UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT
DOCKET NO. 01-3805

In re

CYBERGENICS CORPORATION,

Debtor.

THE OFFICIAL COMMITTEE OF UNSECURED CREDITORS OF CYBERGENICS CORPORATION, on behalf of CYBERGENICS CORPORATION, debtor in possession,

Appellant,

-against-

KATHLEEN CHINERY, Executrix of the Estate of Scott Chinery, et al.

Appellees.

Appeal from the United States District Court for the District of New Jersey Civ. No. 98-3109 (GEB)

Oral Argument Requested

BRIEF OF *AMICI CURIAE* LAW PROFESSORS IN SUPPORT OF THE APPEAL OF THE OFFICIAL COMMITTEE OF UNSECURED CREDITORS OF CYBERGENICS CORPORATION FOR REVERSAL OF THE DISTRICT COURT'S DISMISSAL OF THE COMPLAINT

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UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT
Docket No. 01-3805

In re CYBERGENICS CORPORATION,

Debtor.

BRIEF OF *AMICI CURIAE* LAW PROFESSORS

The law professors set forth on the signature page to this Brief (the "Professors") respectfully submit this Brief as *amici curiae* to provide the Court with their views as teachers and scholars of bankruptcy and commercial law. The Professors request oral argument on this Brief.

STATEMENT OF *AMICI CURIAE*

The Professors are teachers of bankruptcy and commercial law at accredited law schools in the Third Circuit and throughout the United States. Their respective affiliations are set forth below their names. None has an affiliation with the parties in this case.[1]

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[1] One of the Professors, Elizabeth Warren, has occasionally acted as counsel to committees of creditors in other cases, including in the Armstrong World Industries, Babcock & Wilcox, Owens Corning and W.R. Grace & Co. cases. Professors Klee and Bussel are members of the firm of Klee, Tuchin, Bogdanoff & Stern LLP, which actively represents debtors, creditors, creditors' committees, plaintiffs, defendants, and acquirers in cases throughout the United States, including cases in the Third Circuit.

The Professors' interest in this matter derives from their active role in the development of the law of bankruptcy reorganization. All are nationally-recognized authorities with a strong interest in the sound administration of the bankruptcy system.

The Professors submit this Brief in the hope that their unique perspective will help the en banc panel resolve the important issues raised in this appeal.

PRELIMINARY STATEMENT

This appeal is about who has the capacity to sue on behalf of the estate of a debtor in bankruptcy.

In Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery, et al., 304 F.3d 316 (3d Cir. 2002) (hereinafter Cybergenics II),[2] a three-judge panel of this Court affirmed the decision of the United States District Court for the District of New Jersey in the above-captioned adversary proceeding (Civ. No. 98-3109 (GEB)) that the Official Committee of Unsecured Creditors of Cybergenics

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plaintiffs, defendants, and acquirers in cases throughout the United States, including cases in the Third Circuit.

[2] Reh'g granted, vacated by Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery et. al., No. 01-3805, 2002 WL 31554591 (3d Cir. Nov. 18, 2002). In a prior decision, In re Cybergenics, 226 F.3d 237 (3d Cir. 2000), the Third Circuit Court of Appeals held that fraudulent conveyance claims

Corporation lacks the legal capacity to sue on behalf of the Debtor's estate. See Cybergenics II, 304 F.3d at 332-33.

By holding that a creditors' committee lacks this capacity, the rule of Cybergenics II would needlessly destabilize the process of reorganization under Chapter 11 of the United States Bankruptcy Code (the "Bankruptcy Code").[3] See 11 U.S.C. §§ 101-1330 (1994). The rule of Cybergenics II would also contravene the well-established goals and language of the Bankruptcy Code. For the reasons set forth below, we urge this Court to reject the rule of Cybergenics II, and reverse the decision of the District Court prohibiting the Creditors' Committee from suing derivatively on behalf of the Debtor's estate.

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arising from a failed buyout could not be sold by a debtor because they are not "assets" of the debtor.

[3] The phrase "Chapter 11" refers to 11 U.S.C. §§ 1101-1146 as well as certain rules in the Federal Rules of Bankruptcy Procedure that apply only or largely to Chapter 11 reorganizations. See, e.g., Fed. R. Bankr. P. 3003 (filing proof of claim or interest in Chapter 11 reorganization); Fed. R. Bankr. P. 3016 (filing of Chapter 11 plan of reorganization and related disclosure statement); Fed. R. Bankr. P. 3017 (providing for court consideration of disclosure statement); Fed. R. Bankr. P. 3018 (acceptance or rejection of Chapter 11 plans); Fed R. Bankr. P. 3020 (confirmation of Chapter 11 plan of reorganization); Fed. R. Bankr. P. 3021 (providing for distributions under confirmed Chapter 11 plan); Fed. R. Bankr. P. 3022 (providing for final decree in Chapter 11 reorganization case). The Federal Rules of Bankruptcy Procedure are prescribed by the Supreme Court pursuant to 28 U.S.C. § 2075 (1994).

