that it bound parties other than Ms55 and was intended to survive conversion to a chapter 7 case.

The case converted to chapter 7 two years later, and a trustee was appointed. Almost a year afterward, the trustee commenced an adversary proceeding against Akamai seeking to avoid alleged fraudulent and preferential transfers. Akamai moved for summary judgment, claiming that such actions were barred by the financing order. The bankruptcy court denied Akamai's motion, but was reversed on appeal by the district court. The trustee appealed the ruling to the Tenth Circuit.

The Court of Appeals upheld the reversal. Noting that there were essentially two questions before it, the Tenth Circuit first set out to determine whether, as a contractual matter, Ms55, as a DIP, waived its right along with the right of the chapter 7 trustee to bring avoidance actions against Akamai. After determining that it did, the court then considered whether the trustee could still exercise the authority reserved to the creditors' committee in the financing order to bring such a claim.

In addressing this question, the court observed that "*the bankruptcy trustee has no greater rights than the debtor has*." The court also emphasized that a creditors' committee does not have its own right to bring avoidance actions. Instead, the Tenth Circuit explained, when a creditors' committee is allowed to bring an avoidance action, it is solely in the name of the debtor. Moreover, upon conversion, the court noted, the creditors' committee ceases to exist. According to the Tenth Circuit, because, as a contractual matter under the waiver provision, the only party able to bring such a claim is the creditors' committee, and because the creditors' committee no longer exists, there simply is no party that can bring the action. In other words, the court remarked, "[t]he derivative rights exist like a sword in a stone, but there is no Arthur to claim them."

Analysis

The Tenth Circuit's ruling is undoubtedly a welcome development for post-petition lenders intent upon limiting their potential exposure arising from pre-bankruptcy financing relationships with a company that has sought chapter 11 protection. From a post-petition lender's perspective,

the decision highlights the importance of strong waiver language that is broad enough to cover claims brought by any trustee appointed in the case (either a chapter 7 or a chapter 11 trustee).

On the other side of the coin, the message borne by the decision for committees is that the risk of forfeiting estate causes of action against post-petition lenders in the event of conversion can be minimized by harder bargaining at the inception of chapter 11 case to ensure that any waiver language in a DIP financing order expressly reserves the right to sue to a chapter 7 trustee, any chapter 7 creditors' committee or any other entity created for the purpose of prosecuting causes of action on behalf of the estate, such as a litigation trust (a strategy that was recently attempted without success in the chapter 11 case of World Health Alternatives, Inc.). Alternatively, creditors' committees may be forced to take a hard look at potential causes of action against DIP lenders earlier in the chapter 11 process to ensure that litigation involving colorable claims is filed as soon as possible due to the risk of forfeiture upon conversion.

Given the facts of the case before it, the Tenth Circuit did not address whether the waiver would have precluded a chapter 11 trustee from suing Akamai on behalf of the estate. As a general rule, the acts of a DIP are binding on any trustee subsequently appointed in chapter 11 or chapter 7. Under certain circumstances, however, a bankruptcy court will scrutinize agreements entered into by a debtor while in possession to determine, for example, whether there is evidence of fraud or prejudice to the estate that might justify invalidating an agreement or waiver of rights. Notwithstanding the general rule, most DIP lenders insist upon waiver language in a financing order that expressly extends the scope of a waiver to include any trustee subsequently appointed in the bankruptcy case.

Hill v. Akamai Tech., Inc. (In re Ms55, Inc.), 477 F.3d 1131 (10th Cir. 2007).

Armstrong v. Norwest Bank, Minneapolis, N.A., 964 F.2d 797 (8th Cir. 1992).

Official Unsecured Creditors' Committee v. Rachles (In re S. Rachles, Inc.), 131 B.R. 782 (Bankr. D.N.J. 1991).

In re World Health Alternatives, Inc., No. 06-10166 (Bankr. D. Del. Sept. 8, 2006) (unpublished order denying committee's motion to create trust and transfer to trust committee's rights to receive and distribute collateral carve-out and pursue estate causes of action against lender in the event cases were converted to chapter 7).