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POSTPETITION CORPORATE GOVERNANCE: DIRECTING THE DEBTOR FROM WITHIN AND WITHOUT (AND THE FADING LIGHT OF D&O RELEASES)

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Introduction*

When a debtor files for protection under Chapter 11 of the Bankruptcy Code, the roles of its various constituent players change dramatically. Equity shareholders, who once held the reins in the prepetition concern, are in many (but not all) cases forced to take a back seat in determining the future of the debtor, while creditors, who would have no such legal power in a solvent corporation, are given many governance rights, in some situations including the right to stand in the shoes of the postpetition going concern for purposes of seeking relief against third parties.

This outline will address the shifting corporate governance roles of equity and creditor bodies following a debtor-in-possession's bankruptcy filing and the courts' adjudication of equity and creditor rights to compel action by the debtor-in-possession. It will also discuss the courts' gloss on director and officer releases purported to be given in confirmed plans of reorganization.

I. Shareholder Rights & Management Responsibilities During the Chapter 11 Case

A. Overview

Outside of bankruptcy, corporate governance obeys state prerogatives, as states define the general terms and conditions of the corporate existence of their incorporated entities. Numerous state court decisions - of particular note, Delaware Court of Chancery decisions - have interpreted and, in certain instances, set forth the powers and privileges of corporations' various constituents.

As with the rest of the Bankruptcy Code, chapter 11 superimposes a federal statutory mandate upon the several states' corporate governance frameworks. While the goals of the Bankruptcy Code are simple - promoting the preservation, maximization, and timely and equitable distribution of the estate - the resulting overlap of state and federal law is far from straightforward, and both courts and theorists have labored mightily to balance state-law directives with the often conflicting postpetition, going-forward interests of the debtor in possession.

Thus, as bankruptcy courts' powers preempt, or at least have the potential to preempt, debtors' autonomy, this intersection, fraught with uncertainty, becomes critical to an assessment of strategies available to parties-in-interest to a debtor's reorganization.

B. Shareholder Rights - the Right to Call a Shareholder Meeting

1. Shareholders generally have the right to elect directors under state law. *See, e.g.*, N.Y. Bus. Corp. Law §§ 602(b), 703(a); Del. Code Ann. § 8-211(b). They also generally have the right to compel an annual meeting for purposes of holding an election, if such

* Aidan McGlaze, Stanford 2007, a summer associate at WilmerHale, made a significant contribution to this outline.

a meeting is sufficiently overdue. *See, e.g.*, N.Y. Bus. Corp. Law § 603; Del. Code Ann. §8-211(c).

2. The Securities and Exchange Commission has stated its support for continuing to allow shareholder voting and meetings, even during the bankruptcy case, absent special circumstances such as where "a company is in the final stages of a chapter 11 case or if there is a clear case of abuse of the shareholder-director relationship". *See* Mark E. Budnitz, *Chapter 11 Business Reorganizations and Shareholder Meetings*, 58 GEO. WASH. L. REV. 1214, 1226-27 (1990) (footnotes omitted) (noting SEC's position that "[s]hareholder suffrage is crucial because, absent such suffrage, management is free to act 'without the discipline of accountability to shareholders'").

3. What the Bankruptcy Courts Say - *In re Johns-Manville* and the "Clear Abuse" Standard

   a) Under Second Circuit precedent, the right to call a shareholder meeting endures in bankruptcy unless "clear abuse" is shown. *In re Johns-Manville Corp.*, 801 F.2d 60, 64 (2d Cir. 1986). ("It is well settled that the right of shareholders to compel a shareholders' meeting for the purpose of electing a new board of directors subsists during reorganization proceedings. . . . [the shareholders' right] to call a meeting may be impaired only if [the shareholders are] guilty of 'clear abuse' in attempting to call one.")

   b) Courts generally follow the Second Circuit's decision in *In re Johns-Manville. See, e.g., In re Marvel Entm't Group, Inc.*, 209 B.R. 832, 838 (D. Del. 1997), wherein a district court in the District of Delaware considered the question of whether the automatic stay imposed by 11 U.S.C. § 362(a)(3) bars bondholders and the indenture trustee from voting their pledged shares to replace a board of directors. Citing *In re Johns Manville* with approval, the court concluded that "the automatic stay provisions of the Bankruptcy Code are not implicated by the exercise of shareholders' corporate governance rights," reasoning that otherwise review for "clear abuse" would be unnecessary. *Id.*

   c) Notwithstanding, scholars argue for and against allowing shareholder meetings:

      (1) In favor, because of strong state law mandates: Mark E. Budnitz, *Chapter 11 Business Reorganizations and Shareholder Meetings*, 58 GEO. WASH. L. REV. 1214, 1222 (1990). ("[S]ome states have adopted theories that establish a very tight legal relationship between directors and shareholders. Directors who are considered agents and trustees owe strict fiduciary duties to the shareholders. The shareholder meeting is a forum through which the corporation's owners can express their view on whether the board is properly fulfilling its fiduciary responsibilities and take appropriate action when necessary. Unless courts considering meeting requests during bankruptcy apply a test that takes into account this legal relationship, they will be thwarting the well-established law of states that adhere to the agency or trustee theories.")

