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Settlement of Avoidance Actions in Bankruptcy

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I. RULE 9019

Federal Rule of Bankruptcy Procedure 9019 governs settlements in bankruptcy, including settlements of avoidance actions, and provides in relevant part that "[o]n motion by the trustee and after notice and a hearing, the court may approve a compromise or settlement." Fed. R. Bankr. P. 9019(a). Rule 9019 applies both to settlements brought before the court on a standalone basis and those presented as part of a chapter 11 plan, and is aimed at "'prevent[ing] the making of concealed agreements which are unknown to the creditors and unevaluated by the court.'" *Motorola, Inc.* v. *Official Comm. of Unsecured Creditors (In re Iridium Operating LLC)*, 478 F.3d 452, 461 (2d Cir. 2007) (quoting *In re Masters, Inc.*, 141 B.R. 13, 16 (Bankr. E.D.N.Y. 1992)).

II. STANDARDS FOR APPROVAL — IN GENERAL

In reviewing settlements under Rule 9019, courts have continued to follow the Supreme Court's Bankruptcy Act-era holding that the rule "that plans of reorganization be both 'fair and equitable,' appl[ies] to compromises just as to other aspects of reorganizations." *Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc.* v. *Anderson*, 390 U.S. 414, 424 (1968). Many courts have added to the "fair and equitable" standard the requirement that the settlement be in the "best interests of the estate." *See, e.g.*, *In re Adelphia Commc'ns Corp.*, 327 B.R. 143, 158 (Bankr. S.D.N.Y. 2005).

The debtor-in-possession's (or, as applicable, the trustee's or committee's) judgment that the action should be settled is entitled to some weight, but is not dispositive. *In re Drexel Burnham Lambert Grp., Inc.*, 134 B.R. 493, 496 (Bankr. S.D.N.Y. 1991). Instead, a court must undertake an "intelligent and objective opinion of the probabilities of ultimate success should the claim be litigated." *TMT Trailer Ferry*, 390 U.S. at 424. The court's obligation to scrutinize the settlement applies "even where parties in interest are silent" or have waived their objections. *In*

re Texaco Inc., 84 B.R. 893, 901 (Bankr. S.D.N.Y. 1988). Generally, though, the court's obligation to scrutinize settlements does not require it to undertake a mini-trial on the merits of the claims. *Adelphia*, 327 B.R. at 159. Instead, the court should "canvass the issues and see whether the settlement 'fall[s] below the lowest point in the range of reasonableness.'" *In re W.T. Grant Co.*, 699 F.2d 599, 608 (2d Cir. 1983) (quoting *Newman* v. *Stein*, 464 F.2d 689, 693 (2d Cir. 1972)).

III. WHEN IS A SETTLEMENT "FAIR AND EQUITABLE"?

A. General Considerations

The circuit courts have developed multifactor tests for determining whether a settlement is fair and equitable. Several circuits apply a variation on the Third Circuit test set forth in *In re RFE Industries, Inc.*, which considers:

a) the probability of success in litigation;

b) the likely difficulties in collection;

c) the complexity of the litigation involved, and the expense, inconvenience and delay necessarily attending it; and

d) the paramount interest of the creditors.

283 F.3d 159, 165 (3d Cir. 2002); *see also In re Moore*, 608 F.3d 253, 263 (5th Cir. 2010) (considering the above factors as well as whether the settlement was collusive); *United States* v. *Edwards*, 595 F.2d 1004, 1012 (9th Cir. 2010) (applying similar factors to Third Circuit test); *In re Justice Oaks II, Ltd.*, 898 F.2d 1544, 1549 (11th Cir. 1990) (same).

Courts in the Second Circuit consider a more extensive list of factors, as set forth in *Iridium*:

a) the balance between the litigation's possibility of success and the settlement's future benefits;

b) the likelihood of complex and protracted litigation, 'with its attendant expense, inconvenience, and delay,' including the difficulty in collecting on the judgment;

c) 'the paramount interests of the creditors,' including each affected class's relative benefits 'and the degree to which creditors either do not object to or affirmatively support the proposed settlement';

d) whether other parties in interest support the settlement;

e) the 'competency and experience of counsel' supporting, and '[t]he experience and knowledge of the bankruptcy court judge' reviewing, the settlement;

f) 'the nature and breadth of releases to be obtained by officers and directors'; and

g) 'the extent to which the settlement is the product of arm's length bargaining.'

