Derivative Standing in Bankruptcy Proceedings

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In *In re Optim Energy LLC (Walnut Creek Mining v. Cascade Investment LLC)*, Civ. No. 14-738-LPS (D. Del. Mar. 13, 2015), U.S. District Judge Leonard P. Stark of the District of Delaware considered an appeal from the bankruptcy court's denial of a creditor's motion for derivative standing. The opinion is noteworthy for two reasons: first, for its brief discussion of the requirements for a creditor to obtain derivative standing, and second, for its discussion of the requirements to state causes of action for recharacterization of a debt as equity and for equitable subordination.

In 2003, the U.S. Court of Appeals for the Third Circuit joined several other circuits in recognizing that the bankruptcy court, as a court of equity, has the power to authorize a creditors' committee to sue derivatively to recover property for the benefit of the estate, in *Official Committee of Unsecured Creditors of Cybergenics v. Chinery*, 330 F.3d 548 (3d Cir. 2003). In so doing, the court found that the potential for a derivative suit by a creditors’ committee provides a critical safeguard against lax pursuit of avoidance actions by debtors-in-possession, who may be unwilling to pursue claims against individuals or businesses, such as insiders or critical suppliers, with whom they have ongoing relationships. Even if a debtor were willing to bring an avoidance action, it might be too financially weakened to vigorously pursue the claims. In either case, the court concluded, the real losers are the unsecured creditors whose interests avoidance actions are designed to protect. The court rejected arguments that allowing derivative suits might dissipate the value of the estate, that bankruptcy courts could not serve as competent gatekeepers for the purpose of deciding when to authorize derivative standing, or that derivative suits might consume significant judicial resources that would not have been necessary if creditors lacked derivative standing. The court concluded, "Derivative standing is a valuable tool for creditors and courts alike in Chapter 11 proceedings, and we do not believe that any of the proffered alternatives could serve as a realistic substitute for that standing." The ruling has since been
applied to allow the bankruptcy court to confer standing on individual creditors as well as creditors' committees.

As Stark wrote in *Optim Energy*, derivative standing requires a party to show three elements: (1) the existence of a colorable claim, (2) that the trustee unjustifiably refused to pursue the claim, and (3) the permission of the bankruptcy court to initiate the action. The focus of the court's attention in *Optim Energy* was the first requirement: the existence of a colorable claim. Whether a party has asserted a colorable claim requires the court to undertake the same analysis as when a defendant moves to dismiss a complaint for failure to state a claim, as evaluated under the applicable Rule 12(b)(6) standard.

In *Optim Energy*, Walnut Creek Mining Co., a large unsecured creditor, had sought unsuccessfully in the bankruptcy court to obtain derivative standing to pursue claims against another creditor on behalf of the debtors. On appeal, it argued the bankruptcy court had erred in holding that its complaint did not state causes of action for recharacterization and equitable subordination against the other creditor.

Stark outlined the salient facts. Cascade Investment and PNM Resources formed the debtor, Optim Energy, in 2007 for purposes of entering the deregulated Texas electricity market. Cascade and Optim entered into a financing arrangement with Wells Fargo, which provided Optim with a $1 billion revolving line of credit. Cascade guaranteed the debt, and Optim guaranteed to reimburse Cascade for any payments made pursuant to Cascade's guaranty. Optim's guaranty to Cascade was secured by a first lien on substantially all of Optim's assets that was junior to the lien of Wells Fargo.

In 2014, Optim filed for Chapter 11 relief. The filing constituted a default under the Wells Fargo loan, and Cascade was obligated under its guaranty to pay approximately $172 million still outstanding on the loan. In preparation for the default, Cascade wired funds to an account at Wells Fargo, and on the petition date, Wells Fargo set-off this deposit against the amount outstanding on the loan, triggering Optim's obligation to Cascade under the former's guaranty. The bankruptcy court subsequently entered DIP financing orders that provided that all claims and defenses of the debtors against Cascade were irrevocably waived and relinquished as of the petition date, and set a deadline for any adversary proceeding challenging the validity, enforceability, priority or extent of the debtors' prepetition indebtedness to Cascade or Cascade's liens on the debtors' prepetition collateral by a party in interest with requisite standing other than the debtors or an appointed committee. Walnut Creek, the largest unsecured creditor, sought derivative standing to bring an adversary proceeding against Cascade to recharacterize or subordinate Cascade's purported debt. The bankruptcy court denied it standing on the grounds that it had failed to assert a colorable claim.

On appeal to the district court, Stark wrote that evaluating an alleged recharacterization cause of action under a failure to state a claim standard was challenging because the precise contours of the cause of action are not very clear. Courts have adopted a variety of multi-factor tests that are applied on a case-by-case basis. The key inquiry, however, in classifying advances as debt or equity is the intent of the parties as it existed at the time of the transaction. Stark found that Walnut Creek's allegation that Optim was inadequately capitalized at the time of the 2007
transaction was insufficient, standing alone, to state a claim for recharacterization. The fact that a party lends to an inadequately capitalized company does not necessarily mean that it intends to infuse the company with capital. Walnut Creek's additional argument that no prudent lender would have guaranteed Optim's obligations to the bank was also not probative of Optim's and Cascade's intent regarding the 2007 transaction at the time of the transaction. The Cascade guaranty was required by the bank as a condition to extending credit, and does not weigh upon Cascade's intent with respect to entering into the separate guaranty agreement with Optim. Walnut Creek's last argument, that Cascade made subsequent capital contributions to Optim to allow it to pay down the bank loan, also was not probative of their intent at the time of the 2007 transaction. Accordingly, Stark agreed with the bankruptcy court that Walnut Creek had failed to plead a colorable claim for recharacterization.

Stark also agreed that Walnut Creek had failed to plead a colorable claim for equitable subordination. He found no inequitable conduct by Cascade that would warrant equitable subordination. Walnut Creek argued that Cascade designed the transaction to prioritize its interest senior to trade creditors and ahead of other bona fide creditors of the business. Stark wrote, "This merely describes the mechanics of secured versus unsecured lending. It is not inequitable for a lender, even an inside lender, to obtain a lien on the borrower's assets in order to secure its position above other creditors in the event of the borrower's default."

*Optim Energy* is instructive both for its reiteration of the requirements for derivative standing in a bankruptcy proceeding and its evaluation of the recharacterization and equitable subordination causes of action under the colorable claim standard. The court's opinion affirming the bankruptcy court suggests that the Third Circuit was not mistaken in *Cybergenics* when it concluded that the bankruptcy courts could function adequately as competent gatekeepers for the purpose of deciding when to authorize derivative standing. The opinion also reaffirms the challenge in pleading causes of action for recharacterization and equitable subordination that can survive a motion to dismiss.

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