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(2) In favor, because the potential threat of replacement may improve managers' postpetition performance: Robert K. Rasmussen, *The Search for Hercules: Residual Owners, Directors, and Corporate Governance in Chapter 11*, 82 WASH. U. L.Q. 1445, 1466-67 (2004) (" ... the empirical evidence we have from corporate governance generally suggests that boards that are secure in their tenure underperform their peers. ...While it would be a mistake to translate these findings to the environs of the bankruptcy court without scrutiny, they do suggest that boards may respond better when they are not insulated from various forces. Indeed, the extent to which creditors go to great lengths to ensure that they have control of the bankruptcy process suggests that they recognize the costs that can be incurred when directors are not attuned to those with money on the line.")

(3) Against, because of shareholders' problematically diverging incentives: David Arthur Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 VA. L. REV. 461, 508-09 (1992) ("The 'clear abuse' test relied on by the courts is an insufficient response to this problem because shareholders' incentives are systematically, not juts occasionally, flawed. Moreover, any directors elected by shareholders also will have suspect decisionmaking incentives. Thus, the effect of permitting a shareholders meeting would be to put decisionmaking authority in the hands of directors who do not represent the best interests of the corporation as a whole.")

(4) Commentators have further noted that reconfigurations of management occurring during the reorganization process are unlikely to survive its resolution, thus diminishing the effect of shareholder-compelled management changes: Douglas G. Baird & Robert Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 697-98 (2004) ("Perhaps more importantly, while some businesses may emerge from Chapter 11, the directors of these businesses do not survive. The board often turns over during the course of the Chapter 11 case. In any event, by the end of the case, the plan of reorganization brings with it a new set of directors, usually appointed by the creditors. The old creditors typically hold a controlling interest in the equity of the new company and use this right to install a new board.")

C. The Right to Request Formation of an Equity Committee

1. How is an Equity Committee Appointed?

a) Equity Committees may be appointed, at the discretion of U.S. Trustee, pursuant to 11 U.S.C. § 1102(a)(1): "the United States trustee shall appoint a committee of creditors holding unsecured claims and may appoint additional committees of creditors or of equity security holders as the United States trustee deems appropriate." 11 U.S.C. § 1102(a)(1). The court may also order appointment: "On request of a party in interest, the court may order the appointment of additional

committees of creditors or of equity security holders if necessary to assure adequate representation of creditors or of equity security holders. The United States trustee shall appoint any such committee." 11 U.S.C. 1102(a)(2).

2. When Will an Equity Committee Be Appointed?

   a) *In re Williams Communications Group, Inc.*, 281 B.R. 216 (Bankr. S.D.N.Y. 2002), articulates several of courts' common concerns when determining whether or not to appoint an equity committee:

      (1) *Cost concerns* - Committee appointments are usually closely followed by applications to retain attorneys and accountants. *Id.* at 220.

         (a) Cost consideration may also include intangible costs, such as delay. *See Albero v. Johns-Manville (In re Johns-Manville)*, 68 B.R. 155, 160 (S.D.N.Y. 1986).

      (2) *Debtor's solvency* - "When a debtor appears to be hopelessly insolvent, an equity committee is not generally warranted . . ." *In re Williams Communications Group, Inc.*, 281 B.R. at 220.

         (a) Factors in considering whether debtor appears to be hopelessly insolvent:

            (i) Assets v. liabilities

            (ii) Are publicly held bonds traded at discount?

            (iii) If proposed plan exists, does it contain cash distributions? (Lack of cash distributions speaks in favor of hopeless insolvency.)

         (b) Court need not find debtor *is* hopelessly insolvent; *appearance* suffices. *Id.* at 221.

   b) *See also In re Wang Laboratories, Inc.*, 149 B.R. 1 (Bankr. E.D. Mass. 1992).

      (1) Appointment of equity committee is warranted when:

         (a) Large number of shareholders exists

         (b) Case is complex

         (c) Debtor is not hopelessly insolvent

   c) After a plan of reorganization has been approved, it is too late to appoint an equity committee. *In re Etoys*, 331 B.R. 176 (Bankr. D. Del. 2005).

3. Why Should Equity Want to Have Its Own Official Committee?

   a) Having an official committee has significant ramifications with regard to the ability of shareholders to control or participate in the reorganization process (and, not incidentally, official committees are entitled to hire professionals and have their fees paid by the estate, pursuant to 11 U.S.C. § 1103(a)). For an introduction to recent developments, *see* Jane Lee Vris, *Current Developments: Official Committees Review of Recent Cases*, 28th Annual Current Developments in

Bankruptcy & Reorganization, 888 PLI / Comm 391, 412-14, PLI Order No. 8926 (Apr. 24-25, 2006).