ARGUMENT

I. The Creditors' Committee is Central to the Chapter 11 Process

This brief will not elaborate on the facts of Cybergenics II. The facts are amply set forth in the Cybergenics II opinion as well as the briefs of the parties. Rather, this section sketches the Chapter 11 reorganization process and the role of creditors' committees, so that the Court sitting en banc may consider the background against which Cybergenics II would operate if the reasoning of the three-judge panel were adopted.

Commencement of a bankruptcy case automatically results in the appointment of a fiduciary for the debtor's estate. See 11 U.S.C. §§ 701-703, 1107(a). In Chapter 11 reorganization, this fiduciary is, in the first instance, management of the reorganizing debtor, which has the rights and duties of a trustee. See id. § 1107(a) (". . . a debtor in possession shall have all the rights . . . of a trustee serving in a case under this chapter."), § 1101(1) ("'debtor in possession' means debtor . . .").[4]

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[4] See also Lynn M. LoPucki & William C. Whitford, Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies, 141 U. Pa. L. Rev. 669, 679 (1993) ("[B]ankruptcy procedure thrusts management of the debtor corporation into a central role.").

The assets of the estate usually include a variety of causes of action that the debtor in possession (i.e., management) has authority to bring. These causes of action frequently include fraudulent transfers, preferential transfers, breaches of fiduciary duty by the debtor's directors and officers, and subordination of insider claims pursuant to Bankruptcy Code section 510.[5] See Kenneth N. Klee & K. John Shaffer, Creditors' Committees Under Chapter 11 of the Bankruptcy Code, 44 S.C. L. Rev. 995, 1044 (1993). As "trustee" of the debtor's estate, management has a duty to pursue such claims. See Louisiana World Exposition v. Federal Ins. Co., 858 F.2d 233, 252 (5th Cir. 1988) ("the debtor-in-possession is obligated to [pursue such claims]").

Because management often includes the very parties who may be defendants in such actions, the debtor in possession "often acts under the

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[5] The Bankruptcy Code's avoidance actions appear in 11 U.S.C. §§ 542, 543 (requiring turnover of property to trustee), § 544 (authorizing trustee to avoid pre-petition transfers based on status as hypothetical judicial lien creditor and status as pre-petition unsecured creditor), § 545 (authorizing trustee to avoid statutory liens), § 547, 553(b) (authorizing trustee to avoid certain preferential transfers), (authorizing trustee to avoid fraudulent transfers under federal bankruptcy law), § 549 (authorizing trustee to avoid post-petition transfers not otherwise permitted), § 550 (authorizing trustee to recover property transferred or the value of such property upon avoidance pursuant to sections 544, 545, 547, 548, 549, 553(b), or 724(a)). See also Cybergenics I, 226 F.3d 237 (3d Cir. 2000) (discussing nature of trustee's avoiding powers). Under 11 U.S.C. § 510(c), the bankruptcy court may "under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim . . . ."

influence of conflicts of interest." See Canadian Pa. Forest Prod. Ltd. v. J.D. Irving, Ltd. (In re Gibson Group, Inc.), 66 F.3d 1436, 1441 (6th Cir. 1995). Congress created creditors' committees as, among other things, watchdogs to monitor these conflicts. See In re W. Pac. Airlines, Inc., 219 B.R. 575, 577-78 (Bankr. D. Colo. 1998) (discussing committee's "watchdog" role).[6] Thus, where a debtor in possession is "unable or unwilling to fulfill its obligation" to sue "due, for instance, to a conflict of interest," the creditors' committee may do so if authorized by the Bankruptcy Court. Louisiana World Exposition, 858 F.2d at

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[6] See also Marta G. Andrews, The Chapter 11 Creditors' Committee: Statutory Watchdog?, 2 Bankr. Dev. J. 247, 264 (1985) (stating that a "major legislative goal of the Code was to decrease the administrative responsibilities of bankruptcy judges so that they could function as impartial arbiters of disputes between the debtor and its creditors"); Dennis S. Meir & Theodore Brown, Jr., Representing Creditors' Committees Under Chapter 11 of the Bankruptcy Code, 56 Am. Bankr. L.J. 217, 217 (1982) (arguing that Congress intended creditors' committees to monitor debtors' activities); Karen M. Gebbia-Pinetti, First Report of the Select Advisory Committee on Business Reorganization, 57 Bus. Law. 163, 280 (2001) ("The 1978 Bankruptcy Code fundamentally altered pre-Code reorganization practice by reducing the need for judicial intervention and implementing a private bargaining system in which the parties' agreement to the terms of the plan, supplemented by a few, critical, minimum treatment standards, largely governs the reorganization process. The official creditors' committee is a critical component of this structure.") (citations omitted).

252.[7] Without the right to derivatively, creditors' committees would become watchdogs without teeth.

