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INVESTIGATING THE INVESTIGATIONS:
Process and Policy Issues Relating to Bankruptcy Investigations

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I. INTRODUCTION

Often, the most valuable assets held by a debtor in possession include causes of action against third parties. Conflicts of interest, divergent viewpoints regarding the proper allocation of limited estate resources, and questions about the merits of the estate's claims often result in the debtor refusing to bring suit on an otherwise colorable (and potentially valuable) cause of action. In fact, bankruptcy courts have recognized that it is simply not feasible to require a debtor-in-possession to sue in every circumstance where there is a mere potential for estate recovery. However, a refusal by the debtor to sue (which is almost always the result of an inherently subjective analysis) is often vigorously challenged by other estate constituencies, who claim that the debtor's unwillingness or inability to bring the claim is "unjustified" in light of its fiduciary duty to maximize recovery for the estate. For this reason, courts have allowed other parties in interest — such as the creditors' committee — to bring an action on the estate's behalf when the debtor is unwilling or unable to do so.

When parties other than the debtor pursue estate causes of action, a fundamental question is raised: what happens to the attorney-client privilege when the cause of action is transferred? The short answer is that whichever party gains control of the debtor's business usually gets control of the privilege. A chapter 11 trustee, where appointed, would likely own the privilege, but what about when bankruptcy examiners are pursing that same action, or, for that matter, a liquidating trust? What are the implications of common interest privilege when counsel represented both the debtor and the debtor's insiders?

Below is an outline of the issues concerning non-debtor parties filing actions on behalf of the estate, addressing who may file, when they may file, the procedural hurdles to filing, the strategic decisions to be made and the privilege implications.

II. AUTHORITY OF PARTIES OTHER THAN THE DEBTOR TO INVESTIGATE OR PROSECUTE ESTATE CAUSES OF ACTION

a. Authority of Creditors' Committee to Prosecute Estate Causes of Action.

i. Two Part Test. In general, the Bankruptcy Court may authorize a creditors' committee to pursue estate causes of action. Most courts use a two-part test set forth by the Second Circuit to determine whether a committee should be granted standing to sue on a debtor's behalf: There (i) must be a "colorable claim" held by the estate, and (ii) the debtor must "unjustifiably refuse" to bring that claim. *See, e.g.*, *Unsecured Creditors Committee of Debtor STN Enterprises, Inc. v. Noyes (In re STN Enterprises Inc.)*, 779 F.2d 901 (2d Cir. 1985).

A. The Existence of a "Colorable Claim". This is a low threshold to meet, because a claim will usually be deemed "colorable" if it has any potential merit. *See Official Comm. of Unsecured Creditors of Correll Steel v. Fishbein and Co., P.C (In re Correll Steel)*, 1992 WL 196768 at *12 n.3 (E.D Pa. 1992) (creditors' committee has standing to pursue estate claim if claim is "potentially meritorious"; *see also In re STN Enterprises*, 779 F.2d at 905, (defining "colorable" claim as a claim "for relief that on appropriate proof would support a recovery"); *Adelphia Comm. Corp. v. Bank of America N.A. (In re Adelphia Comm. Corp.)*, 330 B.R. 364, 386 (Bankr. S.D.N.Y. 2005) ("no more . . . is required" than claim that, if proven, provided a basis for recovery and expected recovery reasonably commensurate with the litigation's foreseeable cost.

B. The Debtor's "Unjustifiable" Refusal to Bring Suit.

1. The Second, Fifth, Sixth and Seventh Circuits all have some type of "unjustifiable refusal" requirement in determining allowance of a creditors' committee to bring suit on behalf of debtor. *See In re STN Enter.,* 779 F.2d 901, 905 (2d Cir. 1985); *Louisiana World Exposition, Inc. v. Federal Ins. Co. (In re Louisiana World Exposition, Inc.)*, 832 F.2d 1391, 1397 (5th Cir. 1987); *Canadian Pacific Forest Prods. Ltd. v. J.D. Irving Ltd. (In re The Gibson Group, Inc.)*, 66 F.3d 1436, 1443-45 (6th Cir. 1995); *In re Matter of Xonics Photochemical, Inc.*, 841 F.2d 198, 202 (7th Cir. 1988).

2. Determining whether a debtor is acting in an "unjustifiable" manner is fact-intensive and subjective. Most courts employ a "cost benefit analysis" pursuant to which the potential costs of the litigation are weighed against the likely litigation recovery. *See Official Comm. of Unsecured Creditors v. Hudson United Bank (In re Am.'s Hobby Ctr., Inc.),* 223 B.R. 275, 284, *In re Am's Hobby Ctr.,* 223 B.R. 275, 282 (Bankr. S.D.N.Y. 1998). If the outcome of the litigation is likely to yield more than the litigation costs, a court generally will find that the debtor was unjustified in not bringing the suit. *In re STN Enterprises,* 779 F.2d at 904.