478 F.3d at 462 (quoting *In re WorldCom, Inc.*, 347 B.R. 123, 137 (Bankr. S.D.N.Y. 2006)); *see also In re Healthco Int'l, Inc.*, 136 F.3d 45, 50 (1st Cir. 1998) (considering probability of success, cost and delay entailed in litigation, "a reasonable accommodation of the creditors' views," and experience and competence of proponent).

Regardless of which circuit's test is being applied, the views of creditors are important in determining whether a settlement is fair and equitable. Nonetheless, settlements are frequently approved over creditors' objections. Courts may be particularly unmoved by creditors who merely object that the price is too low but are unwilling to support the litigation. As one court has observed, "[w]here creditors have argued successfully that a proposed settlement should be rejected, they have often also proposed to assume the litigation costs or even to proceed with the claim on their own." *In re Hilsen*, 404 B.R. 58, 76 (Bankr. E.D.N.Y. 2009).

B. The Absolute Priority Rule

1. Settlements Within the Plan Process

As with all other aspects of a plan in a cramdown situation, when a settlement is proposed within a plan of reorganization that has not been accepted by all creditors, an additional consideration in determining that the settlement is "fair and equitable" is whether any distribution contemplated by the settlement complies with the absolute priority rule set forth by 11 U.S.C. § 1129(b)(2). *Iridium*, 478 F.3d at 463; *see also In re Armstrong World Indus., Inc.*, 432 F.3d 507, 514-15 (3d Cir. 2005) (applying absolute priority rule to purported settlement/gift in context of chapter 11 plan); *cf. In re Cascade Grain Prods., LLC*, 2009 WL 2843365, at *5 (Bankr. D. Or. Aug. 31, 2009) (noting that, where a settlement is presented as part of a plan, "the absolute priority rule would be implicated in considering the plan, not the settlement agreement").

2. Pre-Plan Settlements

Even where a settlement takes place outside of the plan process, compliance with the absolute priority rule will be at a minimum a significant consideration and at most a strict requirement, depending on the circuit.

In *In re AWECO, Inc.*, the Fifth Circuit set forth a strict rule that that "a bankruptcy court abuses its discretion in approving a settlement with a junior creditor unless the court concludes that priority of payment will be respected as to objecting senior creditors." 725 F.2d 293, 298 (5th Cir. 1984). In reaching its conclusion, the court asserted that such an "extension of the fair and equitable standard" was appropriate because upon the filing of the petition "fair and equitable settlement of creditors' claims becomes a goal of the proceedings" — a goal that cannot be averted by settling prior to the filing a plan. *Id.* The court went on to rule that the bankruptcy court abused its discretion in approving the settlement between the debtor and an

unsecured creditor without an adequate record regarding the value of remaining estate assets for purposes of determining whether the settlement would "deplete[] the estate so severely as to endanger senior claims." *Id.* at 299.

In *Iridium*, the Second Circuit declined to adopt the Fifth Circuit's "rigid" approach, but noted that priority of distribution is a paramount consideration. 478 F.3d 452, 464-65 (2d Cir. 2007). In that case, the settlement between certain prepetition lenders and the creditors who sought to contest their liens provided for the distribution of the estate's remaining cash to the lenders, an entity (the "ILLLC") that would pursue litigation against Motorola, and professionals. The settlement further provided that any funds left in the ILLLC at the conclusion of creditors' litigation against Motorola would be distributed directly to unsecured creditors. According to Motorola, which was an administrative expense claimant in the case, this would violate the absolute priority rule if Motorola prevailed in the litigation or its administrative claims exceeded its liability. The Second Circuit went through its seven-factor test and found that all applicable factors supported approval of the settlement. The court nonetheless vacated the district court's order affirming approval of the settlement, noting that "[t]he record does not explain . . . the Settlement's distribution of residual ILLLC funds to the Committee in violation of the absolute priority rule." *Id.* at 466. While not ruling out such a distribution *per se*, the court further directed that a party presenting a settlement that "impairs the rule of priorities, . . . must come before the bankruptcy court with specific and credible grounds to justify that deviation and the court must carefully articulate its reasons for approval of the agreement." *Id.* The Third Circuit has not resolved this question, but one bankruptcy court has opined that "the absolute priority rule . . . [is] not implicated [where] the settlement does not arise in the context

of a plan of reorganization." *In re World Health Alts., Inc.*, 344 B.R. 291, 298 (Bankr. D. Del. 2006).

