Derivative or Direct? Creditor Claims Turn on Whether Harm Is Collective or Individual

2007-08-07

On July 9, 2007, the United States Court of Appeals for the Second Circuit issued a decision in *In re Applied Theory Corp.*, holding that the unsecured creditors' committee could not equitably subordinate the claims of Applied Theory's secured lenders under Section 510(c) of the Bankruptcy Code.[1] The Second Circuit's main holding—that derivative claims can be brought by creditors' committees only under limited circumstances that were not present in the *Applied Theory* case—is not surprising because it is based on established Second Circuit precedent. However, the court's discussion of the derivative nature of the committee's alleged Section 510(c) claims may place increased emphasis on the distinction between derivative and direct creditor claims in bankruptcy.

Equitable Subordination

Section 510(c) of the Bankruptcy Code states that a bankruptcy court may, "under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim … or order that any lien securing such subordinated claim be transferred to the estate." In effect, Section 510(c) allows the otherwise applicable statutory bankruptcy priority scheme to be adjusted if a creditor has acted inequitably. In *Applied Theory*, the unsecured creditors' committee argued that, based on alleged inequitable conduct of the secured lenders, the secured lenders' claims should lose their secured status and should be paid only if and when all other unsecured claims were paid in full.

Equitable Subordination Claims of Committees Are Derivative

As with shareholder claims in the corporate litigation area, creditor claims in bankruptcy litigation are often placed into one of two categories: derivative claims brought on behalf of and for the benefit of the bankruptcy estate, and direct claims brought on behalf of individual creditors for the benefit of those creditors specifically. The text of Section 510(c), as well as the Second Circuit's decision in *Applied Theory*, suggest that Section 510(c) claims can be derivative or direct. But, in *Applied Theory*, the Second Circuit held that any Section 510(c) claims that are brought by an unsecured creditors' committee must be derivative:

> regardless of how the Committee characterizes it, any equitable subordination claim brought

> by the Committee would allege harm to the Debtor generally and would not seek to subordinate the Lenders to other creditors. Since the Committee is not itself a creditor, it does not have any rights held by any creditor to assert such a claim against another creditor. In other words, the Committee has not sustained an injury for which a "direct" claim might otherwise be available.
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> ...
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> It is clear to us, as it was to the district court and the bankruptcy court, that the Committee's proposed equitable subordination claim would not be directed toward any particularized injury suffered by any creditor. The Committee has demonstrated no interest of its own in subordination separate and apart from the interests of the estate as a whole, and has failed to demonstrate why it should be permitted to step into the shoes of the trustee.

The Second Circuit's conclusion that Section 510(c) claims brought by committees are derivative claims (seemingly as a matter of law) was crucial to the Second Circuit's holding that the committee did not have standing to sue Applied Theory's secured lenders.

Committee Standing to Bring Derivative Equitable Subordination Claims

Prior to *Applied Theory*, the Second Circuit had held that creditors' committees do not have standing to bring derivative claims against third parties, except in two limited circumstances. One exception, discussed in the Second Circuit's *STN Enterprises* decision, is if the bankruptcy court determines that the trustee or debtor in possession has unjustifiably failed to bring the suit or has abused its discretion in not suing, and the suit is likely to benefit the estate.[2] The other exception, discussed in the Second Circuit's *Commodore International* decision, is if the debtor consents, and if the bankruptcy court determines that the suit is in the best interest of the bankruptcy estate and is necessary and beneficial to the fair and efficient resolution of the bankruptcy proceedings.[3]

In the *Applied Theory* case, the debtor declined to bring a Section 510(c) suit against its secured lenders and did not consent to the unsecured creditors' committee doing so.[4] The bankruptcy court determined that the debtor's decision was justified, because the potential benefit of the suit to the bankruptcy estate had not been established. Thus, the court did not allow the committee to proceed. The district court and Second Circuit affirmed the bankruptcy court's decision, and in essence let stand Applied Theory's judgment not to bring the suit.

Direct Equitable Subordination Claims

The standing analysis in *Applied Theory* was predicated on the conclusion that the Section 510(c) claims were derivative claims, and therefore subject to the *STN/Commodore* rules. The Second Circuit suggests that its holding would have been different if the committee's claims had been direct claims. But are there any cases in which direct equitable subordination claims can exist in practice? Are there any circumstances in which committees can bring these claims?

The Second Circuit suggests that a direct Section 510(c) claim can exist, if at all, when one creditor acts inequitably toward another creditor and causes a particularized harm to that other creditor. The other creditor may then be able to seek equitable subordination of the first creditor's claim. But the most common "harm" to creditors in a bankruptcy takes the form of a lower distribution from the bankruptcy estate than the creditors would otherwise receive. It seems that this type of harm will almost always be a generalized harm and not the particularized harm required for a direct claim. Thus, under the Second Circuit's rationale, it seems that there may be only narrow circumstances in which an individual creditor will hold a direct Section 510(c) claim of its own against another creditor. [5] As such, Section 510(c) claims seem in line with state-law fraudulent transfer claims under Section 544. Outside of bankruptcy, individual creditors can sue transferees for fraudulent transfers under state law. But inside bankruptcy, Section 544 essentially aggregates any such state-law causes of action and, by statute, makes them derivative claims of the bankruptcy estate. A major difference between Section 544 and Section 510(c), of course, is that Section 510(c) neither relates to any specific state law nor indicates any legislative intention to limit individual creditor claims for equitable subordination. Thus, there remains the possibility in the Second Circuit—perhaps where two creditors have had unique dealings solely between themselves—that a direct Section 510(c) claim may be brought.

