Chapter 11 Update: Changing Dynamics For Senior Lenders and Agents

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Key Topics in Fraudulent Conveyance Litigation: Can the Debtor Settle the Committee's Lawsuit?

- Where a creditors' committee is granted *STN* standing, can a debtor nonetheless settle the claims brought by the committee?
  - Case law strongly suggests that, in most cases, a debtor may settle the committee's claims if the settlement is in "the best interests of the estate"
  - The debtor best positioned to settle the committee's claims is one that did not object to the grant of STN standing in the first instance (*e.g.*, debtor waived claims against DIP lenders and thus did not object) and otherwise is not subject to improper motives, such as a desire to seek releases for insiders
    - In this sense, the situation is akin to *Commodore* standing (where a debtor affirmatively consents to the grant of standing), as opposed to one in which standing was granted because the debtor unjustifiably refuses to bring the claims
  - *Smart World* and *Adelphia* are the key decisions in the Second Circuit

Key Topics in Fraudulent Conveyance Litigation: Can the Debtor Settle the Committee's Lawsuit? (*cont.*)

- Debtors are vested with authority to manage the estate and settle claims:
  - "That [Rule 9019] vests authority to settle or compromise solely in the debtor-in-possession is hardly surprising in light of the numerous provisions in the Bankruptcy Code establishing the debtor's authority to manage the estate and its legal claims." *In re Smart World*, 423 F.3d 166, 175 (2d Cir. 2005).
  - Debtors owe a fiduciary duty to the entire estate, while "a creditors' committee owes a fiduciary duty to the class it represents." *In re Smart World*, 423 F.3d at 175 n.12.

Key Topics in Fraudulent Conveyance Litigation: Can the Debtor Settle the Committee's Lawsuit? (*cont.*)

- A debtor will sometimes best honor its fiduciary duty to the estate by settling claims in order to emerge from bankruptcy, even where a committee was previously granted standing:
  - "[N]owhere does *Smart World* suggest that . . . where derivative standing does exist, a debtor-in-possession is irreversibly stripped of its authority to settle that litigation absent the consent of the standing committee . . . . *Smart World* confirms repeatedly that it is the fundamental responsibility of the debtor-in-possession to manage the estate." *In re Adelphia*, 371 B.R. 660, 670 (S.D.N.Y. 2007).

Key Topics in Fraudulent Conveyance Litigation: Can the Debtor Settle the Committee's Lawsuit? (*cont.*)

- The Second Circuit in *Adelphia* approved the transfer of claims away from an equity committee into an equity trust:
  - "We hold that . . . a court may withdraw a committee's derivative standing and transfer the management of its claims, even in the absence of that committee's consent, if the court concludes that such a transfer is in the best interests of the bankruptcy estate. . . . It would be contrary to the reasoning of this Circuit's precedent to hold that the bankruptcy court's grant of derivative standing vested the Equity Committee with a veto over both the court and the debtor-in-possession. The bankruptcy court not only had the authority to confer derivative standing upon the Equity Committee, it also had the authority to – and did – effectively withdraw that standing when it concluded that the Equity Committee's role was no longer in the best interests of the estate." *In re Adelphia*, 544 F.3d at 420, 423-25 (2d Cir. 2008) (Sotomayor, J.).
- However, *Adelphia* involved the transfer of claims to a trust, not a final settlement of those claims.
  - One court has endorsed the concept of a debtor settling a committee's claims, but rejected the proposed settlement on other grounds. *In re Exide*, 303 B.R. 48, 67–71 (Bankr. D. Del. 2003).
- The issue was to be litigated in Lyondell but the parties settled before the matter was heard.

