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Creditors’ Committee Prosecution of Avoidance Claims After Cybergenics: a Remedy But Not a Right

GARY D. SESSER AND ROXANNA D. NAZARI∗

INTRODUCTION

Since the enactment of the Bankruptcy Code1 in 1978, it has become commonplace for creditors’ committees to prosecute avoidance claims on behalf of Chapter 11 estates. While the Code grants the power to pursue avoidance claims to the debtor in possession,2 such claims are often asserted against corporate insiders, making it awkward, at the very least, for management of the debtor to litigate against current or former colleagues. To bankruptcy courts and practitioners, allowing creditors’ committees to prosecute avoidance claims in the name of the debtor in possession seemed an elegant solution to this conflict of interest problem. It permits self-interested but conflict-free creditors to pursue recoveries for the benefit of the estate while, at the same time, the estate retains the expertise of existing management to run the debtor’s business during its reorganization. This approach became so popular that it was adopted even in cases where the debtor had no conflict of interest; indeed, in many cases the arrangement was presented to the court for approval by stipulation between the debtor and the creditors.3

Over the years the legality of this practice was rarely questioned. Prior to 2002, every circuit court of appeals to consider the issue acknowledged the authority of a bankruptcy court to permit creditors, or creditors’ committees, to prosecute avoidance claims for the benefit of the estate—at least in appropriate circumstances.4 By 2002, representing creditors’ committees in avoidance litigation had become a sub-specialty among bankruptcy practitioners.

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It therefore came as a shock to the bankruptcy bar when a panel of the United States Court of Appeals for the Third Circuit (“Third Circuit”) unanimously ruled, on September 20, 2002, that the plain language of the Code does not permit a creditors’ committee to prosecute avoidance claims for the benefit of the estate. Relying on the Supreme Court’s statutory analysis in *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1, 120 S. Ct. 1942, 147 L. Ed. 2d 1, 36 Bankr. Ct. Dec. (CRR) 38, 43 Collier Bankr. Cas. 2d (MB) 861, Bankr. L. Rep. (CCH) ¶ 78183 (2000) (“*Hartford Underwriters*”), the panel affirmed the district court’s ruling that only a trustee or (in the absence of a trustee) a debtor in possession could assert such claims.5 [See Norton Bankr. L. & Prac. 2d §§ 4:6, 54:3.]

Because of the importance of the issue (the ruling affected hundreds of pending cases in which creditors’ committees were plaintiffs), the Third Circuit granted rehearing en banc and vacated the Panel Decision on November 18, 2002.6 After allowing six amicus curiae briefs and hearing oral argument, the Third Circuit reversed the district court on May 29, 2003, ruling—by a seven to four margin—that a bankruptcy court can authorize a creditors’ committee to prosecute avoidance claims when the debtor in possession unjustifiably refuses to act.7 However, the *en banc* court’s rationale for upholding the practice—not to mention the narrow margin of victory and the vigor of the dissenting opinion—suggests that clarifying legislation may be required if this widespread and salutary practice is to continue as before.

**Background**

Cybergenics Corporation was formed in 1994 by an investment buy-out firm to acquire the assets of an existing business. The seller was in the business of marketing nutritional supplements and other products for sports training and weight-loss under the Cybergenics trade name. The original purchase price was over $110 million, primarily financed with bank debt. Burdened with this debt, the company was in financial difficulty from the outset. Four months after the closing, the buyer sued the sellers for fraud. That litigation was settled almost immediately, but a subsequent adjustment of the purchase price, a further extension of the company’s credit line, and further equity infusion failed to remedy the company’s financial situation. In August 1996, less than two years after the sale, Cybergenics sought protection under Chapter 11 of the Bankruptcy Code. At the time of the filing, Cybergenics had unpaid trade debt of approximately $10 million and bank debt in excess of $80 million. Two months after its Chapter 11 filing, all of Cybergenics’ assets were sold in a bankruptcy auction for $2.65 million.
Procedural History

In due course the official committee of unsecured creditors (the “Committee”) obtained permission from the United States Bankruptcy Court for the District of New Jersey (“Bankruptcy Court”) to investigate whether the estate had fraudulent transfer claims arising out of the buy-out. Concluding that there were viable claims, the Committee made demand on the debtor in possession to assert such claims for the benefit of the estate. The debtor declined to pursue the claims, citing a release the company had given to the sellers in connection with the post-closing fraud litigation and the expense to the estate of pursuing the fraudulent transfer claims. The Committee thereafter sought permission from the Bankruptcy Court to bring the claims in the name of the debtor in possession. Following a contested proceeding in which the putative defendants objected to the Committee’s motion, the Bankruptcy Court authorized the Committee to proceed, specifically finding that there were colorable claims which could benefit the estate. The court noted that the estate would not be burdened with litigation expenses because the Committee had secured counsel who had agreed to prosecute the claims on a contingent fee basis.

Significantly, none of the objectors to the Committee’s motion suggested that the bankruptcy court lacked the power to authorize the Committee to pursue avoidance claims on behalf of the estate in appropriate circumstances. Rather, their opposition was directed to whether the Committee had met the well-established criteria for securing bankruptcy court approval to assert the claims. Specifically, the objectors argued that the avoidance claims were not colorable and would not benefit the estate. These arguments were rejected by the Bankruptcy Court and this decision was affirmed by the United States District Court for the District of New Jersey (“District Court”) during a proceeding in open court.