D. Management Responsibilities - A Short Survey of the Board of Director's Bifurcated Fiduciary Duties in the Prepetition Period

1. As a corporation nears insolvency, the interests of shareholders (and the corporate managers who represent them) and the entity's creditors may diverge -- managers may become drawn to the riskier, "bet the house" behavior that can harm creditor interests. *See, e.g.,* Alon Chaver & Jesse M. Fried, *Managers' Fiduciary Duty upon the Firm's Insolvency: Accounting for Performance Creditors*, 55 VAND. L. REV. 1813, 1821 (2002) (setting forth mathematical example of shareholder value maximization behaviors working to the detriment of creditors of an insolvent entity).

2. Excessive risk taking has been counterbalanced by the judicial imposition of affirmative duties of care, flowing from the insolvent corporation's managers to its embattled creditors. *See, e.g., In re LTV Steel Co., Inc.*, 333 B.R. 397, 421 (Bankr. N.D. Ohio 2005) ("From a board's decision-making perspective, their fiduciary duties may have already expanded at the moment of insolvency in the time before the actual filing of bankruptcy"). Fiduciary duties also flow from the debtor in possession, as represented by its managers, to the creditors of the debtor. *See Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 355 (1985).

3. For a summary of the fiduciary duties that may be owed to an insolvent corporation's creditors, and the potential triggering events for such duties, *see* Andrea A. Wirum et al., *Corporate Governance and Fiduciary Duties to Creditors of Insolvent Corporations*, 25th Annual Current Developments in Bankruptcy & Reorganization, 849 PLI / Comm 1183, PLI Order Number A0-00GB (Apr. 2003).

E. When Management Fails - Appointment of a Chapter 11 Trustee

1. Chapter 11 trustee appointment is rare: "It is settled that appointment of a trustee should be the exception, rather than the rule." *In re Sharon Steel Corp.*, 871 F.2d 1217, 1226 (3d Cir.1989).

2. Normally, appointment must be for cause or upon conclusion that such appointment is in best interests of parties. 11 U.S.C. 1104(a)(1)-(3).

3. Acrimony among management and official committees, rising to the level of a stalemate, may provide sufficient cause to appoint a Chapter 11 trustee: "a district court may find cause to appoint a trustee for 'acrimony' only on a case-by-case basis, when the inherent conflicts extend beyond the healthy conflicts that always exist between debtor and creditor, or . . . when the parties begin working at cross-purposes." *In re Marvel Entertainment Group, Inc.*, 140 F.3d 463 (3rd Cir. 1998) (internal quotations omitted).

4. Newly-codified mandate of § 1104(e) of the Bankruptcy Code requires the U.S. trustee to move for appointment of a Chapter 11 trustee "if there are reasonable grounds to

suspect that current members of the governing body of the debtor, the debtor's chief executive or chief financial officer, or members of the governing body who selected the debtor's chief executive or chief financial officer, participated in actual fraud, dishonesty, or criminal conduct in the management of the debtor or the debtor's public financial reporting." 11 U.S.C. § 1104(e).

F. Maintaining Connection with the Reorganized Debtor Through Postpetition Financing

1. When shareholders - and, by extension, existing management - are unable to control the bankruptcy process through application of their prepetition rights, they may seek to guide the reorganization by means of (a) postpetition debtor financing ("DIP financing"), or (b) proposing their own plan of reorganization that will allow shareholders to retain some or all of the equity of the continuing concern, in exchange for a contribution of new value to the estate.

   a) DIP Financing Agreements

      (1) Commentator David Skeel describes DIP financing agreements as "often the single most important governance lever in bankruptcy." David A. Skeel, Jr., *The Past, Present and Future of Debtor-In-Possession Financing*, 25 CARDOZO L. REV. 1905, 1933 (2004). A prepetition equityholder granting postpetition financing to the debtor will, through negotiation of the DIP financing agreement, garner substantially more control over the debtor's reorganization process than would the typical shareholder, whose interests will in most cases be wiped out.

2. Proposing a Plan or "New Value" Plan

   a) Equityholders, as parties in interest in the case, may propose plans of reorganization in accordance with 11 U.S.C. § 1121(c), after the debtor exclusivity period has expired. Such plans may include governance and/or ownership provisions that would entitle equityholders to rights they would not otherwise receive as prepetition stakeholders.

      (1) If the plan of reorganization proposed by an equityholder satisfies each of the requirements of 11 U.S.C. § 1129, the court may approve the plan.