3. Potential Justifications of a Debtor for Refusing to Bring the Claim**.** Courts sometimes consider the potential benefit to the estate and the justification for the debtor's refusal to bring the claim as separate prongs of the test to determine whether the creditors' committee has standing. *See In re*

The Gibson Group, Inc., 66 F.3d 1442 (6th Cir. 1995). Accordingly, a debtor-in-possession may be able to justify its refusal to bring suit in some cases — even if the action in question could benefit the estate's creditors if litigated to fruition.

a. Practical Realities of the Case. As noted by one court, Debtors "sometimes have a practical need to avoid confrontation with entities like their secured lenders, because they need those entities' continuing cooperation--, as for example, in connection with exit financing." *Adelphia Comm. Corp. v. Bank of America N.A. (In re Adelphia Comm. Corp.)*, 330 B.R. 364, 373 (Bankr. S.D.N.Y. 2005). *See also Official Unsecured Creditors' Comm. v. Leviton Mfg. Co. (In re Elec. Materials Co.),* 160 B.R. 1018, 1022 (Bankr. W.D. Mo. 1993) ("[a] debtor in possession usually must negotiate with creditors to effect a successful reorganization. Understandably, debtors in possession may be reluctant to institute avoidance actions against parties at the same time they are attempting to negotiate with them for continued supplies, extensions of credit or support of a plan. There is no indication Congress intended debtors in possession to be forced to sue such parties at the same time the debtor is scrambling to stay afloat and put together a plan requiring the support of those parties.").

b. Potential Effect of Litigation. Accordingly, the overall effect of the litigation on the reorganization effort has been a factor in determining whether the debtor's refusal to bring suit was justified. *See Official Comm. of Unsecured Creditors v. Hudson United Bank (In re America's Hobby Center, Inc.),* 223 B.R. 274 (Bankr. S.D.N.Y. 1998) (in cash collateral agreement, where bank stipulated that the Committee has a certain window to challenge the bank's position, approval of this suit will not, in and of itself, imperil the debtor's funding and thereby doom its reorganization effort."); *In re Revco D.S. Inc*., 118 B.R. 468, 477 (Bankr. N.D. Ohio 1990) (denying creditors' committee standing to pursue estate claim where the debtor had concluded that such litigation might have disastrous effects on businesses as a going concern.).

c. Other Considerations. Other considerations include the timing and procedural posture of the proposed litigation, the relative importance of the claim compared to the overall reorganization effort, and the debtor's chance of effectuating a confirmable plan without bringing the litigation. *See, e.g., Chemical Bank v. Pilevsky,* 1994 WL 714287 at *1 (S.D.N.Y. 1994).

ii. Procedural Requirements. In addition to the foregoing substantive issues, generally before granting a committee's authority to bring an estate cause of action, courts generally require that the (i) the debtor unjustifiably refused to pursue the claim; and (ii) the committee obtains Bankruptcy Court approval to bring the action on behalf of the estate. If either of these procedural requirements are overlooked, the bankruptcy court may refuse to recognize the Committee's standing to bring the claim. *See e.g.*, *Adelphia Comm. Corp*, 330 B.R. at 374; *Lehman Capital v. Official Comm. of Unsecured Creditors of Fas Mart Convenience Stores, Inc.*, *(In re Fas Mart Convenience Stores, Inc.)* 2003 WL 22048024, *4 (E.D. Va. 2003); *Unsecured Creditors' Comm.. v. Farmers Sav. Gank (In re Toledo Equip Co.*, 35 B.R. 315, 320) (Bankr. Ohio 1983).

A. Request that the Debtor Bring the Action. First, the Committee must request that the debtor bring the claim, and the debtor must refuse to do so. *See e.g. Unsecured Creditors' Comm. v. Farmers Sav. Bank (In re Toledo Equipment Co.),* 35 B.R. 315, 320 (Bankr. N.D. Ohio 1983); *First Alabama Bank v. Shelby Motel Group, Inc. (In re Shelby Motel Group, Inc.)*, 123 B.R. 98 (N.D. Ala. 1990) (same); *In re Martin*, 124 B.R. 69 (N.D. Ill. 1991) (same); *Bracaglia v. Manzo (In re United Stairs Corp.)*, 176 B.R. 359 (Bankr. D.N.J. 1995) (same); *In re Continental Airlines Corp*., 59 B.R. 782 (Bankr. S.D. Tex. 1986) (same); *see also Collier on Bankruptcy* ¶1103.05[6][a].