Courts are, however, understandably reluctant to permit a derivative suit without good cause. To obtain leave to sue derivatively, a creditors' committee usually must demonstrate that (1) a colorable claim exists that the debtor has not pursued, (2) the committee has made a demand upon the debtor to bring the

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[7] See also Official Unsecured Creditors Comm. v. U.S. Nat'l Bank (In re Suffola, Inc.), 2 F.3d 977, 979 n. 1 (9th Cir.1993) (recognizing "a qualified implied authorization" to commence adversary proceedings in limited circumstances); Louisiana World Exposition, 858 F.2d 233; In re Xonics Photochemical, Inc., 841 F.2d 198 (7th Cir. 1988); Unsecured Creditors Comm. v. Noyes (In re STN Enters.), 779 F.2d 901 (2d Cir. 1985); Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., Inc., 267 F.3d 340, 345 (3d Cir. 2001); Buncher Co. v. Official Comm. of Unsecured Creditors of GenFarm Ltd. Partnership IV, 229 F.3d 245, 250 (3d Cir. 2000); In re Commodore Int'l Ltd., 262 F.3d 96, 100 (2d Cir. 2001); In re Gibson Group, Inc., 66 F.3d at 1446; Liberty Mutual Ins. Co. v. Official Unsecured Creditors' Comm. (In re Spaulding Composites Co.), 207 B.R. 899 (9th Cir. BAP. 1997); Official Comm. of Unsecured Creditors v. DERF II (In re Catwil Corp.), 175 B.R. 362 (Bankr. E.D. Cal. 1994); In re Evergreen Valley Resort, Inc., 27 B.R. 75 (Bankr. D. Me. 1983); Unsecured Creditors' Comm. v. Farmers Sav. Bank (In re Toledo Equip. Co.), 35 B.R. 315 (Bankr. N.D. Ohio 1983); Gander Mountain, Inc. v. Impact Indus. Inc. (In re Gander Mountain, Inc.), 29 B.R. 260 (Bankr. E.D. Wis. 1983); Official Comm. of Unsecured Creditors of Joyanna Holitogs, v. I. Hyman Corp. (In re Joyanna Holitogs, Inc.), 21 B.R. 323 (Bankr. S.D.N.Y. 1982); Liberal Mkt., Inc. v. Malone & Hyde, Inc., 14 B.R. 685 (Bankr. S.D. Ohio 1981); Committee of Unsecured Creditors v. Monsour Medical Center (In re Monsour Medical Center), 5 B.R. 715 (Bankr. W.D. Pa. 1980). At least one court has held that the creditors' committee has a "duty" to sue on behalf of the estate when the debtor unjustifiably fails to do so. In re First Capital Holdings Corp., 146 B.R. 7, 11 (Bankr. C.D. Cal. 1992).

action, and (3) the debtor unjustifiably has refused to pursue the action following the demand. See, e.g., In re STN Enters., 779 F.2d at 904; In re Gibson Group, Inc., 66 F.3d at 1441; see also In re Xonics Photochemical, Inc., 841 F.2d at 203 (stating that a creditor may sue derivatively if it shows that "debtor was shirking his statutory responsibilities").[8]

Breaking with the vast majority of courts, and every appellate court, to consider the issue,[9] Cybergenics II would prevent a creditors' committee from suing on behalf of the estate.

II. Cybergenics II Would Eliminate a Deterrent to Overreaching and Lead to the Liquidation of Otherwise Viable Companies

If adopted by the en banc panel, the rule of Cybergenics II would have two important, unintended consequences. First, it would dilute or eliminate an important check on overreaching by insiders and powerful creditors before and at the commencement of a bankruptcy case. Second, it would likely lead to the liquidation of otherwise viable companies, destroying jobs and going concern value, thus impeding the principal goal of Chapter 11.

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[8] The other decisions cited in note 7, supra, take a similar approach; see also Klee, supra, at 1044-45.

[9] See, e.g., the decisions in note 7 supra.

A. Cybergenics II Would Eliminate an Important Check on Overreaching

Before bankruptcy, interested parties -- usually management and the debtor's most powerful creditors -- typically try to "work out" the debtor's financial distress.[10] In this process, managers typically experience pressure to take extreme measures to protect the company. They may also take advantage of their knowledge and position as insiders to advance their own interests in the company. Thus, management may make extraordinary concessions to stave off foreclosure or to induce a critical vendor to continue to provide goods or services that are vital to the debtor's survival.[11] Management may therefore grant new liens on unencumbered property, agree to an excessive rate of interest, commit to lavish retention bonuses,[12] or do virtually anything to keep the sinking ship afloat.

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[10] See, e.g., LoPucki, supra note 3, at 677 ("When a corporation is unable to pay its debts as they become due, one solution may be to "restructure" the debt."); Claire Finkelstein, Financial Distress as a Noncooperative Game: A Proposal for Overcoming Obstacles to Private Workouts, 102 Yale L.J. 2051 (1993).

[11] See generally LoPucki, supra note 3 (discussing management alignment with creditors).