      (2) An equityholder may also propose a plan of reorganization that satisfies each of the requirements of section 1129 but for 11 U.S.C. 1129(a)(8), which subsection requires approval of the plan by all creditor classes (a so-called "cramdown" plan). *See* 11 U.S.C. §1129(b) (plan may be confirmed if it is "fair and equitable" notwithstanding the requirement of total creditor body acquiescence set forth in subsection 1129(a)(8)).

         (a) If a cramdown plan calls for retention of equityholder interests, it may be held to run afoul of section 1129(b)(2)(B)(ii) (stating that a plan not approved by the entire creditor body must not allow junior claim or interest holders to "receive or retain under the plan on account of such junior claim or interest any property").

(b) Cramdown plans where equity retains an interest in the reorganized debtor may be confirmed, notwithstanding, where the equityholder shows that it is contributing "new value" to the reorganized debtor that is greater than the value the debtor would receive from a non-insider. *See Bank of Am. Nat'l Trust and Savings Ass'n v. 203 North LaSalle Street Partnership*, 526 U.S. 434 (1999).

II. Derivative Standing in Chapter 11[1]

A. Overview

At first glance, derivative standing may appear to have little to do with corporate governance in chapter 11 reorganizations. However, because the claims that creditors and their committees are wont to prosecute often implicate the resources of the estate, and sometimes revolve around the alleged misdeeds of prepetition management, the issues of when and under what circumstances courts may allow derivative standing have proven fertile territory for litigation.

Derivative standing, where allowed, provides a further check on postpetition management's business judgment, allowing creditors and, more often, creditor committees to act when the debtor in possession has determined not to. Whether this judicially-created right is appropriate, helpful or warranted is debated by courts and commentators alike.

B. The Statutory Seeds of Derivative Standing - Sections 1103 and 1109 of the Bankruptcy Code …

1. § 1103(c)(5): "A committee appointed under section 1102 of this title may -- perform such other services as are in the interest of those represented."

2. § 1109(b): "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."

C. …And the Judicial Interpretation Thereof

1. *Cybergenics*, 330 F.3d 548, 556 (3d Cir. 2003) (en banc): "[W]e are satisfied that the most natural reading of the Code is that Congress recognized and approved of derivative standing for creditors' committees. Sections 1109(b) and 1103(c)(5), taken together, evince a Congressional intent for committees to play a robust and flexible role in representing the bankruptcy estate, even in adversarial proceedings."

D. When Will A Court Allow Derivative Standing to Creditors or Committees?

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[1] This section of the outline owes a great debt to the excellent collection of related cases in Jane Lee Vris, *Current Developments: Official Committees Review of Recent Cases*, 28th Annual Current Developments in Bankruptcy & Reorganization, 888 PLI / Comm 391, 404-12, PLI Order No. 8926 (Apr. 24-25, 2006).

1. When the debtor in possession unreasonably or unjustifiably refuses to pursue a colorable claim

   a) Three General Requirements for Unjustified Refusal Standing:

      (1) Creditor (or committee) alleges a colorable claim that would benefit the estate;

      (2) debtor in possession unjustifiably refuses to pursue claim;[2] and

      (3) bankruptcy court has granted permission to creditor to pursue claim.

      For several iterations of this standard, *see Fogel v. Zell*, 221 F.3d 955, 965 (7th Cir. 2000); *In re Gibson Group, Inc.*, 66 F.3d 1436, 1438 (6th Cir. 1995); *In re Louisiana World Exposition, Inc.*, 832 F.2d 1391, 1397 (5th Cir. 1987) (citing cases); *In re National Forge Co.*, 326 B.R. 532, 543 (W.D. Penn. 2005) (citing cases); *In re Grand Eagle Cos.*, 313 B.R. 219, 224 (N.D. Ohio 2004); *In re G-I Holdings, Inc.*, 313 B.R. 612, 628-29 (Bankr. D.N.J. 2004); *In re Tennessee Valley Steel Corp.*, 183 B.R. 795, 800 (Bankr. E.D. Tenn. 1995); *In re First Capital Holdings Corp.*, 146 B.R. 7, 11 (Bankr. C.D. Cal. 1992).

   b) What is a "Colorable Claim"?

      (1) To be colorable, a claim need not be certain to succeed. Courts sometimes accept as "colorable" claims that may be susceptible to challenges when these challenges "are in the nature of factual disputes more appropriately resolved on a fully developed record." *In re National Forge Co.*, 326 B.R. 532, 548 (W.D. Penn. 2005).

      (2) When dispositive affirmative defenses clearly exist, courts are unlikely to find colorable claims. *See In re G-I Holdings, Inc.*, 313 B.R. 612, 631 (Bankr. D.N.J. 2004).