Recent Developments Regarding Examiners

Recent Developments Regarding Examiners

- Judicial Fatigue and Highly Factual Nature of Disputes Makes Courts Increasingly Inclined to Appoint Examiners
  - Statutory function: investigation
  - Original purpose: 1978 legislative compromise for removal of mandatory trustee from statute – a requirement under pre-Bankruptcy Code law; focused on mismanagement
  - Judges see examiners as subcontractors for judicial function and motivators for settlement
- Is Appointment of an Examiner Mandatory?
  - Section 1104(c)(2) of the Bankruptcy Code provides that "…on request of a party in interest or the United States trustee, and after notice and a hearing, the court shall order the appointment of an examiner to conduct an investigation of the debtor as is appropriate…" if "the debtor's fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes, or owing to an insider, exceed $5,000,000" (emphasis added)
  - Some courts have found appointment of an examiner to be mandatory in cases meeting the $5,000,000 debt threshold. *See, e.g., In re Revco D.S. Inc.*, 898 F.2d 498, 500-01 (6th Cir 1990)

Recent Developments Regarding Examiners (*cont.*)

- Examiner Motions as Tactical Devices to Create Settlement Value
  - Examiners can be used in a broad effort to publicly expose embarrassing facts (e.g., emails), regardless of relevance to merit and thus extract value
  - Judges are reluctant to allow appointment of an examiner if not in the best interests of the case
- Despite the view that appointment is mandatory, courts often exercise discretion in designing the examiner's role to counterbalance costs and potential interference with the case or plan process by limiting the scope of the examination and budget. *See, e.g., In re Loral Space and Commc'n Ltd.*, 2004 WL 2979785, *5 (S.D.N.Y. Dec. 23, 2004)
  - In *Lyondell*, Judge Gerber (S.D.N.Y.) harshly criticized the flat requirement and circumscribed the scope of the investigation and budget, contrary to the position of the committee and the US Trustee

Recent Developments Regarding Examiners (*cont.*)

- In a recent *Spansion* decision, Judge Carey (D. Del) held appointment is not mandatory
  - "No sound purpose" in appointing an examiner where the court does not feel investigation is necessary, only to tie the examiner's hands by limiting the mandate and size of budget.
  - Focused on the phrase "as is appropriate" in section 1104(c)(2), concluding that because evidence had not been presented that made an investigation "appropriate" the appointment of an examiner was not mandated. See *In re Spansion*, slip. op. at 15-19 (Bankr. D. Del. Apr. 1 2010)
- *Spansion* has not relieved pressures courts feel to appoint examiners
  - In the *Tribune* case, Judge Carey appointed an examiner with a broad mandate despite extensive investigation conducted by the parties in interest, including special litigation counsel for the creditors' committee; parties agreed rather than fight the court
  - The *Tribune* examiner conducted an extensive investigation, with a budget of approximately $8 million, interviewing numerous witnesses and conducting extensive document discovery, and recently produced a detailed report in excess of 1000 pages
  - In the *Washington Mutual* case, Judge Walrath recently appointed an examiner at the request of shareholders who felt they were given inadequate information, to review claims and assets and a settlement between the company, JPMorgan Chase and the FDIC underlying the proposed plan

Recent Developments Regarding Examiners (*cont.*)

- The *Erickson Retirement Communities* decision offers an interesting view
  - Due to the posture of the case (numerous settlements agreed to, plan on file and proceeding towards confirmation) Judge Jernigan commented that appointment of the examiner at the request of a small group of dissenting creditors was not in the best interests of the estates
  - Judge Jernigan found that appointment *is* mandatory if the debt threshold is met, however the creditors seeking the appointment lacked standing to do so and/or had waived their right to do so by virtue of the prepetition subordination agreements to which they were bound, which prohibited the exercise of any remedies without the consent of the agent for the senior debt
  - Discussing the legitimacy of the request, Judge Jernigan noted that the examiner would provide no benefit to the cases as the questions sought to be investigated would all be considered by the court in the context of plan confirmation, and commented that in the absence of the standing/waiver issues the court would appoint an examiner with *no* duties unless and until the mandate was expanded by the court, thus taking Judge Gerber's approach to its logical extreme