[12] See, e.g., Eduardo Porter & Mitchell Pacelle, Judge Increases Severance Pay To Former Enron Employees, Wall St. J., Aug. 29, 2002, at A3 (discussing multi-million dollar retention bonuses paid by Enron to insiders before bankruptcy and court order authorizing other employees to sue derivatively to recover such bonuses).

Whether or not ultimately successful, such actions will often reduce the assets available to the debtor's other creditors.

The avoidance powers under the Bankruptcy Code are intended, among other things, to deter this kind of overreaching. See H.R. Rep. No. 95-595, at 177 (1977) ("[b]y permitting the trustee to avoid prebankruptcy transfers that occur within a short period before bankruptcy, creditors are discouraged from racing to the courthouse to dismember the debtor during [its] slide into bankruptcy."). Fraudulent conveyance, preference, and similar causes of action require the transferee to return the property or its value to the estate. See 11 U.S.C. § 550(a) (providing for recovery of transfers so avoided). The avoidance powers therefore provide a remedy for the benefit of unsecured creditors, who are usually the principal victims of this kind of behavior.

Parties to workouts are typically sophisticated, and understand that their actions will likely be scrutinized by a creditors' committee after the fact. They also understand that, even though management of the debtor may be reluctant to pursue these avoidance actions, a creditors' committee will not be so hesitant. The threat of a creditors' committee suit is therefore often the most potent deterrent to overreaching by these powerful creditors and insiders. By eliminating

the right to sue derivatively, Cybergenics II would dilute or eliminate much of the deterrent effect of the avoidance powers.

The deterrent effect of the creditors' committee remains critical after the commencement of a bankruptcy case, as well. Large corporate debtors routinely seek so-called "first-day" orders.[13] In these orders, debtors ask the bankruptcy court to approve such urgent matters as key-employee retention plans, the payment of prepetition claims of critical vendors [14] and, most important, going-forward financing for the case.

The non-debtor parties directly affected by these orders (e.g, the key employees, critical vendors and lenders) often demand that the debtor waive other

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[13] See, e.g, David Kurtz & Rena Samole, Bankruptcy Law & Practice Update: New Developments in an Uncertain Economy: A Satellite Program, First Day Orders, at 37 (PLI Commercial Law Practice Course Handbook Series No. A0-00, 2001) (discussing waivers of prepetition claims and debtor in possession lenders).

[14] Martha Stewart, for example, was a "critical vendor" of K-Mart, and was accordingly able to extract preferential terms for continuing to provide merchandise to the debtor. See Will Martha Dump Kmart? (Jan. 17, 2002) <http://money.cnn.com/2002/01/17/ceos/v_martha_stewart/index.html> ("Kmart's best-known supplier is Martha Stewart, whose housewares and other products have been a big draw for Kmart shoppers, pulling in $1.5 billion last year."); Kmart to Keep Martha Stewart, Other Lines, (last modified Mar. 20, 2002) <http://www.clickondetroit.com/det/news/stories/news-131297720020320-060343.html> ("The retailer is allowed to continue its licensing agreements and pay outstanding debts to the five major brands. Kmart owes nearly $132,000 to Kathy Ireland, $1.5 million to Jaclyn Smith-supplier GH Productions and $12.3

claims that it may have against them (e.g., avoidance actions). Post-petition financing orders, for example, can present special problems because they are extremely complex, and often include provisions that cross-collateralize or "white wash" prepetition security interests. See Kurtz & Samole, supra note 13, at 2. Similarly, major vendors will often demand that the debtor release preference or comparable claims as the quid pro quo for doing business with the debtor.

A court facing motions for these orders has a difficult choice. It could simply deny the motions, on the theory that the parties would renegotiate and eliminate the offending provision. Alternatively, the court could take a detour from the motion at hand, and explore the merits of any underlying claims.

Bankruptcy courts would be reluctant to take either course, however, because first day orders are, by definition, extremely urgent. Without an order approving financing or critical vendor terms, the case -- and the debtor -- may terminate immediately, even if the debtor might otherwise be viable.

Thus, bankruptcy courts are generally much more likely to make a pragmatic decision: They will often grant these motions, but reserve to the creditors' committee the right to investigate -- and pursue -- claims that would

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million to Martha Stewart. The five brands account for roughly $1.7 billion in annual gross sales, Kmart said.").

otherwise be released in the first day order. The creditors' committee, in other words, becomes surrogate for a debtor too financially weakened to bargain vigorously for itself. In so doing, courts use the creditors' committee in exactly the way Congress envisioned – as a substitute for the highly managerial bankruptcy court system that preceded the current Bankruptcy Code. See Andrews, supra note 6, at 264.[15]

B. Cybergenics II Would Lead to the Liquidation of Otherwise Viable Companies

Cybergenics II would also have a second, equally troubling, consequence: It would lead to the liquidation of otherwise viable companies.