1. Exception: Clear Conflict of Interest. This requirement may sometimes be excused if the debtor has a clear conflict of interest, and it would therefore not be reasonable to expect the debtor to bring the claim. *See*, *e.g.*, *SouthTrust Bank, N.A. v. Jackson (In re Dur Jac Ltd.)*, 254 B.R. 279, 286 (Bankr. M.D. Ala. 2000) (futile to require bank to seek court approval for creditor to bring suit against family-members of debtor insider); *In re Capital Holdings Corp*., 146 B.R. 7 (Bankr. C.D. Cal. 1992) (adapting from corporate law to excuse demand in bankruptcy case of corporate debtor upon adequate showing that demand was futile).

2. Exception: Debtor Consent. This requirement may also be overlooked if the Debtor consents to allow the Committee to bring the cause of action, and the bankruptcy court "exercises its judicial oversight and verifies that the litigation is indeed necessary and beneficial." *Commodore Int'l Ltd. v. Gould (In re Commodore Int'l Ltd.)*, 262 F.3d 96, 100 (2d Cir. 2001), *citing In re Spaulding Composites Co.*, 207 B.R. 899, 904 (9th Cir. BAP 1997); *see also Coral Petroleum v. Banque Paribas-London*, 797 F.2d 1351, 1362-63 (5th Cir. 1986) (same). Note, however, that some courts have held that, regardless of whether there is an agreement, Committee standing is subject to *STN* showing. *See, e.g., In re KDI Holdings, Inc.*, 114 B.R. 493 (Bankr. S.D.N.Y. 1999).

B. Obtain Court Authority Before Bringing Action: In general, the Committee should request court approval prior to filing a complaint on the estate's cause of action. Among other things, this procedural safeguard allows the court to determine whether the debtor's refusal to file suit was reasonable. *See In re STN,* 779 F.2d at 904; *Scott v. Nat'l Century Financial Enterprises (In re Baltimore Emergency Services I, Corp.),* 432 F.3d 557, 563 (4th Cir. 2005); *Unsecured Creditors' Committee v. Farmers Savings Bank (In re Toledo Equip. Co.)*, 35 B.R. 315, 319-20 (Bankr. N.D. Ohio 1983); *Lehman Capital v. Official Comm. of Unsecured Creditors of Fas Mart Convenience Stores, Inc.*, *(In re Fas Mart Convenience Stores, Inc.)* 2003 WL 22048024, *5 (E.D. Va. 2003).

1. Some Exceptions: *See Official Comm. of Unsecured Creditors v. E. Roger Clark (In re Nat'l Forge Co.)*, 326 B.R. 532, 556 (W.D. Pa. 2005) (offering a non-exhaustive list of eight factors courts should consider in deciding whether to grant derivative standing retroactively and holding that the bankruptcy court did not err in granting retroactive derivative standing where the record supported a finding that the court "would have authorized the Committee's avoidance action if it had been sought prior to . . . filing deadline"); *see Official Comm. of Unsecured Creditors v. Hudson United Bank (In re America's Hobby Center, Inc.),* 223 B.R. 275 (Bankr. S.D.N.Y. 1998) (*nunc pro tunc* approval granted where committee mistakenly believed it had authority to prosecute action); *Catwil Corp. v. DERF II (In re Catwil Corp*.), 175 B.R. 362 (Bankr. E.D. Cal. 1994) (granting *nunc pro tunc* authority to initiate such action when filed shortly before running of statute of limitations).

iii. Some Contrary Authority

A. The First Cybergenics Decision: In 2002, the Third Circuit held that, under *Hartford Underwriters Insurance Co. v. Union Planters Bank, N.A.,* 530 U.S. 1 (2000) (discussed below), section 544(b) did not authorize derivative standing to committees and creditors. See *Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery (In re Cybergenics Corp.)*, 304 F.3d 316 (3d Cir. 2002). Notwithstanding the long line of cases following *STN* and its progeny, the court ruled that the decision to bring a §544(b) avoidance action was the sole prerogative of the trustee (or debtor). .

B. The Second Cybergenics Decision: In 2003, the Third Circuit issued its en banc reversal. *Official Comm. of Unsecured Creditors of Cybergenics Corp. et al v. Chinery (In re Cybergenics Corp.),* 330 F.3d 548 (3d Cir. 2003). The Third Circuit rejected the literal reading of section 544 and the panel's earlier conclusion that no principled basis existed for distinguishing the use of the word "trustee" in sections 506 and 544, but instead relied upon sections 1109, 1103(c)(5) and 503(b)(3)(B) and prior practice under the Bankruptcy Act to provide context and meaning to section 544.