      (3) One recent opinion framed the analysis as an assessment of whether a "proposed claim is not without any legal merit whatsoever." *In re LTV Steel Co., Inc.*, 333 B.R. 397, 425 (Bankr. N.D. Ohio 2005) (finding colorable claims of breach of duty of care, breach of duty of loyalty,

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[2] Courts sometimes prefer to iterate four required elements, splitting the requirement of refusal into two requirements, one of actual request and the second of debtor refusal. *See, e.g., In re LTV Steel Co., Inc.*, 333 B.R. 397, 406 (Bankr. N.D. Ohio 2005) ("[A] creditor's committee may have derivative standing to bring a derivative action if the committee can show: 1) that the creditor's committee has made a request of the debtor-in-possession regarding the initiation or prosecution of an action which will benefit the estate, 2) that the request has been refused, 3) a prima facie demonstration that a colorable claim exists which, if successful, would benefit the estate, and, 4) the creditor's committee's grounds for contending that the debtor-in-possession's inactivity on the claim is unjustifiable or abusive of their discretion.").

negligent misrepresentation and fraud, deepening insolvency, and corporate waste); *see also id.* at 406 (discussing standard and citing cases).

c) When Is Refusal Unjustified?

(1) One recent district court described the assessment of unjustified refusal as "a cost-benefit analysis of the claims to determine whether the creditors' claims have colorable merit and whether, in light of the probable costs of litigation, the claims would likely benefit the estate if pursued." *In re National Forge Co.,* 326 B.R. 532, 548 (W.D. Penn. 2005).

(2) Considerations of this cost-benefit analysis include:

(a) The probability of a claim's success and the costs of litigating;

(b) Whether it would be preferable to appoint a trustee to bring suit;

(c) Whether conflicts of interest exist between debtors and other parties, and to what extent creditors' interests might otherwise be protected. *Id.*

(3) In the recent unpublished case *In re Buildnet*, the court applied an "abuse of discretion" standard: "To find that the Debtor and the Examiner were unjustified in failing to bring the actions, the Court would have to make a finding that the inaction on the part of the authorized parties was an abuse of discretion." *In re Buildnet, Inc.,* Nos. 01-82293, 01-82299, 2004 WL 2898151, at *4 (Bankr. M.D.N.C. Dec. 14, 2004) (denying motion to compel examiner or DIP to pursue settled claims and denying creditor derivative standing to pursue same).

(a) Thus, under *Buildnet*, the relevant factors to consider were found to include:

(i) Realistic assessment of probability of litigation's success;

(ii) The amount the estate may gain through success; and

(iii) The time and money it will take to litigate the claim. *Id.* at *3.

(4) *In re LTV Steel Co.* suggests a quasi-presumption of unjustified refusal when the refusing entity would also be a party defending a claim: "It is unrealistic to believe that the directors and officers who are named defendants would acquiesce to bringing a lawsuit upon themselves. . . . [The "unjustified" requirement] is therefore satisfied upon an appropriate demand made upon interested directors and officers of a corporation." In re LTV Steel Co., Inc., 333 B.R. 397, 425 (Bankr. N.D. Ohio 2005), *citing Cybergenics*, 330 F.3d 548, 573.

2. When the DIP or trustee has authorized the derivative pursuit of the claim, and the claim is (i) in the best interests of the estate and (ii) necessary and beneficial to the fair and efficient resolution of the bankruptcy proceedings.

a) "[A] creditors' committee may bring suit even where the trustee or debtor-in-possession has not unjustifiably refused to do so, as long as (1) the committee has the consent of the debtor in possession or trustee, and (2) the court finds that suit by the committee is (a) in the best interest of the bankruptcy estate, and (b) is necessary and beneficial to the fair and efficient resolution of the bankruptcy proceedings." *Glinka v. Murad (In re Housecraft Indus. USA, Inc.)* 310 F.3d 64, 70 (2d Cir. 2002); *see also Avalanche Mar., Ltd. v. Parekh (In re Parmetex, Inc.)*, 199 F.3d 1029, 1031 (9th Cir.1999).[3]

E. *Hartford Underwriters* - The Supreme Court Renders Its (Circumscribed) Opinion

1. Construing section 506(c)[4] of the Bankruptcy Code, the Supreme Court observed: "all [section 506(c)] actually 'says' is that the trustee may seek recovery under the section, not that others may not. The question thus becomes whether it is a proper inference that the trustee is the only party empowered to invoke the provision. We have little difficulty answering yes." *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1, 13 (2000) (footnotes omitted).