Assuming there are direct Section 510(c) claims of individual creditors, can the individual creditor who holds such a claim assign the claim to a committee, to be brought by the committee at the cost of the estate and for the benefit of all creditors? As a technical matter, this situation, in the rare circumstance where it might arise, may allow a committee to avoid the *STN/Commodore* analysis. In any event, the potential recovery in any direct claim assigned to the committee may be limited to the assignor's individual damages.[6]

The Second Circuit's language suggests one other possibility for committees to bring direct Section 510(c) claims—where the committee itself has suffered some harm. However, a creditors' committee is a creature of the bankruptcy case, and it does not exist pre-bankruptcy. Thus, to require a committee to itself suffer harm in order to sustain a direct Section 510(c) claim against a secured lender is to limit direct Section 510(c) claims of committees to claims based on inequitable conduct of secured lenders during the bankruptcy case. Inequitable conduct during the bankruptcy case is highly unlikely, given the parameters of the Bankruptcy Code and the supervision of the bankruptcy court, and therefore limiting direct committee Section 510(c) claims to the bankruptcy period is tantamount in most circumstances to eliminating those Section 510(c) claims altogether.

Thus, in the Second Circuit, while direct Section 510(c) claims appear to exist in theory, they may exist in practice only in limited circumstances.

Derivative Versus Direct Claims Against Directors

The distinction between derivative and direct claims was also crucial under Delaware state law in the recent Delaware Supreme Court decision *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla.*[7] In *Gheewalla*, the Supreme Court of Delaware held that the creditors of an insolvent corporation or a corporation in the "zone of insolvency" have no right, as a matter of law, to assert claims for breach of fiduciary duty against the corporation's directors, because any claims of creditors for breach of fiduciary duty, by definition, derive from the corporation's rights against the directors. *Id*. at *7. The derivative nature of the Section 510(c) claims precluded the committee's suit in *Applied Theory*, and the derivative nature of the breach of fiduciary duty claims foreclosed the creditors' suit in *Gheewalla* (though the basis for each decision is somewhat different, *Gheewalla* being based purely on state law).

The Bottom Line

The *Applied Theory* and *Gheewalla* decisions focus on the distinction between derivative and direct creditor claims. Though each decision is based on different law, the decisions have the shared effect of limiting the ability of creditors to bring derivative claims. In doing so, the decisions may create a focus on the types of direct creditor claims that may be available to avoid the limitations, as a matter of law, against derivative creditor claims. This focus may be short-lived, as the universe of direct claims may be narrow, and as the direct claims may be difficult to prove. The focus on direct claims may also be problematic in bankruptcy cases, because it runs contrary to the bankruptcy policy favoring collective creditor actions over piecemeal litigation.

For more information on this or other bankruptcy and commercial matters, please contact the authors listed above.

[1] *Applied Theory Corp. v. Halifax Fund, L.P. (In re Applied Theory Corp.)*, No. 06-3390-bk (2d Cir. July 9, 2007).

[2] *In re STN Enterprises*, 779 F.2d 901, 904 (2d Cir. 1985).

[3] *Commodore Int'l Ltd. v. Gould (In re Commodore Int'l Ltd.)*, 262 F.3d 96, 100 (2d Cir. 2001).

[4] While *Applied Theory* involves an equitable subordination claim brought by a creditors' committee after the debtor in possession declined to do so, the trustee or debtor in possession will sometimes seek to be the plaintiff in such an action. When a trustee or debtor in possession brings an equitable subordination cause of action on behalf of the estate, the trustee or debtor in possession is acting as a representative of the creditor body and is not suing on behalf of or for the benefit of the debtor in possession itself. Indeed, a debtor in possession, acting for itself, has *no standing* to bring an equitable subordination action. *See Riccitelli v. U.S. Trustee (In re Riccitelli)*, 14 F. App'x 57, 58 (2d Cir. 2001).

[5] For example, a direct claim for equitable subordination might exist if a secured lender misrepresents the debtor's financial condition to a single important trade creditor, the trade creditor relies on the misrepresentation in shipping a large amount of new product to the debtor on credit and the debtor enters bankruptcy without paying the trade creditor for the product. The trade creditor's product might, in this circumstance, increase the value of the debtor's estate and increase the recovery of creditors generally, at the expense of the trade creditor. Thus, in this example, there may be no generalized harm to all creditors, but there may nevertheless be a particularized harm to the single trade creditor.

[6] For example, if the direct claim belongs to a creditor holding a $1 million unsecured claim against a $20 million secured lender, the result of a successful action might be subordination of the

secured creditors’ claims to the $1 million claim (for the ratable benefit in such $1 million to all unsecured creditors), and not to the entire unsecured indebtedness of the debtor. This result would be different from the result under Section 544, where, because a Section 544 fraudulent transfer suit is essentially made derivative by statute, a single creditor’s $1 million claim can become a suit for a much greater amount on behalf of all creditors.

[7] --- A.2d ---, 2007 WL 1453705 (Del. 2007).

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