C. Subsequent Decisions: The 10th Circuit Bankruptcy Appellate Panel has recently disagreed with the holding of *Cybergenics* en banc decision. *United Phosphorus, Ltd. v. Fox* (*In re Fox*), 2004 WL 509605 (10th Cir. BAP, March 15, 2004). In *Fox*, the court held that a creditor lacked standing to bring a fraudulent conveyance claim against the wife of the debtor in possession. *Id.* at *1. Finding § 548 to be "explicit, unambiguous, and absolute," the panel ruled that the trustee, and only the trustee, may assert statutory remedies on behalf of the estate. *Id*. at *2. The panel characterized the *Cybergenics* en banc decision as "an analysis of why it would be good policy to allow [derivative] suits" and stated that "this reasoning was best considered by Congress." *Id*. at *2-3. *See also Scott v. Nat'l Century Financial Enterprises (In re Baltimore Emergency Services II, Corp.)*, 432 F.3d 557, 561-563 (4th Cir. 2005) (concluding that procedural requirements for derivative standing not met, and questioning litigants and lower courts' presumptions "that the [derivative standing] doctrine exists in some form, and merely debate[d] its proper contours" and rejecting the premise that "the *Commodore* safeguards should add up to a loose functional requirement rather than a strict formal one.")

b. Authority of Other Non-Debtors to Prosecute Estate Causes of Action

i. Individual Creditors

A. Where a committee is unable or unwilling to bring an action, individual creditors may obtain derivative standing to bring suit. *See Glinka v. Murad (In re Housecraft Indus. USA, Inc.),* 310 F.3d 64 (2d Cir. 2002) (secured creditor granted standing to pursue estate cause of action).

B. Many jurisdictions have extended the rulings in *STN* and *Commodore* to allow standing for individual creditors. *See e.g. Canadian Pac. Forest Prods. Ltd. v. J.D. Irving, Ltd. (In re Gibson Group, Inc.)*, 66 F.3d 1436, 1446 (6th Cir. 1981); ("A creditor's implied right to initiate an adversary proceeding might be derived from the language that a party in interest 'may raise and may appear and be heard on any issue in a [Chapter 11]case'")**;** *Campana v. Pilavis (In re Pilavis)*, 233 B.R. 1, 3-4 (Bankr. D. Mass. 1999) (same); *U.S.A./FmHA v. Indi-Bel, Inc. (In re Williams)*, 167 B.R. 77, 82 (Bankr. N.D. Miss. 1994) (same); *Lilly v. Federal Deposit Ins. Corp. (In re Natchez Corp.),* 953 F.2d 184, 187 (5th Cir. 1992); *In re Xonics Photochemical, Inc.,* 841 F.2d 198, 203 (7th Cir.1988); *McCarthy v. Navistar Fin. Corp. (In re Vogel Van & Storage, Inc.),* 210 B.R. 27, 32 (N.D.N.Y. 1997).

ii. Examiners

A. In some cases, courts have allowed examiners to pursue causes of action normally reserved to the Trustee. *Williamson v. Roppollo*, 114 B.R. 127, 129 (W.D. La. 1990) (quoting H.R. Rep. No. 595, 95th Cong. 1st Sess. 404 (1977) (court appointed examiner with expanded powers to pursue claims debtor refused to bring because committee had not yet been formed and because appointment of a trustee would have had the unwanted effect of pushing the debtor's management not to remain in office); *See Official Comm. of Unsecured Creditors of Cybergenics Corp. et al v. Chinery (In re Cybergenics Corp.),* 330 F.3d 548, 577 (3d Cir. 2003)), it is unlikely that Congress intended to force a court to displace management in the relatively commonplace event that a debtor makes a questionable decision not to prosecute a fraudulent avoidance claim"). *Weld v. Robert A. Sweeney Agency, Inc. (In re Patton's Busy Bee Disposal Service, Inc.)*, 182 B.R. 681, 686 (Bankr. W.D.N.Y. 1995) just as 11 U.S.C. §§ 1103(c)(5) and 1109(b) (just as 11 U.S.C. §§ 1103(c)(5) and 1109(b) imply a qualified right for Committees' to initiate suit, in the case of examiners, "a similar implication derives from sections 1106 and 1109").

iii. Litigation Trusts

A. Receipt of Causes of Action under a Plan: It is common now for plans of reorganization to transfer estate causes of action to Litigation Trusts.

1. Statutory Authority: Section 1141(b) of the Bankruptcy Code provides that "confirmation of a plan vests all of the property of the estate in the debtor, subject to that which is "provided in the plan or the order confirming the plan. Section 1123(b)(3) of the Bankruptcy Code permits a plan to provide for the "retention and enforcement . . . by a representative of the estate appointed for such purpose, of any . . . claim or interest [belonging to the debtor or to the estate]."