With Bankruptcy Court approval, the Committee commenced an adversary proceeding against the parties to the ill-fated buy-out in March 1998. The District Court initially dismissed the case in 1999 on the ground that the fraudulent transfer claims had been sold as part of the post-bankruptcy asset sale and therefore the Committee lacked standing to pursue them. The Third Circuit reversed, ruling that the power to avoid transfers under Section 544 of the Code is not an “asset” of the debtor, and therefore the claims were not sold as part of the asset sale.8

On remand to the District Court, the defendants renewed their motions to dismiss the Committee’s complaint on grounds not previously reached by the District Court or the Third Circuit. In addition, the defendants raised a new ground for dismissal. Relying on Hartford Underwriters, the defen-
dants argued for the first time that the Committee lacked standing to assert fraudulent transfer claims because only a trustee or a debtor in possession is authorized to prosecute such claims under Section 544 of the Code.

In *Hartford Underwriters*, the debtor in a Chapter 11 case obtained workers’ compensation insurance from Hartford during its attempted reorganization. Apparently the debtor failed to pay Hartford the premiums for this insurance. When the attempt at reorganization failed, the case was converted to a Chapter 7 liquidation. Because all of the debtor’s assets were encumbered, Hartford could not collect its unpaid premiums by contending that the premiums were administrative expenses entitled to priority over pre-petition unsecured claims. Instead, Hartford sought to avail itself of Section 506(c) of the Code, which states 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.” Relying on Section 506(c), Hartford sought to surcharge the collateral held by secured creditor Union Planters Bank.

A unanimous Supreme Court rejected Hartford’s position, ruling that an administrative claimant in a Chapter 7 bankruptcy case cannot, for its own benefit and without court approval, seek payment of its administrative claim by surcharging a secured creditor’s collateral under Section 506(c) of the Code. In an opinion authored by Justice Scalia, the Court ruled that under the plain language of the statute, only a trustee could exercise that power.

Factually, the holding in *Hartford Underwriters* did not control the outcome in *Cybergenics*. Indeed, in a much quoted footnote, the Supreme Court expressly left open the issue presented in *Cybergenics*:

> 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). *Amici*. . . draw our attention to the practice of some courts of allowing creditors or creditors’ committees a derivative right to bring avoidance actions when the trustee refuses to do so, even though the applicable Code provisions, see 11 U.S.C. §§ 544, 545, 547(b), 548(a), 549(a), mention only the trustee. See, e.g., *In re Gibson Group, Inc.*, 66 F.3d 1436, 1438 (6th Cir. 1995). Whatever 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 (7th Cir. 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). 10

Because Section 544 has the same “the trustee may” language as Section 506(c), application of the holding in Hartford Underwriters to Cybergenics would have been unobjectionable had the Committee sought an “independent right” to recover fraudulent transfers for its own benefit, as had the claimant in Hartford Underwriters. In Cybergenics, however, the Committee was pursuing the estate’s claims, in the name of the debtor in possession, with express authorization of the bankruptcy court.

While acknowledging that the Supreme Court had left the issue open and that court decisions subsequent to Hartford Underwriters had recognized, explicitly or implicitly, the derivative right of a creditors’ committee to assert claims of the bankruptcy estate, the District Court nevertheless found “no principled basis” on which to distinguish the Supreme Court’s interpretation of the words “the trustee may” in Hartford Underwriters. The Supreme Court had interpreted those words to mean that only "the trustee may." Moreover, neither policy arguments nor historical practice is controlling, said the Supreme Court, where the statutory language is clear. In such circumstances, policy arguments must be addressed to Congress. Citing these precepts, the District Court ruled that the Committee lacked standing to assert claims under Section 544, as only a trustee or (in the absence of a trustee) a debtor in possession had the statutory authority to do so.

On appeal from the District Court’s second dismissal of the case, a panel of the Third Circuit (the “Panel”) unanimously affirmed. The Panel agreed that there was no principled basis for distinguishing the Supreme Court’s statutory analysis in Hartford Underwriters. Like the District Court, the Third Circuit Panel was unpersuaded by contrary precedent from other circuits and even its own prior decisions because they had not explicitly addressed Hartford Underwriters.

The Panel noted that decisions from the Second Circuit had cited Sections 1103(c) (5) and 1109(b) of the Code, as well as pre-Code practice, as authority for permitting creditors’ committees a qualified right to sue. 11 Section 1109(b) states: “[a] party in interest, including the debtor, the trustee, a creditors’ committee… may raise and may appear and be heard on any issue in a case under this chapter.” Section 1103(c)(5) broadly states that “[a] committee appointed under section 1102 of this title may perform such other services as are in the interest of those represented.” The Third Circuit Panel found these sections insufficient to authorize a creditors’ committee to
bring the estate’s avoidance claims. It noted that in *Hartford Underwriters* the Supreme Court had rejected Section 1109(b) as a basis for permitting Hartford to assert a claim under Section 506(c). Section 1109(b) was by its terms inapplicable because *Hartford Underwriters* had been converted to a Chapter 7 case. However, the Supreme Court went on to state more generally: “we do not read § 1109(b)’s general provision of a right to be heard as broadly allowing a creditor to pursue substantive remedies that other Code provisions make available only to other specific parties.”