2. While this, without more, would have dealt the coup de grace to derivative standing for creditors or committees, the Justices explicitly excluded derivative standing, as established by the factors set forth *supra*, from the scope of *Hartford Underwriter*'s holding: "We do not address whether a bankruptcy court can allow other interested parties to act in the trustee's stead in pursuing recovery under § 506(c) ... [w]hatever the validity of that practice, it has no analogous application here, since petitioner did not ask the trustee to pursue payment under § 506(c) and did not seek permission from the Bankruptcy Court to take such action in the trustee's stead. Petitioner asserted an independent right to use § 506(c), which is what we reject today. *Cf. In re Xonics Photochemical, Inc.*, 841 F.2d 198, 202-203 (C.A.7 1988) (holding that creditor had no right to bring avoidance action independently, but noting that it might have been able to seek to bring derivative suit)." *Hartford Underwriters*, 530 U.S. 1, 13 n.5.

F. Academics and Courts Continue to Dispute the Applicability of Derivative Standing

1. The Strict Statutory Construction Approach - No Derivative Standing

a) *United Phosphorus, Ltd. V. Fox (In re Fox)*, 305 B.R. 912, 915 (B.A.P. 10th Cir. 2004) (citations omitted) (noting, *inter alia*, that the same problems giving rise to creditors committees' need to sue (i.e., unjustifiable refusal to sue by the debtor in possession) would also be cause for appointment of a chapter 11 trustee under

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[3] *But see In re Spirtos*, 443 F.3d 1172, 1175 (9th Cir. 2006), which posits circuit uncertainty as to viability of derivative standing option ("To date, we have not squarely addressed the question of whether the creditor of a bankruptcy estate also has standing to assert claims on behalf of the estate").

[4] 11 U.S.C. §506(c) provides that"[t]he trustee may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim, including the payment of all ad valorem property taxes with respect to the property."

section 1104, or for removal of the "trustee" under section 324); *cf Scott v. Nat'l Century Fin. Enter., Inc. (In re Baltimore Emergency Services II Corp.)*, 432 F.3d 557, 561 (4th Cir. 2005) (noting, without decision, that "[i]t is far from self-evident that the Bankruptcy Code permits creditor derivative standing.")

b) "Neither the Bankruptcy Code nor otherwise applicable nonbankruptcy law authorizes creditor derivative suits. Because such suits are not expressly authorized by the Bankruptcy Code, a bankruptcy court's equitable powers may not properly be used to confer standing where none would otherwise exist. Though it is true that creditor derivative suits were sometimes endorsed though rarely if ever actually used in early pre-Code practice, later pre-Code practice appears to have forbidden them. And while permitting creditors to bring derivative suits would undoubtedly add value to the estate in some bankruptcy cases, whether they would enhance value for creditors overall is a contestable proposition. Finally, even if they are on balance value enhancing, creditor derivative suits remain at odds with other objectives of bankruptcy policy." Keith Sharfman, *Derivative Suits in Bankruptcy*, 10 STAN. J.L. BUS. & Fin. 1, 26 (2005).

2. The Greater Good Approach - Derivative Standing When It Will Aid Reorganization

a) The *Cybergenics* opinion explores at length the policy reasons for allowing derivative standing for creditors' committees. These reasons were found to include (i) the positive use of the bankruptcy court's equity powers; (ii) pre-Code tradition allowing courts to confer derivative standing, (iii) derivative standing providing a salutary safeguard against "lax pursuit of avoidance actions"; (iv) derivative actions no more likely to dissipate the estate than direct actions; (v) bankruptcy courts capable of discerning when a debtor's refusal to pursue an avoidance action is unreasonable; (vi) allowing derivative standing will not create undue burden on judicial resources; and (vii) the alternatives to derivative standing appear less effective. 330 F.3d at 567-79.

b) *See also In re Adelphia Communications Corp.*, 330 B.R. 364, 372-74 (Bankr. S.D.N.Y. 2005) (describing practice of granting derivative standing as "nearly universally recognized," summarizing Second Circuit "trilogy" of cases allowing standing,[5] and describing derivative standing as "a salutary (and many might say essential) element of the chapter 11 process").

c) "The derivative standing doctrine has served and continues to serve as a means by which a DIP can continue the rehabilitation of its business notwithstanding any

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[5] *See Glinka v. Murad (In re Housecraft Indus. USA, Inc.)* 310 F.3d 64, 70-71 (2d Cir. 2002); *Commodore Int'l, Ltd. v. Gould (In re Commodore Int'l, Ltd.)*, 262 F.3d 96, 100 (2d Cir. 2001); *Unsecured Creditors Committee of Debtor STN Enterprises, Inc. v. Noyes (In re STN Enterprises)*, 779 F.2d 901, 904 (2d Cir. 1985) (each allowing derivative standing to pursue trustee's actions where denial unreasonable); *but see Smart World Techs., LLC v. Juno Online Servs., Inc. (In re Smart World Techs., LLC)*, 423 F.3d 166, 177 (2d. Cir. 2005) (denying derivative authority to creditors to settle lawsuit against the wishes of the debtor in possession; stating that "we do not rule out that in certain, rare cases, unjustifiable behavior by the debtor-in-possession may warrant a settlement over the debtor's objection, but this is not such a case.").