2. Required Plan Provisions: Some courts have required that plans of Reorganization providing for transfer of claims to litigation trust meet certain requirements, namely that causes of action transferred to the trust are expressly identified.

B. Express Causes of Action. In general, the Plan must provide for estate causes of action to be retained, although there is a split in authority over the degree of specificity required in the Plan. *Compare Peltz v. Worldnet Corp.(In re USN Communications Inc.)*, 280 B.R. 573, 590-91 (Bankr. D. Del. 2002) (Bankr. D. Del. 2002) (plan was sufficiently specific where the plan listed "avoidance powers" causes of action transferred to litigation trust), *with Kelley v. South Bay Bank (In re Kelley)*, 199 B.R. 698, 704 (B.A.P. 9th Cir. 1996) ("Even a blanket reservation by the debtor reserving 'all causes of action which the debtor may choose to institute' has been held insufficient to prevent the application of res judicata to a specific action.").

C. Other Requirements. *Guttman v. Martin (In re Railworks Corp.)*, 325 B.R. 709, 722 (Bankr. D. Md. 2005) (three requirements for litigation trustee standing under Section 1123(b)(3) that were each met: 1) the confirmed plan specifically retained fraudulent conveyance claims; 2) the litigation trustee was appointed pursuant to the plan; and 3) "the fraudulent transfer claims belong to the estate because they were reserved to the debtors in possession during administration of the case and transferred by the Plan to the Litigation Trustee").

1. *In re Resorts Int'l*, 372 F.3d 154 (3d Cir. 2004). The Third Circuit considered whether the bankruptcy court had

jurisdiction to hear a medical malpractice claim brought by a litigation trust created through the plan. The court in Resorts affirmed the bankruptcy court's holding that there was an insufficient nexus between the malpractice claim and the bankruptcy case to warrant jurisdiction. *Id.* at 166-67. The court in *Railworks* distinguished *Resorts* in allowing the fraudulent conveyance claim.

iv. Independent Directors. In a case where the debtor may be liable for breach of fiduciary duty, innocent directors who are not conflicted may have a fiduciary duty to pursue the causes of action on behalf of the estate.

c. Strategic Reasons Why the Debtor, the Committee or Others Should Pursue Estate Causes of Action.

i. Interference with Debtors' reorganization efforts. Certain types of avoidance actions do not suggest any misconduct on the part of the debtor or its insiders, but nonetheless become unattractive for the debtor to pursue. For example, suppose one of the chapter 11 debtor's key suppliers fails to perfect its lien on the debtor's inventory in accordance with Article 9 of the UCC prior to the petition date. Under the strong-arm powers of 11 U.S.C. § 544, the debtor-in-possession is granted the right to pursue an action to avoid the creditor's lien. However, the debtor may be reluctant to pursue the action where the debtor perceives that a successful reorganization is dependant on the continued relationship. A creditors' committee, being removed from the regular dealings between the debtor and creditor may have a different perspective on whether pursuing the action is worthwhile.

ii. Alternatively, suppose 45 days prior to bankruptcy, a debtor granted a secured creditor a lien on equipment necessary to run the business for less than fair consideration. For a variety of reasons (e.g., maintaining a business relationship with the creditor or avoiding allegations of wrongdoing), the debtor may very well not want to pursue that cause of action. This is a classic example of when a party should step into the shoes of the debtor to pursue an action to avoid the lien.

iii. Debtor and Debtors' Management is Conflicted. Other types of avoidance actions carry with them underlying appearances of insider misconduct. Fraudulent conveyances are the classic example. For example, suppose within a year prior to the bankruptcy, the debtor, in conjunction with a debt refinancing, paid a dividend to its shareholders. The debtor files for bankruptcy and there is a significant fact question as to whether the debtor was solvent at the time of the dividend payment. The debtors have no incentive to bring an action to avoid the transfer. To the extent the debtors insiders are shareholders, the insiders would stand to lose on the preference claim. Furthermore, to the extent the dividend is avoided, the

insiders may very well be liable for a breach of a fiduciary duty to its creditors. There must be a mechanism in place for parties other than the debtor to pursue those causes of action.

iv. Convenience. Other times, actions may be brought by parties other than the debtor where convenience so warrants. For example, where causes of action might complicate negotiations towards a plan of reorganization or distract the debtors from pursuing negotiations, the plans can be structured to transfer the right to pursue estate causes of action to a post-confirmation litigation trust.

