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In *Housecraft*, Second Circuit Stands Its Ground on Derivative Fraudulent Transfer Actions in Spite of Controversial Third Circuit *Cybergenics II* Holding

Only five weeks after the Third Circuit Court of Appeals ruled that a creditors' committee cannot bring a fraudulent transfer action on behalf of a bankruptcy estate, the Second Circuit Court of Appeals issued an opinion upholding the long-standing practice of derivative fraudulent transfer claims. The Second Circuit decision foreshadowed the demise of the Third Circuit ruling, which has subsequently been vacated pending a rehearing by the Third Circuit *en banc* on February 19, 2003.

On September 20, 2002, the Third Circuit issued a panel opinion in *In re Cybergenics Corporation* (*Cybergenics II*), holding that only a trustee may assert a fraudulent transfer action under Bankruptcy Code Section 544 and that a creditor or creditors' committee cannot bring such an avoidance action derivatively. The opinion makes clear that neither the refusal of a trustee to bring the action nor the approval of the Bankruptcy Court of a committee's derivative action can overcome the fact that avoidance actions are within the exclusive authority of trustees (and debtors-in-possession by operation of Bankruptcy Code Section 1107(a)). The *Cybergenics II* decision surprised the bankruptcy bar, which had come to accept the prosecution of avoidance actions by creditors' committees as a standard practice.

On October 24, 2002, even as a petition for rehearing *en banc* of the *Cybergenics II* case was pending, the Second Circuit, in *In re Housecraft Industries USA, Inc.*, issued a panel opinion holding that a secured creditor may, under certain circumstances, bring avoidance claims under Bankruptcy Code Sections 548 and 549. Perhaps because of the short period of time between the two rulings, the *Housecraft* opinion did not cite to the *Cybergenics II* decision or its rationale. Nonetheless, the *Cybergenics II* and *Housecraft* opinions pitted two powerhouse bankruptcy jurisdictions against one another in a battle between strict "plain language" statutory construction and holistic "best interest of the estate" bankruptcy law policy. Presently, the resolution of this split in authority remains uncertain—especially in light of the Third Circuit's November 19, 2002, decision to vacate the *Cybergenics II* ruling and conduct a rehearing of the case on February 19, 2003.

Third Circuit decides to vacate *Cybergenics II* holding pending a rehearing *en banc*.

The Third Circuit's "Plain Language" Approach

In the *Cybergenics II* decision, the Third Circuit stated that the relevant question was not whether a creditors' committee has standing to bring a fraudulent transfer claim. In fact, the Third Circuit found that the creditors' committee in that case satisfied the constitutional and prudential requirements for standing. Instead, the Third Circuit hinged its decision solely on a determination that the words "the trustee may avoid any transfer" in Bankruptcy Code Section 544(b) are *exclusive* and that *only* a trustee may exercise such a right. The Third Circuit predicated its "plain language" reading of Section 544 on the Supreme Court's opinion in *Hartford*

Underwriters Insurance Co. v. Union Planters Bank N.A., 530 U.S. 1 (2000) (*Hen House*), which held that similar language in Bankruptcy Code Section 506(c) permitted the trustee, and only the trustee, to surcharge collateral to pay its expenses. Although the Third Circuit recognized the historical precedent and bankruptcy law policy considerations supporting derivative avoidance actions, the Court decided that the Bankruptcy Code text and the *Hen House* opinion were insurmountable obstacles preventing the further prosecution of avoidance actions by creditors and creditors' committees. The Third Circuit noted the possible alternatives available to creditors in the absence of derivative actions: dismissal of the bankruptcy case, appointment of a trustee, and confirmation of a plan of reorganization that permits an estate representative to bring avoidance actions by operation of Bankruptcy Code Section 1123(b)(3)(B).

Second Circuit finds that a creditor may bring avoidance actions under Bankruptcy Code sections 548 and 549.

The Second Circuit's "Best Interest of the Estate" Approach

In contrast to *Cybergenics II*, the Second Circuit's *Housecraft* opinion focused on the standing of a secured creditor to bring a fraudulent transfer action. Citing to prior Second Circuit decisions, but without referencing *Cybergenics II* or *Hen House*, the Court described two situations in which creditors and creditors' committees have standing to bring avoidance actions. First, under *In re STN Enterprises*, 779 F.2d 901 (2d Cir. 1985), a creditors' committee may bring an avoidance action in the name of a trustee if the trustee "unjustifiably refuses" to bring the action itself. Second, under *In re Commodore International, Ltd.*, 262 F.3d 96 (2d Cir. 2001), a creditors' committee may bring an avoidance action even where a trustee does not unjustifiably refuse to do so, but only if (1) the trustee has consented; and (2) the Bankruptcy Court finds that the action brought by the committee (a) is in the best interest of the estate and (b) is necessary and beneficial to the fair and efficient resolution of the bankruptcy proceedings. The facts in *Housecraft* involved a joint suit by the trustee and a secured creditor; however, the opinion is written broadly to support other derivative avoidance actions that comply with the STN or Commodore standards.