conflicts of interest it may have due to pre-petition transfers to insiders or other favored creditors. The doctrine is therefore consistent with and furthers the purposes of chapter 11. Despite the fact that the words 'the trustee may' are contained in both section 506(c) and the avoidance provisions, the precise textual interpretation of these sections cannot and should not be 'blindly applied to another.' Proper analysis of Justice Scalia's reasoning and plain meaning construction in *Hartford Underwriters* as applied to sections 1107(a), 1109(b), and 503(b)(3)(B), compels the conclusion that this practice should continue. Bankruptcy courts indeed possess the requisite statutory authority to confer standing upon a creditor or committee in a chapter 11 case to commence avoidance actions on behalf of a DIP when the DIP unjustifiably refuses to act." Alan R. Lepene & Sean A. Gordon, *The Case for Derivative Standing in Chapter 11*, 11 AM. BANKR. INST. L. REV. 313, 337-38 (2003) (citations omitted).

d) "[I]f bankruptcy courts can identify situations where a creditors' committee is better situated than the trustee or debtor-in-possession to prosecute particular estate causes of action, they can and should authorize the committee to do so." Daniel J. Bussel, *Creditors' Committees as Estate Representatives in Bankruptcy Litigation*, 10 STAN. J.L. BUS. & FIN. 28, 36-37 (2005).

3. The Liberal Grant of Standing Approach - Forgoing "Demand"

a) In *Official Comm. of Unsecured Creditors v. Clark (In re National Forge Co.)*, 326 B.R. 532, 544 (W.D. Penn. 2005). (following *Infinity Investors Ltd v. Kingsborough (In re Yes! Entm't Corp.)*, 316 B.R. 141 (D. Del. 2004) and other precedent) the court concluded that "under appropriate circumstances, [courts may] excuse a creditors' committee's failure to formally request a debtor to file suit" prior to pursuing a derivative claim.

(1) "Appropriate circumstances" may include (a) the debtor's awareness of the third party's intent to pursue the claim; and (b) lack of prejudice to the debtor, such as where the debtor has waived its right to pursue the claim. *Id.*, at 544-5.

b) *See also In re G-I Holdings, Inc.*, 313 B.R. 612, 630 (Bankr. D.N.J. 2004) ("a debtor's refusal to pursue an avoidance action can be implied even where no formal demand has been made by a creditors committee.")

III. Non-Debtor Third Party Releases in Plans of Reorganization

A. Overview

The Sunday night playbook actions of a debtor's directors and officers in the prepetition period may be the subject of great scorn in the Monday morning armchair of the bankruptcy case. Indeed, in certain instances derision gives way to litigation - allegations of mismanagement, waste, and other breaches of fiduciary duties. In order to quell such litigation, many plans of reorganization seek to enjoin further action against nondebtor parties, including, among others, the debtors' prepetition directors and officers, for decisions made concerning prepetition debtor.

As with derivative standing issues, courts in the several circuits have taken different approaches to nondebtor releases. Some circuit courts, taking a strict statutory construction approach, have held that nondebtor releases are *per se* invalid; others have granted relatively broad releases to nondebtor parties, pursuant to their general equity powers; another has held that injunctions on actions against nondebtors may be maintained only against those creditors voting in favor of the plan of reorganization prior to its confirmation; and yet another has held that "unusual circumstances" must exist before a release may be granted.

A recent case in the Second Circuit, however, appears to bring closer together what were once widely diverging views with regards to nondebtor releases. Under current precedent, it appears unlikely that a nondebtor director or officer can be granted a release as part of a debtor's plan of reorganization - if at all - unless extenuating circumstances exist showing the need for such a release to be vital to the debtor's reorganization.

B. Statutory Framework

1. 11 U.S.C. § 524(e): "Except as provided in [section 524(a)(3)], discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt."

2. 11 U.S.C. § 105(a): "The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."

C. "No Means No" - The Fifth, Ninth and Tenth Circuits' Prohibition on Nondebtor Releases

1. The Fifth, Ninth and Tenth Circuits have each explicitly held that nondebtor releases may not be allowed under any circumstance. *See In re Zale Corp.*, 62 F.3d 746 (5th Cir. 1995); *In re Lowenschuss*, 67 F.3d 1394 (9th Cir. 1995), cert. denied, 517 U.S. 1243 (1996); *In re Western Real Estate Fund Inc.,* 922 F.2d 592 (10th Cir. 1990).

   a) In so holding, courts have found that a bankruptcy court does not have jurisdiction over actions between nondebtors. *See* Ralph Brubaker, *Nondebtor Releases and Injunctions in Chapter 11: Revisiting Jurisdictional Precepts and the Forgotten Callaway v. Benton Case*, 72 AM. BANKR. L. J. 1, 53, fns. 221-2 (compiling cases holding that bankruptcy court may not enjoin action by one nondebtor third party against the second)

   b) Further, these courts look to section 524(e) of the Bankruptcy Code, holding that the section explicitly disallows release of creditor claims against nondebtor third parties. *See, e.g., In re Zale Corp.*, 62 F.3d at 760 (stating that the court would thus be compelled to "overturn a § 105 injunction if it effectively discharges a nondebtor"); *In re Western Real Estate Fund Inc.,* 922 F.2d at 600 ("Obviously, it is the debtor, who has invoked and submitted to the bankruptcy process, that is entitled to its protections [as set forth under section 524(e)]; Congress did not intend to extend such benefits to third-party bystanders").