The Cybergenics II panel apparently believed that Cybergenics II would create little harm because it "leaves a . . . creditors' committee with several options." See Cybergenics II, 304 F.3d at 333. These options were to move for the appointment of a trustee or to dismiss the bankruptcy case. See id. The panel apparently did not, however, consider that these options would effectively replace the scalpel of derivative suit with a chainsaw, thereby destroying otherwise viable businesses.

[15] This dynamic may continue throughout the case. For example, a debtor may be "reluctant to proceed with adversary proceedings against defendants who may be major shareholders of the debtor or major creditors with whom the debtor is

The Cybergenics II panel opinion is correct in suggesting that a creditors' committee has the power to seek appointment of a trustee.[16] See Cybergenics II, 304 F.3d at 333. Under Bankruptcy Code section 1104, any "party in interest" (including a creditors' committee) may request appointment of a trustee "for cause," or if the appointment would be "in the interests of creditors." See 11 U.S.C. § 1104(a). "Cause" to appoint a trustee may include "fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after commencement of the case." Id. § 1104(a)(1). Although not suggested by the opinion, presumably a similar remedy would be the appointment of an examiner.[17]

Congress has made the appointment of a trustee in a Chapter 11 case an

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attempting to negotiate terms for a successful reorganization plan." In re Calvary Temple Evangelistic Ass'n, 47 B.R. 520, 523 (Bankr. D. Minn. 1984).

[16] See also 11 U.S.C. § 1103(c)(4) (stating that a creditors' committee may "request the appointment of a trustee or examiner under section 1104 of this title . . .").

[17] Section 1104(c) of the Bankruptcy Code provides that "a party in interest" may request the appointment of an examiner, which the court may order after notice and a hearing, "to conduct such an investigation of the debtor as is appropriate." Id. The duties include investigation of the debtor, the debtor's business, and "any other matter relevant to the case or to the formulation of a plan." See id. § 1106(a)(3). In most cases, examiners do not have the power to sue. See id. § 1106 (b) (allowing an examiner to perform the duties of a trustee set forth in section 1106(a)(3) and (4)). But cf. In re Carnegie International Corp., 51 B.R.

"extraordinary remedy." See 7 Collier on Bankruptcy ¶ 1104.02[1] (15th rev. ed. 1998)(citations omitted); In re Sharon Steel Corp., 871 F.2d 1217, 1226 (3d Cir. 1989) ("It is settled that appointment of a trustee should be the exception, rather than the rule."). There is a "strong presumption"[18] that the debtor should be permitted to remain in possession unless there has been the showing of need for the appointment of a trustee, or a significant post-petition change in debtor's management. See In re Marvel Entertainment Group, Inc., 140 F.3d 463, 471 (3d Cir. 1991); Committee of Dalkon Shield Claimants v. A.H. Robins Co., Inc., 828 F.2d 239 (4th Cir. 1987).

There is no necessary connection between the right to sue derivatively and the appointment of a trustee in bankruptcy. The facts that would lead to derivative standing may fall well short of grounds to appoint a trustee or examiner. For example, management's refusal to commence a particular cause of action belonging to the estate may not be "fraud, dishonesty, incompetence or gross mismanagement." It may simply reflect management's reluctance to sue an important creditor, supplier, employee or other insider, and so not warrant the "extraordinary remedy" of terminating management entirely. It would certainly

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252 (Bankr. S.D. Ind. 1984) (authorizing examiner to bring suit on behalf of debtor).

not be in the "interests" of creditors of an otherwise mending debtor to do so. Nor would it be in the interests of creditors – or the reorganization system as a whole – to shield such a creditor, employee or other insider from liability if they have in fact received otherwise avoidable transfers.

Moreover, appointing a trustee would create needless costs and almost certainly reduce the debtor's value. As Professor Klee has observed, "the incremental cost" of a trustee usually "outweighs the benefits." Klee, supra, at 1045. These costs include the statutory fee to which trustees are entitled for their services,[19] and the appointment of a replacement management team, if the debtor is to continue in operation.

Alternatively, the Cybergenics II panel suggested that a creditors' committee could move to dismiss the Chapter 11 case or convert it to a liquidation under Chapter 7 of the Bankruptcy Code. See Cybergenics II, 304 F.3d at 333. Under section 1112(b), a creditors' committee (or any other party in interest) may request that the court dismiss the Chapter 11 case, or convert it to a case under Chapter 7, "for cause." See 11 U.S.C. § 1112(b). "Cause" to dismiss or convert a

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[18] 7 Collier on Bankruptcy ¶ 1104.02[3][b].
[19] See 11 U.S.C. §§ 326(a) (setting forth fee schedule), 330(a) (setting forth trustee's right to compensation); Cf. 11 U.S.C. § 1107(a) (providing that debtors in possession are not entitled to statutory trustee's fees).

Chapter 11 case may include continuing loss to, or diminution of, the estate coupled with an absence of a reasonable likelihood of rehabilitation, the inability to effectuate a plan of reorganization, or unreasonable delay by the debtor that is prejudicial to creditors. See id. § 1112(b)(1)-(3).