C. Section 363

Several courts have concluded that, because a settlement of estate claims constitutes a disposition of estate property, "a bankruptcy court is obliged to consider, as part of the 'fair and equitable' analysis, whether any property of the estate that would be disposed of in connection with the settlement might draw a higher price through a competitive process and be the proper subject of a section 363 sale." *In re Mickey Thompson Entm't Grp., Inc.*, 292 B.R. 415, 422 (B.A.P. 9th Cir. 2003); *accord Moore*, 608 F.3d at 265; *see also In re Martin*, 91 F.3d 389, 395 (3d Cir. 1996) (considering § 363 in the context of a settlement that "compromised an asset of the debtors' estate"); *but see Healthco Int'l*, 136 F.3d at 49-50 (rejecting argument that settlement is subject to § 363).

Courts applying section 363 to proposed settlements have been careful to clarify that they "are not suggesting that every compromise of a bona fide controversy presented to a bankruptcy court under Rule 9019 must pass muster as a sale under section 363" and that whether to impose sale procedures is a matter of discretion "that depends upon the dynamics of the particular situation." *Mickey Thompson*, 292 B.R. at 422 & n.7. In *Mickey Thompson*, the Ninth Circuit Bankruptcy Appellate Panel noted that "[f]unctionally, there was no compromise at all," and instead the trustee "simply attempted to sell to prospective defendants for $40,000" the estate's potential fraudulent transfer claims against them. *Id.* at 422 n.7. Thus, when a third party offered $45,000 for the same claim, the court determined that the best interests of the creditors would be better served by a competitive bidding process. *Id.* at 421. In *Moore*, the Fifth Circuit rejected the parties' attempt to establish such a bona fide controversy through the defendant's release of a $12 million indemnity claim against the estate, asserting that "[b]ankruptcy courts

should not allow defendants to settle estate claims at a discount and avoid § 363 scrutiny by filing large, frivolous claims against the estate." *Moore*, 608 F.3d at 265-66.

IV. WHO HAS THE POWER TO SETTLE AVOIDANCE ACTIONS?

Generally, the debtor-in-possession is not merely authorized but is *required* as a fiduciary to manage the estate's legal claims in a way that maximizes value for the estate, and Rule 9019 "by its terms permits only the debtor-in-possession to move for settlement." *In re Smart World Techs., LLC*, 423 F.3d 166, 175 (2d Cir. 2005). Accordingly, at least where no trustee or examiner has been appointed, creditors cannot settle the estate's legal claims without the consent of the debtor. *Id.*; *accord In re Adelphia Commc'ns Corp.*, 368 B.R. 140, 233 (Bankr. S.D.N.Y. 2007).

The questions of who may settle estate actions being pursued derivatively by creditors is significantly more complicated. In order for creditors to wrest power from the debtor-in-possession to pursue avoidance claims belonging to the estate, they must obtain derivative standing from the court either with the consent of the debtor or trustee, or by establishing that the debtor unjustifiably failed to pursue the litigation. *See, e.g.*, *Official Comm. of Unsecured Creditors* v. *Chinery (In re Cybergenics Corp.)*, 330 F.3d 548 (3d Cir. 2003); *Unsecured Creditors Comm.* v. *Noyes (In re STN Enters.)*, 779 F.2d 901 (2d Cir. 1985). Notably, such unjustifiable failure *may* be based on bad faith or a conflict of interest, but a debtor may also fail to pursue a claim because the DIP financing order limits the debtor's ability to bring certain actions against prepetition lenders, or merely because it lacks the time or inclination to pursue litigation. *In re Adelphia Commc'ns Corp.*, 330 B.R. 364, 373 (Bankr. S.D.N.Y. 2005).