Although dicta, the Third Circuit Panel noted that Supreme Court dicta may not be lightly ignored. While *Hartford Underwriters* did not address Section 1103(c)(5), which was likewise inapplicable to a Chapter 7 case, the Third Circuit Panel found that it was too general a grant of authority to override the exclusivity of the trustee’s role in pursuing the estate’s avoidance claims. Instead, the Panel was persuaded that reading the “catch all” provision in Section 1103(c)(5) as conferring a right to sue would render meaningless the more specific grants of authority to creditors’ committees under the Code. Again, the prevailing view of the Panel seemed to be that if Congress had intended creditors’ committees to prosecute avoidance claims, it could have said so explicitly. The Panel went on to suggest that, even if a committee could not sue, the creditors were not without alternative methods of pursuing fraudulent transfers, the most obvious of which is to seek appointment of a trustee.

In one important respect the Panel’s decision differed from the opinion of the District Court. The District Court had ruled that the Committee lacked “standing” to assert claims under Section 544. The Third Circuit Panel ruled that the Committee satisfied the Article III constitutional and prudential requirements for standing, but was not the “real party in interest” because it was not entitled to enforce the avoidance claims under Section 544. This was a proper recognition that the claims belonged to the *estate*, and the only issue was who may *represent* the estate in bringing these claims. Notwithstanding that recognition, the panel did not adequately explain why it should not remand the case to permit substitution of the real party in interest (either a trustee or the debtor in possession), as apparently is required by the mandatory language of Fed.R.Civ.P. 17(a). Instead, the panel affirmed the District Court’s outright dismissal of the case, citing the Committee’s failure to request the appointment of a trustee in the District Court.

At the time the Panel Decision was rendered, there were hundreds of actions pending in the Third Circuit in which creditors’ committees were plaintiffs. In the aggregate, these actions sought recovery of billions of
dollars and at least one large asbestos case was on the verge of trial. In a celebrated case outside the Third Circuit, the bankruptcy judge in the Enron case had just authorized the unsecured creditors’ committee to pursue avoidance claims under Section 547 of the Code (which also includes “the trustee may” language) against Arthur Andersen and claims against former Enron directors, officers and employees. The Panel Decision invalidating a creditors’ committee’s ability to sue caused significant disruption in the Third Circuit and provoked a predictable outcry within the bankruptcy bar. It was therefore not surprising that the Third Circuit granted en banc review, even though requests for such review are rarely granted. Nor was it surprising that the en banc rehearing attracted substantial interest from academia and the bar, with six amicus parties, including a number of bankruptcy law professors, other creditors’ committees, and a corporation which had been a defendant in numerous avoidance actions weighing in on the issues before the Third Circuit.

**EN BANC OPINION**

The most striking aspect of the Third Circuit’s lengthy majority opinion is its formulation of the legal issue. While the District Court and the Third Circuit Panel had been preoccupied with the powers of creditors’ committees, the en banc majority approached the problem from an entirely different perspective. The majority viewed Cybergenics as involving “a bankruptcy court’s equitable power to craft a remedy when the Code’s envisioned scheme breaks down.” In other words, rather than focus solely on the rights and powers of a creditors’ committee, the majority asked whether the Code permits a bankruptcy court to authorize the action it had authorized in this case, i.e., permitting the Committee to assert avoidance claims on behalf of the estate. As the Committee had not claimed a unilateral right to sue without bankruptcy court approval, and was prosecuting the action for the benefit of the estate and not for its own benefit, this was surely the correct analytical approach.

The dissent adhered to the view that Cybergenics presented no more than a question of strict statutory interpretation—invoking a section of the Code that on its face allows only one party—the trustee—to take action. To the dissent, if Congress had intended creditors’ committees to assert avoidance claims, it could have said so explicitly in the Code. After all, the dissent observed, numerous Code sections set forth in detail the specific parties who may exercise certain rights and responsibilities. Section 544 mentions only the trustee.
While the substantive question of derivative standing attracted nationwide interest, the divergent approaches to interpretation of the Code taken by the Third Circuit majority and dissent may be the enduring legacy of Cybergenics II. The majority and the dissent each claimed fidelity to the principles of statutory interpretation outlined by the Supreme Court in Hartford Underwriters. However, the majority also relied on principles of Code interpretation from earlier Supreme Court rulings and found significance in pre-Code practice and policy considerations—an approach which the dissent found to be both unwarranted and inconsistent with Hartford Underwriters.