III. IMPACT OF THIRD PARTY PURSUIT OF ESTATE CAUSES OF ACTION ON ATTORNEY-CLIENT PRIVILEGE

Introduction. When a non-debtor party brings an action on behalf of the estate, a tension may arise between the debtor's interest in maintaining the attorney-client privilege and the litigating party's need to access as much information as possible in order to properly pursue the claim. This tension is strongest in situations where management could potentially be implicated for wrongdoing. Further complicating the issue is what happens when the debtor and its insiders are subject to a common interest privilege. Can the debtor assign the privilege without permission from the insider? The following section outlines the attorney-client privilege issues related to nondebtor parties pursuing actions on behalf of the estate.

a. Black Letter Law: Who Controls The Attorney-Client Privilege in Bankruptcy?

i. General Principle: Control of the privilege accompanies management control of the debtor. Accordingly, both debtors and trustees are recognized to control the debtors' attorney-client privilege.

A. Weintraub. In *Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 358 (1985) a unanimous Supreme Court held that "the trustee of a corporation in bankruptcy has the power to waive the corporation's attorney-client privilege with respect to prebankruptcy communications."

B. The Court reached this conclusion "[b]ecause the attorney-client privilege is controlled, outside of bankruptcy, by a corporation's management, the actor whose duties most closely resemble those of management should control the privilege in bankruptcy, unless such a result interferes with policies underlying the bankruptcy laws." *Id.* 351-52.

C. The court further noted that "[g]iven that the debtor's directors retain virtually no management powers, they should not exercise the traditional management function of controlling the corporation's attorney-client privilege . . . ." *Id.* at 353.

ii. Examiners. In certain circumstances, a court-appointed examiner may also control the privilege.

A. Courts may empower examiners to perform managerial functions normally carried out by a trustee. *See In re Boileau*, 736 F.2d 503, 506 (9th Cir. 1984). In such cases, where court-appointed examiners are given expanded powers similar to those of a trustee, the examiner would have the authority to waive the debtor's attorney-client privilege. *Id.*

B. Additionally, a court may authorize an examiner to waive the debtor's attorney-client privilege. *See* Order Pursuant to 11 U.S.C. §§ 1104(c) and 1106(b) Directing Appointment of Enron Corp. Examiner, *In re Enron Corp.*, Case No. 01-16034 (AJG) (Bankr. S.D.N.Y. Apr. 8, 2002), at 3 ("ORDERED that the Examiner shall have the power to waive, on an issue-by-issue basis, the attorney-client privilege of the Debtors' estates with respect to pre-petition communications relating to matters to be investigated by the Examiner hereunder . . . .").

b. Impact of Transfer of Estate Assets on Attorney-Client Privilege.

i. In general, courts follow the rule that control of the privilege follows control of the debtor's business. Where there is a transfer of control, courts will find a transfer of the privilege. Where there is no transfer of control, the privilege will remain with the debtor.

A. Liquidating Trusts.

1. Though *Weintraub* specifically addressed a chapter 7 trustee's ability to waive a corporate debtor's attorney-client privilege, *Weintraub* has been construed to allow a trustee of a chapter 11 liquidating trust to waive the privilege of the former corporate debtor and debtor in possession. *Official Committee of Unsecured Creditors v. Fleet Retail Finance Group*, 285 B.R. 601, 613 (D. Del. 2002) (holding that the liquidating trust controls the privilege regarding pre-petition matters).

B. Asset Sales.

1. Sale of Entire Business.

a. The right to assert the attorney client privilege is "an incident of control of the corporation and remains with the corporation as it undergoes mergers, takeovers, and name changes." *NCL Corp. v. Lone Star Bldg. Ctrs., Inc.,* 144 B.R. 170, 174

(S.D. Fla. 1992); *see also Ramada Franchise System, Inc., v. Hotel of Gainesville Assoc.*, 988 F. Supp. 1460, 1464 (N.D. Ga. 1997) (corporation which purchased all of debtor's assets pursuant to bankruptcy court order controlled the privilege).

2. Sale of Subsidiary.

   a. In some cases, the effect of a transfer of management control is not clear cut. For example, in *Polycast Tech. Corp.*, 125 F.R.D. 47 (S.D.N.Y.); *Medcom Holding Co. v. Baxter Travenol Laboratories*, 689 F. Supp. 841 (N.D. Ill. 1988), a purchaser sought the disclosure of prior communications between the purchased subsidiary and an attorney that had represented both the subsidiary and the selling parent. The court held that a joint privilege existed and that the buying corporation acquired the subsidiary's share of the privilege as a result of the sale. *Polycast,* 125 F.R.D. at *51. Relying on *Weintraub,*the court found that Polycast acquired the authority to waive the joint privilege when it purchased the stock of the subsidiary because "the power to waive a corporation's attorney-client privilege rests with corporate management." *Id.* The court further found that a joint privilege may be freely waived by either party. *Id.* at *50.