D. "Acquiescence Means Consent" - The Seventh Circuit Approve-and-Enjoin Standard

1. The Seventh Circuit has adopted a middle ground approach, granting releases as against third parties where the creditor holding the released claim has consented, i.e., voted in favor of the plan. *See In re Specialty Equipment Companies*, 3 F.3d 1043 (7th Cir. 1993).

   a) The Seventh Circuit disregarded jurisdictional objections to nondebtor releases. *Id.*, at 1045 ("... the bankruptcy court's subject matter jurisdiction [ ] is quite broad under section 105(a) ...")

   b) Section 524(e) was found not to be so limiting as to deny a bankruptcy court all right to approve nondebtor releases. *Id.*, at 1046-7 ("[W]hile section 524(e) has generally been interpreted to preclude the discharge of guarantors, the statute does not by its specific words preclude all releases that are accepted and confirmed as an integral part of a reorganization").

   c) Under Seventh Circuit precedent, a lower court may thus allow nondebtor releases, provided such releases are "consensual and non-coercive". *Id.*, at 1047.

E. "Important" Injunctions Allowable - The (Once) Broad Scope of Second and Fourth Circuit Nondebtor Releases

1. Historically, the Second and Fourth Circuit courts have been the most permissive in granting broad injunctions against actions by third parties against nondebtor parties, as set forth in confirmed plans of reorganization, following *In re Drexel Burnham Lambert Group, Inc.*, 960 F.2d 285 (2d Cir. 1992) *and In re A.H. Robins Co.*, 880 F.2d 694 (4th Cir. 1989); Brubaker, 72 AM. BANKR. L. J. at 54, fn. 223 (quoting the broad releases contained in the *A.H. Robins* and *Drexel Burnham* plans of reorganization).

   a) The *A.H. Robins* court made reference to specific findings of fact concerning the particular case at issue, 880 F.2d at 702, and determined, in light of the overwhelming support of the plan of reorganization by the creditor body, as well as the integral nature of the nondebtor releases contained therein, that it would "not construe § 524(e) so that it limits the equitable power of the bankruptcy court to enjoin the questioned suits". *Id.*

   b) The *Drexel Burnham* court did not reference section 524(e) at any point in its analysis, and cited the *A.H. Robins* decision to bolster its holding that "[i]n bankruptcy cases, a court may enjoin a creditor from suing a third party, provided the injunction plays an important part in the debtor's reorganization plan." 960 F.2d at 293.[6]

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[6] This "important part [of the plan]" language "has been frequently cited in support of the inclusion of nondebtor releases in many reorganization plans ...." *See* Menachem Zelmanovitz, *Nondebtor Releases in Reorganization Plans*, ABI Journal, Vol. XXV, No. 4, April 2006, fn. 27 (compiling lower court cases).

F. "Unusual Circumstances" - Coming Around to the Sixth Circuit's Point of View

1. After the recent Second Circuit case *In re Metromedia Fiber Network Inc.*, 416 F.3d 136 (2d Cir. 2005), a release granted by a lower court in the Second Circuit must not only be "important" to reorganization, but also limited in breadth and scope and necessary to the plan.

   a) "A nondebtor release in a plan of reorganization should not be approved absent the finding that truly unusual circumstances render the release terms important to success of the plan…." (citing to *In re Dow Corning Corp.*, 280 F.3d 648 (6th Cir. 2002).

   b) In *Dow Corning*, the court pointed to numerous factors pointing to a determination of necessary release, including (1) identity of interests or indemnity by the debtor of the third party (2) substantial contribution by the nondebtor; (3) essential nature of the injunction; (4) overwhelming acceptance of impacted class(es); (5) substantial payment of all impacted creditors; (6) opportunity for non-settling creditors to recover in full; and (7) specific findings of fact as to each of the above, set forth in the confirmation decision. *Id.*, at 658.

2. Accordingly, in almost every circuit to have decided the issue, nondebtor releases are currently (i) proscribed *ab initio*, or (ii) proscribed except in the most rare of cases, or (iii) proscribed except where the affected creditor has previously given its consent to release the nondebtor through approval of the plan.