Language of the Code: Sections 1109(b), 1103(c)(5), and 503(b)(3)(B)

There was considerable common ground in the statutory analyses of the majority and the dissent. Both agreed, for example, that neither Sections 1109(b) nor 1103(c)(5), standing alone or taken together, conferred standing on creditors’ committees to assert avoidance claims. This was significant because, both before and after Hartford Underwriters, the Second Circuit had cited those Sections as authority for implying a qualified right of creditors’ committees to assert avoidance claims on behalf of the estate. As noted, the Panel Decision (and presumably the dissenters) dismissed those Second Circuit rulings as unpersuasive because they failed to address Hartford Underwriters. The en banc majority found it inconceivable that sophisticated judges and bankruptcy practitioners in the Second Circuit had simply failed to appreciate the relevance of a recent Supreme Court decision dealing with interpretation of the Code. Instead, suggested the majority, the Second Circuit probably had recognized that Hartford Underwriters had not addressed (and, as the Supreme Court itself said, had “no analogous application” to) the derivative right of a creditors’ committee to sue in the name of the trustee. Thus, the majority found the Second Circuit precedents themselves to be significant, and perhaps persuasive, but also clearly suggested that the statutory analysis in those decisions was too superficial to fend off the challenge to derivative standing posed in Cybergenics II.

While conceding that neither Sections 1109(b) nor 1103(c)(5) conferred on creditors’ committees a derivative right to sue, the en banc majority did not find them irrelevant to the analysis. Here, the majority and the dissent parted company. According to the majority, these Sections demonstrated Congress’ intent that creditors’ committees should play a vibrant and flexible role in Chapter 11 reorganizations. They are, as the majority later put it, “a piece of the puzzle” in a holistic interpretation of the Code. The dissent, having concluded that these Sections do not confer derivative standing, did
not see that they had any further relevance to the interpretation of an unambiguous statute, i.e., Section 544.

Section 503(b)(3)(B) of the Code proved to be a greater challenge to the position espoused by the defendants in Cybergenics and the dissent. Largely ignored by the various circuit court of appeals decisions that had recognized derivative standing,19 Section 503(b)(3)(B) authorizes recovery of certain expenses incurred by “a creditor that recovers, after the court’s approval, for the benefit of the estate any property transferred or concealed by the debtor.” The Panel Decision made a puzzling reference to the absence of “the key phrase ‘the trustee may’” in this Section, presumably as support for the proposition that Congress understood how to confer rights on creditors when it so desired. Yet a plain reading of this Section seemed to undermine the proposition that only a trustee (or debtor in possession) was authorized to recover, for the benefit of the estate, property transferred by the debtor. After all, Section 503(b)(3)(B) certainly implies that a bankruptcy court could authorize a creditor’s recovery of property transferred by the debtor for the benefit of the estate.

The defendants in Cybergenics II and their amici devoted much of their briefing, prior to the en banc argument, to offering possible interpretations of 503(b)(3)(B) that did not necessarily imply an endorsement of derivative standing. This was a theme picked up in both the majority decision and the dissent. The problem for the defendants and the dissent, however, is that none of the alternative explanations withstood real scrutiny. Moreover, in posing these alternatives, the defendants forfeited their claim to be strict constructionists of the Code. For example, the defendants argued that a creditor, who helps to locate property transferred or concealed by the debtor and thereby assists the trustee in recovering such property, might qualify for an award of its expenses under 503(b)(3)(B). Yet, the plain language of the statute does not speak of a creditor who uncovers or discovers property transferred or concealed; instead, it speaks of a creditor who recovers such property. As stated by one bankruptcy court in a decision issued shortly before the Panel Decision, to be “a creditor that recovers” means that the creditor must have taken direct action under the avoidance provisions of the Code or otherwise utilized a cause of action to which the estate succeeded, which necessarily implies derivative standing.20 Indeed, the similarity in language between Section 503(b)(3)(B) and Section 550(a) reinforces that view. Section 550(a) provides, among other things, that to the extent a transfer is avoided under Section 544, “the trustee may recover, for the benefit of the estate, the property transferred…” (emphasis supplied).
As a fallback, the dissent pointed out that 503(b)(3)(B) only speaks of “a creditor” and not a “creditors’ committee”—even though a nearby provision, Section 503(b)(3)(D), does refer to a creditors’ committee. While this is literally true, it hardly advances the notion that an avoidance action may only be asserted by a trustee or debtor in possession. For if a single creditor can recover property for the benefit of the estate with bankruptcy court approval, then, as the majority observed, all creditors could do so jointly. From there it is a short logical step to invoke Section 1103(c)(5) and assert that it is “in the interest of those represented” (i.e., the creditors) for the creditors’ committee to represent all the creditors in avoidance litigation.

The dissent finally cited bankruptcy court decisions stating that Section 503(b)(3)(B) does not itself confer standing. This, again, is literally true and is not a point with which the majority took issue. Section 503(b)(3)(B) clearly does not state that a creditor has standing to recover property transferred or concealed by the debtor; however, it certainly implies that such a right exists. Absent derivative standing or a viable alternative explanation for Section 503(b)(3)(B), the Section would have no purpose in the Code, which is a result to be avoided in statutory construction. Furthermore, the predecessor of Section 503(b)(3)(B), Section 64(a) of the Bankruptcy Act, was often cited in pre-Code caselaw as a basis for permitting a creditor to take action in the name of the trustee. Finally, the language of 503(b)(3)(B) is facially inconsistent with the notion that it is contrary to Congress’ intent to permit any party other than the trustee (or debtor in possession) to recover property transferred by the debtor for the benefit of the estate.