3. Sale of Isolated Assets. The mere transfer of some assets from one corporation to another does not result in a transfer of the attorney-client privilege. *Sobol v. E.P. Dutton, Inc.*, 112 F.R.D. 99, 103 (S.D.N.Y.) (finding that because the assignment was an ordinary commercial transaction "having nothing to do with the relationship between [the assignor] and its counsel," the assignee could not waive the privilege); *In re Yarn Processing Patent Validity Litigation*, 530 F.2d 83 (5th Cir. 1976) (transfer of patent rights does not result in transfer of attorney-client privilege); *NCL Corp. v. Lone Star Building Centers (Eastern), Inc.*, 144 B.R. 170, 174 (S.D. Fla. 1992) (assignment of lease does not constitute a transfer of attorney-client privilege).

4. Liquidators. A liquidator, who takes control of a company's assets for the purpose of disposing of them, does not succeed to the attorney-client privilege and,

therefore, does not have the power to waive it. *See FDIC v. Amundson*, 682 F. Supp. 981, 986-87 (D. Minn. 1988) (finding that the FDIC, acting as a liquidator, did not control the attorney-client privilege); *FDIC v. McAtee*, 124 F.R.D. 662, 664 (D. Kan. 1988) (same).

C. Receivers. A receiver, who takes on the role of management and continues the entity's operations, does have the power to waive attorney-client privilege. *See CFTC v. Standard Forex*, 882 F. Supp. 40 (E.D.N.Y. 1995) (attorney-client privilege should transfer to a receiver who supplants the prior management and performs management functions); *Odmark v. Westside Bancorp.*, 636 F. Supp. 552, 554-55 (W.D. Wash. 1986) ("It is undisputed that, as receiver, FSLIC succeeds to all the rights, titles, powers and privileges of Westside, and to the rights, powers, and privileges of its members, officers and directors.").

1. In *Standard Forex*, the CFTC sued Standard Forex and several of its former officers and directors. A receiver was appointed, and the CFTC subpoenaed Standard Forex's law firm to turn over certain documents to the receiver. The law firm objected to the production of documents, asserting that its files contained documents that were covered by the attorney client privilege. The Magistrate granted the CFTC's application and ordered the law firm to produce the documents. The Magistrate's order was predicated on the grounds that, "pursuant to [*Weintraub*] the power to assert or waive the attorney-client privilege of Standard Forex rests with the Receiver, who functions as the management of the company in receivership." *Standard Forex*, 882 F. Supp. at *41.

2. While *Standard Forex* was not a bankruptcy case, "the Receiver stated on the record . . . that the company was dormant, making it more like a bankrupt corporation than a solvent, ongoing entity." *Id.* at *42, n.1.

D. Transfer of Authority to Pursue Causes of Action. There is comparatively little authority concerning the impact of a transfer of authority to bring causes of action on the debtor's attorney client privilege. One case, however, suggests that control over the privilege may be transferred with the right to pursue causes of action.

1. In *White v. Williams (In re Williams)*, 152 B.R. 123 (Bankr. N.D. Tex. 1992), the committee brought an avoidance action against the individual chapter 11 debtor's family

members (the claims against the estate exceeded $100 million). The joint plan provided that all estate causes of action would be transferred to a liquidating trust, but expressly left to the court the issue of who controlled the attorney-client privilege. The court held that the privilege belonged to the liquidating trust. Relying on an earlier unpublished decision authored by the same judge, the court in *Williams* reasoned that "control over the evidentiary privilege in connection with or in relation to the avoidance action must be exercised by the fiduciary charged with liquidating the action." *Id.* at 128.

a. The court in *In re Hunt* took a contrary position and held that the attorney-client privilege remained with the individual chapter 11 debtor. *Hunt*, 153 B.R. 445 (Bankr. N.D. Tex. 1992). The court further held, however, that due to the distinction between a corporate debtor and an individual debtor, the issue as to whether a trustee can waive the debtor's attorney-client privilege is "fundamentally different" in those situations. *Id.* at 452.

c. Common Interest Privilege (the Joint Defense Rule)

i. Situation. Suppose a committee seeks recovery of assets sold to XYZ Corp. within 30 days of filing. Management communicated to corporate counsel, the only counsel in the case, that the fair market value of the assets was double the consideration paid. Management had guaranteed the debt secured by these assets and had an interest in having the assets sold. Does the debtor retain the privilege? If not, is the debtor prevented from transferring the privilege to the committee by virtue of a shared common interest with management?

ii. When the Common Interest Privilege Applies

A. Federal common law recognizes a "joint defense privilege" or "common interest rule," which "serves to protect the confidentiality of communications passing from one party to the attorney for another party where a joint defense effort or strategy has been decided upon and undertaken by the parties and their respective counsel." *United States v. Schwimmer*, 892 F.2d 237, 243 (2d Cir. 1989). Inter-client communications are also protected if they refer to a common interest and are made in the presence of the clients' attorneys. *See* 3 Weinstein's Federal Evidence § 503.21[2]. In federal court, the joint defense privilege can arise whether or not litigation is "current or imminent." *Id.; see also In re Subpoena duces Tecum Served on New York Marine and*

General Ins. Co., No. M 8-85 MHD, 1997 WL 599399, at *3 (S.D.N.Y. Sept. 26, 1997) (noting that the privilege properly applies "not only if litigation is current or imminent, but whenever the communication is made in order to facilitate the rendition of legal services to each of the clients involved in the conference").