The Future of Derivative Avoidance Actions

While the Third Circuit panel's literal interpretation of the Bankruptcy Code purports to follow the Supreme Court's current trend toward strict statutory construction, as is evidenced by the *Hen House* decision, it is not clear that a plain reading of the Bankruptcy Code leads to the *Cybergenics II* result. Section 503(b)(3)(B) specifically authorizes allowance as an administrative expense, the actual 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." Some commentators have suggested that this provision explicitly contemplates derivative standing of a creditor to bring the kind of action that *Cybergenics II* precludes; to give meaning to the plain reading of the section, it is necessary to find derivative standing. Aside from the literal reading issues, the *Cybergenics II* holding provides no meaningful redress for creditors when a debtor-in-possession is unwilling to bring an avoidance action that promises a substantial increase in the dividend available to creditors. The possibilities of conversion, dismissal, appointment of a Chapter 11 trustee and confirmation of a plan of reorganization are often unavailable, too risky or too difficult to implement.

A more flexible, but still literal, reading of the Bankruptcy Code would require only that avoidance actions must be brought *in the name* of a trustee, allowing for trustee consent and Bankruptcy Court approval to authorize creditors and creditors' committees to sue on the trustee's behalf. Such a reading would bring the Third Circuit in accord with the Second Circuit, which continues to follow the traditional, policy-based rule permitting "derivative" avoidance actions so long as they truly "derive" from the trustee's express powers under the Bankruptcy Code.

The conflict between the Third Circuit and Second Circuit treatments of derivative avoidance actions may be reconciled following the Third Circuit's rehearing of the *Cybergenics II* case next year. Until the issue is resolved, however, creditors interested in potential avoidance action recoveries will want to consider the *Cybergenics II* and Housecraft decisions, along with other cross-jurisdictional differences in substantive law, if they are able to influence the location of a debtor's bankruptcy filing.

Use of Lock-Up Agreements in Pre-Negotiated Restructurings Challenged

In connection with many pre-negotiated restructurings, debtors typically negotiate the terms of a restructuring plan with its major creditor constituencies, and have such creditors enter "lock-up" agreements that bind the creditors to vote in favor of the negotiated restructuring. These "pre-negotiated filings" are valuable tools, usually resulting in quick "dips" into bankruptcy to implement the negotiated plans, but without the cost, delays and risks of a traditional Chapter 11 filing.

Recently, in *In re NII Holdings, Inc.*, Case No. 02-11505 (MFW), the Delaware Bankruptcy Court invalidated the votes of creditors that executed lock-up agreements postpetition, but refused to invalidate the votes of creditors that executed them prepetition. In the case, the United States Trustee (UST) filed a motion to invalidate the votes of creditors who executed lock-up and voting agreements (the Lock-up Agreements) prepetition, as well as those who executed them a few days after the filing of debtors' petitions for bankruptcy relief. The UST argued that the Lock-up Agreements constituted votes in favor of a plan of reorganization, and that the debtors solicited such votes in violation of 11 U.S.C. § 1125(b), as to creditors that executed them postpetiton, and in violation of § 1126(b), as to creditors that executed them prepetition. The opinion of the court only states its holdings without any explanation. As a result, it is not possible to state the reasons why the court did what it did. The following analysis is based on a review of the briefs and only constitutes a possible explanation for why the court invalidated the postpetition votes and not the prepetition votes.

In finding that the Lock-up Agreements constituted votes to accept a plan, the court rejected the debtors' argument that the Lock-up Agreements were only contingent "agreements to agree," apparently adopting the UST's position that the Lock-up Agreements were votes for a plan of reorganization since they obligated each creditor-signatory to cast an accepting ballot in favor of the plan proposed in the Lock-up Agreements, and such obligation was enforceable by specific performance and injunctive relief.

By not invalidating the votes of creditors who executed the Lock-up Agreement prepetition, the court implicitly found that the debtors had provided "adequate information" to the creditors under 11 U.S.C. §1126(b). However, once the debtors filed for bankruptcy protection, no additional "solicitation" could occur unless the debtors re-transmitted such information in the form of an approved disclosure statement pursuant to 11 U.S.C. §1125(b). Apparently, the act of obtaining signatures to the Lock-up Agreements, even though the agreements were negotiated and distributed for signature prepetition, constitutes "solicitation."

In addition to attacking the votes of creditors executing the Lock-up Agreements, the UST also refused to select for membership on the NII Holdings creditors' committee any creditor that executed a Lock-up Agreement, on the basis that a creditor that has already agreed to vote for a particular plan cannot fulfill its fiduciary duties as a member of the committee. If the UST adopts this position as a general policy, creditors' committees in pre-negotiated filings are unlikely to represent major creditor constituencies.

The court's holding and the UST's position highlight the importance of complying with the adequate information requirements of 11 U.S.C. §1126(b) and finalizing and executing lock-up agreements before filing for Chapter 11 protection. The UST 's position regarding creditors committees is disconcerting and, if followed, could create significant new obstacles to pre-negotiated restructurings in the Delaware bankruptcy courts.

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