# *CYBERGENICS:* A CORPORATE SOLUTION TO A BANKRUPTCY PROBLEM

Published on www.DelawareLawWeekly.com on November 27, 2002

By Neil B. Glassman and Kurt M. Heyman

The United States Court of Appeals for the Third Circuit recently rendered a decision that has thrown bankruptcy practice in Delaware into disarray. Contrary to longstanding bankruptcy practice in this (and virtually ever other) district, the Third Circuit held that a creditors' committee cannot initiate or prosecute avoidance actions under the Bankruptcy Code prior to confirmation of a plan of reorganization, even if authorized to do so by a bankruptcy court. *See The Official Committee of Unsecured Creditors of Cybergenics Corp. v. Chinery*, 2002 WL 31102712 (3d Cir. Sept. 20, 2002) ("*Cybergenics*"). The purpose of avoidance actions is to recover, on behalf of a debtor's estate, fraudulent transfers or preferential payments made by the debtor to third parties prior to the debtor's bankruptcy petition. Bankruptcy courts have frequently authorized creditors' committees to bring such actions "derivatively" on behalf of debtors when the debtors refused to bring the claims themselves or the claims involved "insiders" of the debtors. In barring creditors' committees from bringing such actions, *Cybergenics* is having, and will continue to have, a significant impact on bankruptcy practice in this busy district, as there are literally hundreds of pre-confirmation avoidance actions pending in the United States Bankruptcy Court for the District of Delaware (the "Bankruptcy Court") that were initiated by creditors' committees with authorization from the Bankruptcy Court.

As recognized in *Cybergenics* itself, there is a split of authority among the circuit courts of appeals on whether creditors' committees can bring avoidance actions under the Bankruptcy Code, with the Third Circuit holding that the committees cannot do so and all other circuit courts that have addressed the issue holding to the contrary. Indeed, the Second Circuit just rendered a decision that directly contradicts the *Cybergenics* holding on this very point (albeit without citing *Cybergenics*). *See In re Housecraft Indus. USA, Inc. (Glinka v. Murad)*, 2002 WL 31388883 (2d Cir. Oct. 24, 2002) ("*Housecraft*"). The creditors' committee in *Cybergenics* has filed a petition for a rehearing by the Third Circuit en banc. If nothing else, in light of the Second Circuit's decision in *Housecraft*, *Cybergenics* could well end up before the United States Supreme Court if the Third Circuit refuses to rehear the matter or lets the decision stand.

Whatever the ultimate fate of *Cybergenics*, for the moment at least it is the law in this district, and it applies to the myriad pending avoidance actions filed by creditors' committees in the Bankruptcy Court and otherwise binds all creditors' committees in this district. Accordingly, the purpose of this article is not to question the rationale of *Cybergenics* -- there will be ample opportunity for that in the appellate proceedings -- but to suggest at least one means of dealing with the implications of the decision.

*Cybergenics* was based entirely on the statutory language of the avoidance provisions of the Bankruptcy Code (Sections 544, 545, 547(b), 548(a) and 549(a)). The Third Circuit held that, under the "plain language" of those provisions, only a trustee or debtor-in-possession is permitted to bring avoidance actions, and therefore a creditors' committee cannot do so. It follows, therefore, that *Cybergenics* does not bar a creditors' committee from obtaining bankruptcy court authorization to bring claims other than avoidance claims on behalf of debtors' estates.

In searching for other types of claims that could be asserted by creditors' committees during the pendency of a chapter 11 case after *Cybergenics*, the opinion itself suggests an analogy to corporate law when it discusses the "derivative" nature of claims brought by a creditors' committee on behalf of a debtor. In corporate law, stockholders may under appropriate circumstances be permitted to bring claims derivatively on behalf of a corporation when the corporation's board of directors refuses to bring a claim. Not surprisingly, most stockholder derivative claims brought on behalf of corporations are for breach of fiduciary duties against the directors themselves.

Corporate law also recognizes that, under certain circumstances, a board of directors owes fiduciary duties not only to the corporation and its stockholders, but to creditors as well. In *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784 (Del. Ch. 1992), the Delaware Court of Chancery held that, while corporate directors do not ordinarily owe fiduciary duties to creditors, such duties arise when the corporation is insolvent. Other cases have said that the duty arises when the corporation is in the "vicinity of insolvency." *See, e.g., Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, 1991 WL 277613 (Del. Ch. Dec. 30, 1991). *Geyer's* express rationale was that the imposition of such duties would cause the directors of an insolvent corporation to choose a course of action that best served the entire corporate enterprise rather than the stockholders alone.

*Geyer* states that an entity is insolvent when it is unable to pay its debts as they fall due in the usual course of business, or when it has liabilities in excess of the reasonable market value of its assets -- definitions that are, at least in part, comparable to those under the avoidance provisions of the Bankruptcy Code. When a corporation is insolvent (or in the vicinity of insolvency), the stockholders' interests are often worthless, whereas the secured and unsecured debt usually still has some value. If directors are required to consider only the interests of stockholders when the corporation is in or near insolvency, they may be inclined to take speculative actions that pose little risk -- but possibly promise great reward -- to the stockholders, with money that equitably belongs to the creditors. By imposing fiduciary duties to creditors on corporate directors of insolvent corporations, *Geyer* sought to minimize the occurrence of such actions.