**Equity Power of the Bankruptcy Court**

Recognizing that no section of the Code explicitly states that creditors’ committees may be authorized to pursue avoidance claims on behalf of the estate, the en banc majority found the “missing link” to be the equitable power of the bankruptcy court. Bankruptcy courts have long been recognized as equitable tribunals. Indeed, the equitable power of the bankruptcy court is codified in Section 105(a) of the Code, which states, in relevant part, that “(t)he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Code].” According to the majority, this power permits the bankruptcy court to authorize a creditors’ committee to sue in the name of a debtor in possession which unjustifiably refuses to prosecute an avoidance claim for the benefit of the estate. Such power may be exercised *as a remedy* when the party with a fiduciary obliga-
tion to act—i.e., the trustee or debtor in possession in the case of Section 544—unreasonably declines to do so.

The dissent accepted the proposition that bankruptcy courts have broad equitable powers, but admonished that courts of equity still must follow the law and cannot “change the clear and plain language of a Code provision.”23 The dissent cited the Supreme Court’s decision in *Norwest Bank Worthington v. Ahlers* for the proposition that “whatever equitable powers bankruptcy courts have, they ‘must and can only be exercised within the confines of the Bankruptcy Code.’”24 However, what the dissent failed to recognize is that unlike the situation in *Hartford Underwriters*, where the claimant sought to improve the priority of its claim, no substantive rights are created or altered by permitting a creditors’ committee to sue in the name of the debtor in possession. Whether the nominal plaintiff is a trustee, a debtor in possession, or a creditors’ committee acting in the name of the debtor in possession, the avoidance claim is prosecuted on behalf of the estate in exactly the same way, and the proceeds of any recovery are distributed in exactly the same way.

Moreover, the defendants and the dissent acknowledged that a bankruptcy court has the power to compel a debtor in possession to pursue avoidance claims if, after demand by the creditors, the debtor unreasonably declines to do so.25 This is so even though no specific provision in the Code grants that power explicitly. In addition, the Third Circuit has ruled that under Section 1109(b), a creditors’ committee has an unqualified right to intervene in an action brought by the debtor in possession.26 Having conceded that a creditors’ committee may seek an order from the bankruptcy court compelling the debtor to prosecute an avoidance claim, and recognizing that the creditors’ committee would then have an absolute right to intervene in that suit under 1109(b), the dissent’s contention that the bankruptcy court cannot exercise its equitable power to authorize a creditors’ committee to bring the avoidance claim itself (in the name of the recalcitrant debtor) seems an unduly rigid interpretation of the Code. The unpalatable and senseless alternative of having the creditors’ committee, as intervenor, second-guessing and prodding an unenthusiastic debtor acting under compulsion cannot reflect the outer limit of the bankruptcy court’s equitable power to effectuate the purpose of the Code. Yet, in the final analysis, that is how the dissent read the Code. In effect, the statutory construction offered by the dissent is not so much based on a literal reading of Section 544, but rather on an inflexible interpretation of the broadly-worded Section 105(a).
On the other hand, the majority’s view that a bankruptcy court may grant a creditors’ committee the derivative right to sue in the name of the debtor may represent nothing more than a sensible and effective method of compelling the debtor to act.

The Role of Pre-Code Practice

The majority made it clear that its ruling was fully supported by a fair reading of the Code itself, and was not dependent on an analysis of pre-Code practice. Instead, pre-Code practice merely confirmed that derivative standing is a “prudent” method for a bankruptcy court to remedy the failure of a trustee or debtor in possession to act in accordance with its fiduciary duty. The reluctance of the majority to hinge its decision on pre-Code practice is understandable given the Supreme Court’s warning in Hartford Underwriters that pre-Code practice, while useful in interpreting ambiguous text, cannot be used as an “extratextual supplement” to change the meaning of an unambiguous statute. Taking its cue from the Supreme Court, the dissent in Cybergenics concluded that pre-Code practice was neither compelling nor even relevant because, in its view, Section 544 is not ambiguous.

The practice of permitting a creditor to take action in the name of the trustee when the trustee unreasonably refuses to act goes back more than a century. It is hard to accept that this long history was not influential in persuading the majority that the practice is not forbidden by the Code. Indeed, not too long before Hartford Underwriters, the Supreme Court reaffirmed that it “will not read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure.” There was no such showing made in Cybergenics.

If pre-Code practice can be an important tool in interpreting the Code, how is such practice to be established, particularly in the context of a motion to dismiss a complaint? In Hartford Underwriters the Supreme Court appeared to do a nose-count of reported decisions and failed to find a pre-Code practice so compelling that it could overcome the plain meaning of Section 506. Inspired by that mode of analysis, the dissent in Cybergenics II jumped on a concession at oral argument that there may only have been four or five circuit decisions under the Bankruptcy Act in which derivative action by creditors’ committees was recognized. The majority, on the other hand, noted that the cases recognizing such action are “ legion” and set forth the supporting citations in a lengthy footnote. The majority also placed “great weight on the fact that the 1978 version of the authoritative treatise Collier
on Bankruptcy, in summarizing practice under the pre-Code Bankruptcy Act, references in six different volumes creditors’ ability to obtain court permission to pursue actions on behalf of the estate.”34