As with the appointment of a trustee, "maximization of value rarely lies down this path." Klee, supra, at 1049. First, if the Chapter 11 case were dismissed or converted, the committee itself would cease to exist. There would, in other words, no longer be a direct representative of creditors. Second, if the case were dismissed, scores, perhaps hundreds, of individual collection and avoidance actions would be commenced in state court, at enormous – and needless -- cost, defying the collective remedy created by Congress. See Thomas H. Jackson, The Logic and Limits of Bankruptcy Law 7 (1986) ("All agree that [the bankruptcy law] serves as a collective debt-collection device."); Nat'l Bankr. Rev. Comm'n, Bankruptcy: The Next Twenty Years, Final Report, 898-99 (1997) (explaining that single forum and set of procedural rules ensures uniform treatment of every type of claimant). This would be especially ironic, since prudential concerns about the proliferation of lawsuits were almost certainly a motive force behind Cybergenics II.

If, instead, the bankruptcy court declines to appoint a trustee or dismiss the

case, it would leave unrealized potentially important and valuable causes of action. Because avoidance actions are often an important source of value for creditors, plans of reorganization would likely become more difficult to confirm. Management would remain in control, however, free from meaningful creditors' committee scrutiny. Thus, the inability to sue derivatively would protract Chapter 11 cases that would be more likely to liquidate in the end, or would return less to unsecured creditors, or both.

These consequences of Cybergenics II would directly contravene what Congress sought to create in Chapter 11. When it enacted Chapter 11 in 1978, Congress intended to create a process that would preserve jobs and assets. "The premise of a business reorganization," the legislative history provides, "is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap."[20] H.R. Rep. No. 595, at 220 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6179, 123 Cong. Rec. H35,444 (daily ed. Oct. 27, 1977) (statement of Rep. Rodino) ("For businesses, the bill facilitates reorganization, protecting investments and jobs."). Chapter 11 therefore exists "to assist financially distressed business enterprises by providing them with breathing space in which to return to a viable state." In re Winshall

[20] See also Martin J. Bienenstock, Bankruptcy Reorganization 6-10 (1987).

Settlor's Trust, 758 F.2d 1136, 1137 (6th Cir. 1985). Forcing liquidation whenever management is reluctant to sue (e.g., for return of a preference) is absurdly out of proportion, the equivalent of killing the patient because the doctor is playing golf.

III. Strict Construction Should not Produce Results in Direct Conflict with the Structure and Purpose of the Bankruptcy Code

The Cybergenics II panel was unmoved by the purpose of the Bankruptcy Code because, in its view, the "plain language" of the statute forbids a creditors' committee from suing on behalf of the estate. See Cybergenics II, 304 F.3d at 323-24. Drawing an analogy from Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A., 530 U.S. 1, 120 S.Ct. 1942, 147 L.Ed.2d 1 (2000), the panel concluded that neither the pre-Code "practice" of recognizing derivative standing nor "policy" concerns can override the statute. See Cybergenics II, 304 F.3d at 331-32. The Cybergenics II panel erred, however, because it misused strict statutory construction and ignored the structure and purpose of the Bankruptcy Code.

Strict statutory construction may be an appropriate interpretative technique. It has, for example, sometimes been the basis on which the Supreme Court has interpreted the Bankruptcy Code. See, e.g., Patterson v. Shumate, 504 U.S. 753, 757-58 (1992) (using "plain language" of § 541(c)(2) of Bankruptcy Code to

determine if ERISA-qualified pension plan constitutes restriction on transfers).[21]

It is equally clear, however, that statutory silence should not be used to contravene common law or the undisputed purpose of a statute. See Norfolk Redevelopment & Housing Auth. v. Chesapeake & Potomac Tel. Co. of Va., 464 U.S. 30, 35 (1983) (asserting the "well-established principle of statutory construction that '[t]he common law . . . ought not to be deemed repealed, unless the language of a statute be clear and explicit for this purpose'" (quoting Fairfax's Devisee v. Hunter's Lessee, 11 U.S. (7 Cranch) 603, 623 (1812))).[22]

Here, there is no dispute that creditors have long had derivative standing to sue under appropriate circumstances, with or without express statutory authorization.[23] See In re Godon, Inc., 275 B.R. 555, 561 (Bankr. E.D. Cal. 2002)

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[21] See also Union Bank v. Wolas, 502 U.S. 151, 155-56 (1991) (using legislative history to support "literal reading" of Bankruptcy Code); Toibb v. Radloff, 501 U.S. 157, 160 (1991) (using "plain language" of Bankruptcy Code to decide whether non-business debtor may reorganize under Chapter 11); United States v. Ron Pair Enters., Inc., 489 U.S. 235, 242 (1990) (plain language should be used when reading statutes).

[22] See also Custis v. U.S., 511 U.S. 485, 503 (1994) (Souter, J., dissenting) (arguing that the majority opinion's "effort to infer intent from the statutory silence runs afoul of the context of the statute's enactment").