Courts, including the United States District Court for the District of Delaware, have expressly approved the reasoning of *Geyer* to support the assertion of fiduciary duty claims by creditors' committees on behalf of debtors against directors, controlling stockholders and lenders, at least in cases involving self-dealing by the fiduciaries (meaning that the fiduciary stands "on both sides" of a challenged transaction). *See Official Committee of Unsecured Creditors of Hechinger Investment Co. of Delaware, Inc. v. Fleet Retail Finance Group*, 274 B.R. 71 (D. Del. 2002) ("*Hechinger*"); *In re Ben Franklin Retail Stores, Inc. (Steinberg v. Kendig)*, 225 B.R. 646 (Bankr. N.D. Ill. 1998), *aff'd in part, rev'd in part*, 2000 WL 28266 (N.D. Ill. Jan. 12, 2000).

While corporate law thus recognizes a fiduciary duty to creditors when a corporation is in the vicinity of insolvency, the scope and nature of such a duty remain unsettled. For example, it is not clear from the case law whether directors of an insolvent corporation owe only a duty of loyalty to creditors, or whether they also owe a duty of care. Nor is it clear whether the duty of loyalty extends beyond instances of actual self-dealing, or whether a director who is also a stockholder (but not a creditor) should be viewed as engaging in self-dealing any time he makes a decision that favors stockholders over creditors. While some bankruptcy case law suggests that only actual self-dealing will trigger a breach of the duty, the governing state law is not settled on this point. The unsettled state of the law in the area of fiduciary duties to creditors is reflected in a recent Delaware Supreme Court order that affirmed a decision of the Court of Chancery, but notably stated that it was not reaching the general question of whether or to what extent directors of a corporation said to be in the "so-called 'vicinity of insolvency'" owe fiduciary duties to preferred stockholders -- who are often treated more like creditors under the law than like common stockholders. *See Kohls v. Kenetech Corp.*, 2002 WL 529908 (Del. Apr. 5, 2002).

It is also unclear whether the "fiduciary duty to creditors" in the vicinity of insolvency is actually owed directly to the creditors, such that it gives rise to a direct claim by the creditors, or whether it is owed to the corporation, such that any claim could only be pursued derivatively by the creditors. *Geyer* states that the duty is owed "to the creditors" or "on behalf of the creditors," suggesting that any claim for breach of the duty would be a direct claim. On the other hand, *Hechinger*, relying on *Credit Lyonnais*, states that the duty is not owed directly to the creditors, but to the entire corporate "community of interest," supporting the conclusion that any breach of the duty would give rise to a derivative claim. (For a more complete discussion of the distinction between derivative and direct claims, *see* Kurt M. Heyman and Patricia L. Enerio, "The Disappearing Distinction Between Derivative and Direct Actions," 4 *Del. L. Rev.* 155 (2001)). The characterization of a claim for breach of the duty to creditors as derivative or direct is critical to a creditors' committee's ability to pursue such a claim: if it is a derivative claim, then the committee could be authorized by a bankruptcy court to pursue the claim on behalf of the debtor, whereas if it is a direct claim belonging to the creditors themselves, then the committee would not have standing to pursue such a claim.

To the extent that it is possible to recast avoidance claims as fiduciary duty claims that are derivative in nature, *Cybergenics* should not bar a creditors' committee from pursuing such claims prior to confirmation (with bankruptcy court approval). Fiduciary duty claims are emphatically not avoidance claims. The *Hechinger* Court observed that, unlike avoidance claims, which seek avoidance of a transfer and recovery from the transferee, fiduciary duty claims seek money judgments from the fiduciaries and their aiders and abettors.

Derivative fiduciary duty claims could hold several advantages over ordinary avoidance actions (aside from not being barred by *Cybergenics*). As indicated in *Hechinger*, such claims could be asserted against both the fiduciaries and the transferee of the challenged payment. Increasing the number of defendants could increase the likelihood of a monetary recovery, and because some of the defendants would likely be current or former directors, directors' and officers' liability insurance might also be available to cover any monetary award. Moreover, because the duty to creditors arises in the "vicinity of insolvency," it may not be necessary to prove that the debtor was actually insolvent at the time of the challenged transfer within the meaning of the avoidance provisions of the Bankruptcy Code. Finally, there is a significant body of corporate case law addressing the issue of when a board of directors has conflicts of interest with respect to initiating a particular derivative suit, which law could be relied upon by creditors' committees in seeking bankruptcy court permission to bring fiduciary duty claims.

Fiduciary duty claims are not a panacea for the "*Cybergenics* problem," however. First, not all avoidance claims could be successfully recast as fiduciary duty claims, even if it is not necessary to demonstrate actual self-dealing in connection with a challenged transfer. Second, to the extent that actual self-dealing is an element of a fiduciary duty claim, it could be more difficult to plead or prove such a claim than an ordinary avoidance claim. It could also be difficult to plead or prove that the transferee of the challenged payment should be charged with knowingly "aiding and abetting" a breach of fiduciary duty.

Although the possibility of characterizing avoidance claims as fiduciary duty claims is by no means a complete solution to the "*Cybergenics* problem" for creditors' committees, it could provide a fertile source of potential claims to be asserted by creditors' committees in the wake of *Cybergenics*.