In *In re Adelphia Communications Corp.*, the equity committee had been granted standing under *STN* to pursue avoidance litigation against bank lenders and investment banks. 368 B.R. 140 (Bankr. S.D.N.Y. 2007). The debtor subsequently proposed a plan that would

transfer those claims to a litigation trust. The bankruptcy court overruled the equity committee's objection, holding that the granting of *STN* standing "does not strip a debtor of standing," and that in any event the parties had stipulated that the debtors retained the right to settle the litigation. *Id.* at 271-73. The district court affirmed, *see* 371 B.R. 660 (S.D.N.Y. 2007), followed by the Second Circuit, which held that a court could withdraw creditors' derivative standing even without the creditors' consent "if the court concludes that such a transfer is in the best interests of the bankruptcy estate." 544 F.3d 420, 423 (2d Cir. 2008) (Sotomayor, J.). The court reasoned that creditor derivative standing to pursue estate claims was an "implied, but qualified right under 11 U.S.C. §§ 1103(c)(5) and 1109)(b)" but that the court's finding of this implied right "did not undermine . . . the debtor's central role in handling the estate's legal affairs." *Id.* at 423-24 (internal quotation marks omitted). The Second Circuit emphasized, however, that although the bankruptcy court had found that the debtor "unjustifiably failed" to pursue the claims in granting the equity committee's motion for standing, it found no "improper motive." *Id.* at 425.

In *In re Exide Technologies*, the debtor had ceded control of certain claims against prepetition lenders to the creditors' committee, but then proposed a settlement of those claims as part of its plan of reorganization. 303 B.R. 48 (Bankr. D. Del. 2003). The bankruptcy court agreed with the debtor that the debtor retained the power to propose a settlement of the creditor-controlled estate claims. However, it found that the settlement was not fair and equitable under the applicable Third Circuit standard because, *inter alia*, the debtor had failed to establish that the creditors were unlikely to succeed or that settlement was in the best interests of the creditors given their overwhelming rejection of the plan. *Id.* at 68-71. Additionally, the court looked to the *Texaco* factors (subsequently adopted by the Second Circuit in *Iridium*) and found that those

also weighed against approving the settlement, given that the consideration was "minimal" and "the proposed settlement was not the result of arms-length bargaining with the unsecured creditors, who are the plaintiffs in the action and are directly affected by it." *Id.* at 71. Thus, although the court seemed to endorse the concept of a debtor unilaterally settling a creditor-led action, it demonstrated the significant barriers that a debtor seeking to do so might face.

The Lyondell bankruptcy squarely presented the question of whether a debtor may settle an avoidance claim over the objection of creditors who have been granted standing under STN to pursue that claim. The creditors' committee (the "UCC") had been granted standing under *STN* to pursue avoidance litigation arising out of a 2007 leveraged buyout. On December 23, 2009, Lyondell filed a motion for approval of a settlement that proposed to resolve the creditors' litigation in exchange for $300 million in cash and other benefits. Motion to Approve Settlement, Official Comm. of Unsecured Creditors v. Citibank, N.A. (In re Lyondell Chem. Co.), No. 09-01375 (Bankr. S.D.N.Y. Dec. 23, 2009), Docket No. 284. However, the UCC was not involved in the negotiation of the settlement and, along with other creditors, objected, arguing that the debtors could not unilaterally settle litigation once derivative standing to pursue that litigation had been conferred on the committee unless the court first determined that it was no longer in the best interests of the estate for the committee to pursue the litigation. Objection of the Official Committee of Unsecured Creditors, *Lyondell*, No. 09-01375 (Bankr. S.D.N.Y. Feb. 11, 2010), Docket No. 342. The UCC went on to argue that the debtors were incapable of undertaking a "neutral, independent" assessment of the litigation, because, among other reasons, the debtors' counsel was conflicted. *Id.* at 56, 62-63. The court scheduled a hearing to resolve the dispute; however, shortly before it was set to begin the parties presented a new settlement involving all constituencies that provided $450 million to unsecured creditors. Revised Motion

to Approve Settlement, *Lyondell*, No. 09-01375 (Bankr. S.D.N.Y. Mar. 6, 2010), Docket No. 365. The court approved the settlement in March 2010. Order Approving Revised Settlement, *Lyondell*, No. 09-01375 (Bankr. S.D.N.Y. Mar. 11, 2010), Docket No. 371.