In its reliance on the Collier treatise, the majority was clearly on to something, no doubt recognizing that an authoritative treatise, in a highly specialized area of law, is more likely to reflect existing practice in the trenches than a simple nose count of circuit court decisions. After all, if a practice is widely accepted, one would not necessarily expect many disputes about the validity of the practice to reach the circuit court level. One could easily argue that the more widely accepted the practice, the fewer circuit court decisions one should expect. And, as the majority observed, the Supreme Court itself has relied upon Collier as evidence that a particular practice was “widely accepted” under the Bankruptcy Act.35

In truth, nothing in the extensive legislative history of the Bankruptcy Code suggests that Congress gave the issue of derivative standing any thought at all. While the dissent used this as evidence that Congress cannot be deemed to have been aware of derivative standing as a well established pre-Code practice, the repeated references in Collier on Bankruptcy indicate Congress was at least presumptively aware of the issue and did not mean to overturn the practice without discussion or significant amendment. On the other hand, it is also fair to assume that Congress did not quite foresee how Chapter 11 would develop, how debtor conflicts of interest could impede the twin goals of maximizing assets for creditors and promoting rehabilitation of the debtor, and how common committee avoidance actions would become as a consequence.36 One could argue that the very purpose of equitable powers is to afford bankruptcy courts the flexibility to address such problems as they arise, both anticipated and unanticipated, bearing in mind the objectives of Congress as manifested in the Code. In short, given the broad scope of a bankruptcy court’s equitable powers as set forth in Section 105(a), the long history of pre-Code practice—and its wide acceptance as reflected in the Collier treatise—may well have played a more decisive role in the result than the majority was willing to admit in its opinion.

**Policy Considerations**

As it did with pre-Code practice, the majority disavowed reliance on policy considerations in its finding that the Code permits a creditors’ committee to prosecute avoidance actions on behalf of the estate. This is based on the principle, reiterated in Hartford Underwriters, that, where statutory language is clear, arguments based on policy considerations must be addressed to Congress, not to the courts. Indeed, the Supreme Court pointed-
ly reminded the parties and the bar in *Hartford Underwriters* that it does not “sit to assess the relative merits of different approaches to various bankruptcy problems.” 37

Even so, one cannot ignore the role of policy considerations in persuading the Third Circuit to hear *Cybergenics II* en banc in the first place. The suggestion in the Panel Decision, that the problem of a debtor unreasonably declining to sue could easily be addressed by seeking appointment of a trustee or by dismissing the Chapter 11 case, brought the twin goals of asset maximization and debtor rehabilitation into sharp conflict. There is ample authority that the appointment of a trustee is intended to be the exception in Chapter 11 cases precisely because trustees are not believed to be as adept at running businesses as existing management, and, therefore, not as likely to effectuate a successful rehabilitation of the debtor. 38 So, the question presented in the en banc petition was whether Congress really intended to force the choice between asset recovery—by appointment of a trustee—and debtor rehabilitation—by accepting management’s decision not to pursue avoidance claims which could benefit the estate. The Panel’s other alternative—i.e., dismissing the case and permitting the creditors to pursue fraudulent transfer claims individually—was really no choice at all, as it would entail forfeiting bankruptcy’s advantages of efficient consolidation of claims and equitable sharing of the proceeds of recovery among creditors, not to mention abandoning the goal of rehabilitating the debtor.

To be frank, *Cybergenics* was not the ideal vehicle to advance these policy arguments. Because all assets of the debtor had been sold within two months of the bankruptcy filing, the case resembled a Chapter 7 liquidation, more than a Chapter 11 reorganization. It was therefore not unreasonable for the Panel to conclude that appointment of a trustee was the obvious solution in *Cybergenics*, even if the Panel’s subsequent refusal to remand to the District Court for substitution of a trustee as plaintiff seemed inexplicably harsh to the creditors in the case. Still, the Panel’s rationale was not based on the atypical facts of *Cybergenics*, but rather on the plain language of Section 544, and, therefore, the Panel Decision profoundly affected numerous more traditional reorganizations in the Third Circuit and, potentially, elsewhere as well.

By the time the en banc appeal had been fully briefed, the broad application of the Panel Decision was recognized and the debate had clearly shifted away from the stark choice between appointing a trustee or keeping the debtor in possession and abandoning potentially valuable avoidance claims. Instead, the focus was on alternatives to creditors’ committee derivative suits that could accommodate both goals. Upon close examination, however,
none of the alternatives to derivative standing considered by the parties or their amici seemed satisfactory.39

For example, moving to compel the reluctant debtor to prosecute what is often a complex and time-consuming claim is, as the majority stated, “unlikely to yield a vigorous prosecution.”40 As noted previously, the creditors’ committee could intervene in such an action, at least in the Third Circuit, but the scope of an intervening party’s participation is unclear. It is likely the committee could only “monitor” the suit, not take an active role in prosecuting the claim.41