[23] The practice developed under § 64(1) of the Bankruptcy Act of 1898, which, like current section 503(b)(3)(B), provided for the reimbursement of costs and expenses "where property of the bankrupt, transferred or concealed by him either before or after the filing of the petition, is recovered for the benefit of the estate of the bankrupt by the efforts and at the cost and expense of one or more creditors").

("It has been a settled feature of bankruptcy law since 1898 that creditors may recover property for the benefit of the estate . . . ."). This simply reflects the power that courts have in a variety of contexts to recognize derivative capacity to sue when the nominal plaintiff cannot or will not pursue an action for the benefit of the real parties in interest.[24]

See Chatfield v. O'Dwyer, 101 F. 797, 799-800 (8th Cir. 1900); In re Kenny, 269 F. 54, 57 (W.D. Pa. 1920). Even before codification, it was well understood that courts had the equitable power to confer derivative creditor standing. See Glenny v. Langdon, 98 U.S. 20, 27 (1878) (right to sue derivatively "is founded upon the enlarged principles of equity. . .").

[24] For example, the right of sureties to sue in the shoes of creditors was a well-established feature of the common law before codification in the Federal Rules of Civil Procedure or the Uniform Commercial Code. Indeed, to the extent a surety's rights are not governed by statute (e.g., the UCC), the only basis for suing in the shoes of a creditor paid by the surety is through common law. See e.g., U.S. v. Tilleraas, 709 F.2d 1088, 1092 (6th Cir. 1983) (holding that surety provision of student loan program of Higher Education Act did not prevent the government from enforcing its rights at common law. "Changes in or abrogation of the common law must be clearly expressed by the legislature.").

Similarly, the right of a shareholder to sue derivatively on behalf of the corporation is also rooted in the common law of both England and the United States. See generally Deborah A. DeMott, Shareholder Derivative Actions: Law and Practice § 1:03 (2002); Bert S. Prunty, Jr., The Shareholder's Derivative Suit: Notes on its Derivation, 32 N.Y.U. L. Rev. 980 (1957) (stating that "[t]he remedy made available in equity [in the mid-19th century by Dodge v. Woolsey, 59 U.S. (18 How.) 331 (1855)] was the derivative suit, viewed in this country as a suit to enforce a corporate cause of action against officers, directors, and third parties"); see also Ralph Brubaker, Creditor/Committee Derivative Litigation: Of Textualism and Equitable Powers, 22 Bankr. L. Letter 6 (Nov. 2002); Leach, et al. v. F.D.I.C., 860 F.2d 1266, 1271 (5th Cir. 1988), cert. denied, 491 U.S. 905 (1989)

Of course, a statute such as the Bankruptcy Code may alter this power. There is, however, no reason to conclude that Congress did so when it enacted the Bankruptcy Code. It is well understood that "[w]hen Congress amends the bankruptcy laws, it does not write 'on a clean slate.'" See Dewsnup v. Timm, 502 U.S. 410, 419 (1992) (quoting Emil v. Hanley, 318 U.S. 515, 521 (1943)).[25] Rather, the Court is "reluctant to accept arguments that would interpret the Code . . . to effect a major change in pre-Code practice that is not the subject of at least some discussion in the legislative history." Dewsnup, 502 U.S. at 419. No history – legislative or otherwise – indicates that Congress sought to eliminate the right to sue derivatively.

("What we today term shareholder derivative suit was a part of the general commercial common law....).

Finally, the right of a beneficiary to sue a third party directly if a trustee is unable or unwilling to sue the third party, originates in common law. See Bogert, Trusts and Trustees, §869 (2nd ed. rev. 1982); see also Brubaker, Creditor/Committee Derivative Litigation: Of Textualism and Equitable Powers, Bankr. L. Letter 6 (discussing instances of derivative standing).

[25] See also Midlantic National Bank v. New Jersey Department of Environmental Protection, 474 U.S. 494 (1986) (relying on pre-Code practice); Pennsylvania Dep't of Pub. Welfare v. Davenport, 495 U.S. 552, 562-63 (1990) (refusing to read the Bankruptcy Code to erode prior bankruptcy practice without clear indication of congressional intent to discontinue such practice); BFP v. Resolution Trust Corp., 511 U.S. 531, 542-44 (1994) (upholding price received at "regularly" held foreclosure sale based on pre-Code fraudulent transfer law) (Scalia, J.). See generally Daniel J. Bussel, Textualism's Failures: A Study of Overruled Bankruptcy Decisions, 53 Vand. L. Rev. 887 (2000).

Against this backdrop, it is apparent that, for at least three reasons, the Hartford decision was inapposite, and should not have formed the basis for the decision in Cybergenics II.