Although the court never resolved the issue in *Lyondell*, *Adelphia* and *Exide* support the notion that a debtor may, at least in theory, settle creditor-led litigation over creditor objections under appropriate circumstances. Under the applicable standard of review, though, courts will consider whether the settlement is fair and equitable and in the best interests of the estate, including whether it is collusive. If, as suggested by *Exide*, only negotiations involving the actual litigants — namely, the creditors pursuing the claims derivatively — will be regarded as truly arms-length, debtors who exclude creditors entirely from negotiations may face substantial challenges. Additionally, the courts' emphasis on the absence of improper motive in *Adelphia* signals that the reason that the creditors were initially granted standing matters. Accordingly, where a debtor seeks to settle a claim unilaterally that is being pursued by creditors precisely because the court previously ruled that the debtor was acting under a conflict of interest, the settlement may be subject to particularly close scrutiny.

V. ADDITIONAL CONSIDERATIONS

A. Obtaining "Global Peace"

In *Iridium*, although the Second Circuit remanded for further findings on the absolute priority issue, it rejected Motorola's contention that the settlement, which provided for the distribution of all of the estate's remaining cash, constituted a *sub rosa* plan, since the settlement had a "proper business justification." *Iridium*, 478 F.3d at 466-67. With the above-discussed limitations under the absolute priority rule in mind, this aspect of the Second Circuit's ruling suggests that parties can resolve a broad scope of issues as part of a settlement.

However, although parties may understandably desire to resolve *all* claims relating to a particular transaction, courts have placed significant constraints on parties' ability to fold creditors' direct claims into settlements of estate litigation. In *In re Johns-Manville Corp.*, the Second Circuit rejected the parties' attempt to include in a settlement of litigation between the debtor and insurance companies an injunction of all claims by any person against the insurance companies. 517 F.3d 52, 56-57 (2d Cir. 2008), *rev'd on other grounds, Travelers Indem. Co.* v. *Bailey*, 557 U.S. 137, 155 (2009); *see also In re Johns-Manville Corp.*, 600 F.3d 135, 153 (2d Cir. 2010) (on remand, reasserting lack of jurisdiction to enter injunction). The court agreed with the plaintiffs that the court lacked jurisdiction to enjoin non-debtor claims unless they "directly affect[ed] the *res* of the bankruptcy estate." *Id.* at 66; *see also In re Zale Corp.*, 62 F.3d 746, 756 (5th Cir. 1995) (reversing approval of settlement purporting to release third-party claims because "the bankruptcy court would have no jurisdiction" over them). In contrast, in *In re Trinsum Group, Inc.*, the Bankruptcy Court for the Southern District of New York recently approved a settlement of twenty avoidance and director and officer liability actions that had been brought by the distributing agent that included releases for the insurer and distributing agent. 2013 Bankr. LEXIS 1753, at *21-23 (Bankr. S.D.N.Y. Apr. 30, 2013). There, the court found that the insurance policy from which the settlement was paid was property of the estate, that the releases were "integral to the global settlement," and that a majority of parties in interest supported the settlement. *Id.* at *16, 18, 21-22.

B. Post-Confirmation Settlements

Where a post-confirmation settlement contemplated distribution that was inconsistent with the confirmed plan, and furthermore amendment of the plan was not feasible because the plan had been substantially consummated, the District of Delaware held that denial of the

parties' motion to approve the settlement was proper. *In re Northwestern Corp.*, 352 B.R. 32 (D. Del. 2006).

VI. CONCLUSION

Settlements are generally favored as an important element of "administering reorganization proceedings in an economical and practical matter." *TMT Trailer*, 390 U.S. at 424. However, courts in recent years have been expanding the scope of their review, for example by including the absolute priority rule and section 363 into settlement standards, to ensure that settlements are not used as an end-run around fair treatment of all creditors. The debtor's discretion to settle is not limitless, and although creditors complaining that a higher price might have been obtained are by no means entitled to veto power, their involvement or lack thereof may be an important signal as to whether settlement negotiations were genuinely calculated to lead to the best result for the estate. In discharging their duty to ensure that estate assets are disposed of in a manner that is fair and equitable to creditors, bankruptcy courts will likely continue to shift and expand their review of plan and pre-plan settlements.