A more serious alternative is the appointment of an examiner to prosecute the claim when the debtor refuses. An examiner may be appointed under Section 1104(b) and may be given the rights and duties of a debtor in possession that the court orders the debtor in possession not to perform under Section 1106. However, the legislative history makes clear that an examiner is to “proceed on an independent basis from the procedure of the reorganization under chapter 11.”42 Examiners are not permitted to later serve as trustee,43 and trustees may not employ an examiner who has served in the case.44

The majority found it debatable whether the Code permits an examiner to initiate lawsuits and questioned whether allowing an examiner to litigate against a debtor would compromise its independent role.45 The expense of appointing an examiner also is a factor to consider.46 Although a handful of lower courts have indicated that an examiner could be appointed to bring avoidance actions, the courts that have done so have resorted to methods of interpretation other than a strict construction of the Code.47 Thus, even if the appointment of an examiner to pursue claims were permissible or appropriate in Chapter 11 cases, this remedy is not so obviously mandated by the Code that it necessarily would exclude the option of allowing a creditors’ committee to pursue the action instead.

In summary, the lack of attractive alternatives to accomplish Congress’ twin goals of maximizing recovery of assets and enhancing the prospects of debtor rehabilitation makes it more likely that permitting committee avoidance actions is consistent with Congressional intent. Thus, policy considerations were not used by the Court to contradict or vary unambiguous statutory language, but rather, like pre-Code practice, to interpret how much latitude bankruptcy courts should be given in executing their equitable powers under Section 105(a).
Derivative Standing After Cybergenics

The en banc decision in *Cybergenics* is by far the most comprehensive analysis of the legal basis for creditors’ committee derivative suits. Because it will not be reviewed by the Supreme Court, it is likely to be the definitive opinion in this area, at least in the near term. At the same time, it is a very narrow opinion. It holds that creditors’ committees may be authorized to prosecute avoidance claims, as a remedy, when the debtor in possession unreasonably refuses to do so. The majority’s rationale does not appear to permit such derivative suits unless “the Code’s envisioned scheme breaks down.” That leaves a host of other situations in which committees are regularly authorized to pursue claims up in the air or, worse yet, in serious doubt.

Interestingly, the majority addressed one such situation in its opinion. An amicus brief filed by a group of distinguished law professors in support of the Committee’s position drew the Court’s attention to so-called “first day orders” which are routinely sought in large corporate reorganizations. These orders typically include arrangements for post-petition financing of the debtor’s operations. Lenders and critical vendors often require the debtor to release claims against them, including avoidance claims, as the price for supporting the debtor in its reorganization phase. The urgency of the situation precludes the bankruptcy court from examining the merits or importance of such claims before signing the orders. As a solution, courts often reserve to the creditors’ committee the right to investigate and pursue claims that otherwise would be released in these orders. Under the rationale of *Cybergenics II*, it is far from clear that this situation represents a “breakdown” of the system which would justify granting the creditors’ committee a derivative right to sue. After all, the bankruptcy court could simply refuse to approve the release of claims in the first day orders, hoping that the lenders and critical vendors will relent and provide post-petition support without such a release from the debtor.

In fact, the “system breakdown” rationale of *Cybergenics II* casts substantial doubt as to whether derivative standing generally can be conferred by consent of the estate representative. In the seminal Second Circuit case on derivative standing, the court of appeals held that a creditors’ committee can be granted standing where the debtor in possession unjustifiably refuses to bring an avoidance action. In 2001, that holding was expanded in *Commodore International, Ltd. v. Gould (In re Commodore International Limited)*, which involved an agreement between the functional debtor in possession and the creditors’ committee to allow the committee to pursue avoid-
ance claims. The Second Circuit concluded in *Commodore* that derivative standing may be granted where: “(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.”

More recently, the Second Circuit liberally expanded the *Commodore* holding that derivative standing may be conferred by consent. In *Glinka v. Abraham and Rose (In re Housecraft Industries USA, Inc.)*, 310 F.3d 64 (2d Cir. 2002), a Chapter 7 case, the trustee and the debtor’s primary secured creditor entered into an agreement to jointly prosecute avoidance actions pursuant to Sections 548 and 549 of the Code. The bankruptcy court retroactively ratified the agreement after a motion to dismiss for lack of standing was made. The court did not address whether the trustee and the creditor should have obtained the permission of the bankruptcy court before the avoidance action was commenced. The Second Circuit found the case for allowing joint prosecution even stronger than an agreement to allow a creditors’ committee to prosecute the action itself. Again, however convenient this arrangement might be, it does not seem to fit within the Third Circuit’s “system breakdown” rationale in *Cybergenics II*.

After the *Cybergenics* experience, the bankruptcy bar must acknowledge that a number of respected jurists, informed by the Supreme Court’s analysis in *Hartford Underwriters*, have raised substantial doubt as to whether there is a legal basis for derivative standing in the Code. That doubt was resolved only to a very limited degree in *Cybergenics II*. Given that creditors’ committee derivative suits can be useful in a broader range of circumstances, it would seem prudent to make it clear in the Code that the bankruptcy court has the power to authorize such suits in appropriate circumstances. Codification would not only bring clarity to the practice, but hopefully greater uniformity as well.

NOTES:


2. The Code explicitly grants the power to avoid transfers to the trustee. See 11 U.S.C. §§ 544-550. However, where no trustee has been appointed, as in most Chapter 11 cases, the debtor-in-possession may exercise the powers of a trustee. 11 U.S.C. § 1107(a).