B. Disclosure to a third party generally constitutes waiver of privilege. However, the common interest privilege is an exception to the waiver rule whereby the attorney-client privilege is *not* waived with respect to privileged communications disclosed to a third party with "an identical legal interest with respect to the subject matter of the communication." *Libbey Glass, Inc. v. Oneida, Ltd.*, 197 F.R.D. 342, 347 (N.D. Ohio 1999).

1. In order to establish a common interest, the party asserting the privilege must show (i) that the communications were made in the course of a joint defense effort, (ii) the statements were designed to further that effort, and (iii) the privilege has not been waived. *See Haines v. Liggett Group*, 975 F.2d 81, 94 (3d Cir. 1992); *In re Bevill, Bresler & Schulman Asset Management Corp.*, 805 F.2d 120, 126 (3d Cir. 1986).

2. Generally, the parties claiming a common interest privilege must in fact share an "identical legal interest" and not solely a commercial interest. *Zenith Industries*, 1988 U.S. Dist. LEXIS 7985, at *9; *Bank Brussels Lambert v. Credit Lyonnais,* 160 F.R.D. 437, 447 (S.D.N.Y. 1995) ("The common interest doctrine . . . has both a theoretical and a practical component. In theory, the parties among whom privileged matter is shared must have a common legal, as opposed to commercial, interest. In practice, they must have demonstrated cooperation in formulating a common legal strategy.").

C. <u>Who May Have a Common Interest with the Debtors</u>.

1. <u>Creditors' Committees</u>. Bankruptcy cases frequently involve parties who share common commercial interests, but whose interests in other respects may be different. *Value Prop. Trust v. Zim Co. (In re Mortgage & Realty Trust)*, 212 B.R. 649, 653 (Bankr. C.D. Ca. 1997). This is especially true when the parties at issue are a debtor in possession under chapter 11 and a committee of creditors. *Id.*

2. The debtor in possession and the committee of creditors share a duty to maximize the debtor's estate. *In re Kaiser Steel Corp.,* 84 B.R. 202, 205 (Bankr. D. Colo. 1988).

a. For example, *Mortgage & Realty Trust* involved an action to set aside a postpetition transfer of property, on the grounds that the parties failed to obtain court approval required by the Bankruptcy Code. *Mortgage & Realty Trust*, 212 B.R. at 651-52. The court found that the debtor and the creditors' committee shared a common interest in opposing the claim, and that communications between the parties in furtherance of this common interest were privileged. *Id.* at 654.

D. Impact of Transfer of Estate Assets on Common Interest Privilege

1. The common interest privilege cannot be waived unilaterally. *Dexia Credit Local v. Rogan*, 231 F.R.D. 268, 274 (N.D. Ill. 2004). Both parties that share the interest must agree to waive the privilege, unless one of the parties sharing the interest becomes an adversary. *Id.* Therefore, it would appear that where there is a transfer of control, and therefore a concurrent transfer of privilege, the transferee would *not* be able to unilaterally waive the common interest privilege. However, the transferee *would* remain free to disclosure communications made by the transferor other than those made in furtherance of the common interest. *See In re Grand Jury Subpoena*, 274 F.3d 563 (1st Cir. 2001) ("[A] party always remains free to disclose his own communications.").

d. Policy Considerations in Various Situations

i. Liquidation in Chapter 11 or Chapter 7

A. In a liquidation, the business does not continue, but winds down. As a result, allowing the Debtor to maintain the privilege is not necessary to prevent disruption to the business. Accordingly, a court would be more likely to find that a party obtaining authority to pursue a cause of action would also be able to access privileged debtor's communications.

ii. Sale of Business to Third Parties with Litigation Remaining with Creditor Controlled Litigation Trust

A. Where the debtor's business is ongoing, there is a stronger underlying interest in not allowing the privilege to terminate.

Allowing a litigation trustee to penetrate the debtor's attorney client communications could be disruptive and could threaten the underlying value of the business.

1. When a sophisticated purchaser discounts the value of the business, the estate's creditors suffer as a result. A question then arises as to whether the benefit to the estate that may be realized by pursing the litigation meets the discount realized.