First, as a structural matter, it is clear that creditors' committees are very different entities under the Bankruptcy Code than are administrative claimants, such as the petitioner in Hartford. In seeking priority in payment, the Hartford petitioner was acting solely in its own behalf, requesting payment for insurance premiums that accrued but were not paid during the case. 530 U.S. at 5. Because the debtor's assets there were fully encumbered, the petitioner sought to step into the shoes of the trustee who, under Bankruptcy Code section 506(c), is entitled to surcharge collateral for the cost of maintaining it.[26]

Creditors' committees, by contrast, act for the benefit of all of the debtor's creditors, who are the principal beneficiaries of the estate created upon commencement of the case. 11 U.S.C. § 541(a). It is well known that the bankruptcy "trustee" is not simply a discrete individual (or group of individuals),

[26] Section 506(c) provides that the "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." 11 U.S.C. § 506(c).

but rather *any* authorized party that represents the estate.[27] As discussed above, creditors' committees are often the most important – sometimes the only – party to represent the interests of the estate in matters where management refuses to do so. By saying that a creditors' committee can never represent the estate – even when the nominal representative may be derelict in its duties – Cybergenics II would ignore the structural role that creditors' committees play in the Bankruptcy Code and the reorganization process.

Second, common law and practice differ significantly as between Hartford and Cybergenics II. One reason the Hartford Court declined to clothe the petitioner in the rights of the trustee was the lack of common law or practice permitting administrative claimants to surcharge collateral prior to enactment of the Bankruptcy Code. See Hartford Underwriters Ins. Co., 530 U.S. at 10 ("It is questionable whether these precedents establish a bankruptcy practice sufficiently widespread and well recognized to justify the conclusion of implicit adoption by the Code."). Statutory silence on the point was a fair indication that Congress did not create a new right for administrative claimants when it enacted the Bankruptcy Code. By contrast, and as noted above, the right to sue derivatively has been a

[27] The Bankruptcy Code expressly defines the "trustee" as the "representative of the estate." See 11 U.S.C. § 323(a). See also Brubaker, supra note 24.

feature of bankruptcy (and other) law for many years.

Third, unlike Cybergenics II, Hartford's inference from statutory silence was entirely consistent with other applicable, well-established policies. It is, for example, beyond dispute that vested property interests of secured creditors (i.e., perfected security interests) must be respected.[28] The Hartford decision is completely consistent with that goal; indeed, a contrary result would have been an affront to it. It is not surprising that in a footnote anticipating the very issue presented in Cybergenics II, Justice Scalia observed that recognizing derivative rights in other contexts "has no analogous application" to the practice prohibited there. See Hartford Underwriters Ins. Co., 530 U.S. at 13, n. 5. In other words, Justice Scalia was suggesting, simply because an administrative claimant could not be "the trustee" for purposes of surcharging collateral does not mean that others – e.g., creditors' committee – could not represent the estate in other contexts.

Here, as discussed above, denying creditors' committees the right to sue on behalf of the estate would contravene sound and established practice and policy. Surely, by its silence on the right to sue derivatively, Congress did not seek to

[28] See, e.g., 11 U.S.C. §§ 506(a), 1129(b)(2)(A) (entitling holder of perfected secured claim to value of interest in property subject to security interest or to retain the lien or its "indubitable equivalent").

encourage overreaching by powerful creditors or insiders; surely it did not seek to increase the likelihood that otherwise viable businesses would be forced to liquidate because management unjustifiably refused to commence suit. These, however, would be the inevitable results of Cybergenics II.

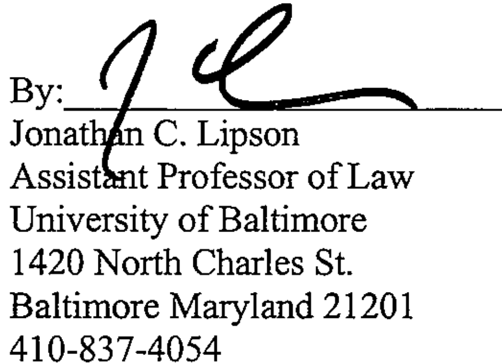
IV. Conclusion

At the heart of Cybergenics II is a question not addressed by the panel opinion: Who benefit would from its rule? The answer is, No one deserving of protection. Rather, Cybergenics II would create a procedural impediment to the just and efficient resolution of claims that an estate may have, but which would otherwise languish. Cybergenics II would eliminate an important deterrent to conduct that would harm a debtor and its creditors, and increase the likelihood that otherwise viable businesses will liquidate. It would therefore threaten the stability of the reorganization system Congress created.

We urge this court to reverse that portion of the District Court decision denying the Official Committee of Unsecured Creditors of Cybergenics Corporation the authority to sue on behalf of the Debtor's estate.

Dated: Baltimore, Maryland
December 13, 2002

Respectfully submitted,



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CERTIFICATION PURSUANT TO FED. R. APP. P. 32(a)(7)(C)

I, Jonathan C. Lipson, hereby certify that the foregoing brief contains 4224 words, excluding the Table of Contents, Table of Authorities and this Certification.

Dated: December 13, 2002

Jonathan C. Lipson