9. Section 544 (b) states in relevant part that “the trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under section 502 of this title or that is not allowable only under section 502(e) of this title.”


13. Rule 17(a) provides, in relevant part: “No action shall be dismissed on the ground that it is not prosecuted on behalf of the real party in interest until a reasonable time has been allowed after objection for ratification of commencement of the action by, or joinder or substitution of, the real party in interest…”

14. The Panel acknowledged that “(t)he procedure followed by the Committee has been adopted in varying forms by several [other] circuits,” and “was reasonably well-established” prior to Hartford Underwriters. Presumably, then, there was no reason for the Committee to have requested appointment of a trustee in the District Court. Moreover, the Panel generally overlooked the defendants’ failure to raise the “real party in interest” objection until nearly three years after the Complaint was
filed. Failure to raise a “real party in interest” objection in a timely manner can result in a waiver because that objection is not jurisdictional. See Richardson v. Edwards, 127 F.3d 97, 99, 38 Collier Bankr. Cas. 2d (MB) 1662, Bankr. L. Rep. (CCH) ¶ 77542 (D.C. Cir. 1997); Martinez v. Roscoe, 100 F.3d 121, 123 (10th Cir. 1996). See also Swaim v. Moltan Co., 73 F.3d 711, 69 Fair Empl. Prac. Cas. (BNA) 1156, 67 Empl. Prac. Dec. (CCH) ¶ 43873, 34 Fed. R. Serv. 3d 577 (7th Cir. 1996) (failure to raise capacity defense in a responsive pleading or motion amounts to waiver).

15. At the time of the petition for a rehearing en banc, the Committee found no fewer than 261 avoidance actions being prosecuted by creditors’ committees in the Third Circuit alone.


17. See, e.g., “Cybergenics Appellate Decision Stuns Bankruptcy Bar,” The Daily Deal, October 3, 2002, p. 7 (describing the Panel Decision as “a ruling that has shocked the bankruptcy bar”). The District Court opinion was unpublished and not widely known before the Panel Decision was issued on September 20, 2002.


21. As a matter of construction under the Code, the singular “creditor” in 503(b)(3)(B) includes the plural as well. 11 U.S.C. § 102(7).

22. See, e.g., Frost v. Latham & Co., 181 F. 866 (C.C.S.D. Ala. 1910). In Frost, the court stated: “The Bankruptcy Act clearly recognizes the right of a creditor to institute proceedings to recover, for the benefit of the estate of the bankrupt, property transferred by him either before or after filing of the petition, wherein it provides that, when such property shall have been recovered by the efforts and at the expense of one or more creditors, the reasonable expenses of such recovery shall be paid out of the bankrupt estate. While the language employed does not expressly vest in a creditor the right to bring suit to recover such property, it implies that right to exist as clearly as language can do so.”


¶ 78861 (3d Cir. 2003), cert. dismissed, 124 S. Ct. 530 (U.S. 2003) and cert. dismissed, 124 S. Ct. 530 (U.S. 2003).


38. When Congress enacted the Code, it created a presumption that the debtor is entitled to remain in possession during a Chapter 11 case. Section 1104 authorizes the court to appoint a trustee only in extraordinary cases. See 7 Collier on Bankruptcy ¶ 1104.02[1] (Lawrence P. King ed., 15th rev. ed. 1998); In re Sharon Steel Corp., 871 F.2d 1217, 1226, 19 Bankr. Ct. Dec. (CCR) 415, Bankr. L.
Rep. (CCH) ¶ 72822 (3d Cir. 1989) ("It is settled that appointment of a trustee should be the exception, rather than the rule.").

39. See In re W.R. Grace & Co., 285 B.R. 148 (Bankr. D. Del. 2002). In W.R. Grace, committees were set for trial involving prosecution of avoidance actions when the Panel Decision was issued. The defendant moved for dismissal of the action on the basis of the Panel Decision. Possible alternatives to derivative standing were considered in depth by the court, which found none to be satisfactory.


43. Section 321(b).

44. Section 327(f).


48. As a result of a settlement of the Cybergenics case, petitions for writs of certiorari filed by the defendants were withdrawn in November 2003.


54. In December 2003, the Seventh Circuit, citing Hartford Underwriters and Cybergenics II, ruled that a creditor may be authorized to assert a Section 547 preference claim on behalf of the estate, “step[ing] into the shoes” of a dissolved debtor. Mellon Bank, N.A. v. Dick Corp., 351 F.3d 290, Bankr. L. Rep. (CCH) ¶ 80011 (7th Cir. 2003). The Court found that the propriety of this proce-
dure required “little discussion,” but left open the question of whether a creditor could be so autho-
ized over the objection of a trustee or debtor in possession.

55. Authority clearly exists to permit creditors’ committee suits in connection with a plan of
reorganization. Section 1123(b)(3)(B) of the Code permits a plan to provide for “the retention and
enforcement by the debtor, by the trustee, or by a representative of the estate appointed for such pur-
pose, of any such claim or interest.” 11 U.S.C. § 1123(b)(3)(B), emphasis supplied.