Schulte Roth&Zabel

Alert

Ninth Circuit Gives Creditors' Committee Members Limited Litigation Protection

December 13, 2016

"Any ... suit [against creditors' committee members for their official acts] must be brought in the bankruptcy court, or in another court only with the express permission of the bankruptcy court," held the U.S. Court of Appeals for the Ninth Circuit on Nov. 28, 2016. *In re Yellowstone Mountain Club LLC*, 2016 U.S. App. LEXIS 21187, *9 (9th Cir. Nov. 28, 2016). Modifying the lower courts' broad dismissal of the plaintiff's suit against the chairman of the creditors' committee ("Committee") in the district court ("another forum"), *Id.* at *5, the Ninth Circuit found that: (a) the prior-leave requirement (the so-called "Barton" doctrine) protects Committee members, not just bankruptcy trustees; (b) claims against Committee members based on asserted pre-bankruptcy "tort, contract and fraud" could be brought outside the bankruptcy court without prior permission; and (c) a Committee member is not "entitle[d] … to immunity for all actions as" a member. *Id.* at *15. More importantly, *Yellowstone* did not insulate Committee members from liability. In fact, the Ninth Circuit remanded the matter to the bankruptcy court "to consider whether [the defendant Committee member] is [even] entitled to derived judicial immunity for [the plaintiff's] post-[bankruptcy] claims." *Id.* at *15.

Relevance

A party must obtain prior leave of the appointing court before suing a trustee in a non-appointing court for acts done in the trustee's official capacity, held the U.S. Supreme Court in *Barton v. Barbour*, 104 U.S. 126 (1881). According to the Supreme Court, "before suit is brought against a receiver[,] leave of the court by which he was appointed must be obtained." *Id.* at 127-128. If a plaintiff fails to obtain that permission, the unauthorized suit can be dismissed for lack of subject matter jurisdiction. In the words of the Supreme Court, the suit would be a "usurpation of the powers and duties which belonged exclusively" to the court administering the debtor's estate. *Id.* at 136. Although *Barton* involved a state court receiver, the appellate courts have extended the rule to protect a bankruptcy trustee. E.g., *In re Crown Vantage, Inc.*, 421 F.3d 963, 970 (9th Cir. 2005); *In re Lehal Realty Assocs.*, 101 F.3d 272, 276 (2d Cir. 1996).

The *Barton* rule does not insulate a trustee from suit for actions taken in its official capacity, but merely requires the plaintiff to obtain prior leave of the court that appointed the trustee, usually the bankruptcy court, before suing in another court. As a practical matter, bankruptcy courts typically protect their appointed officials, as *Yellowstone* confirms.

"No court of appeals has held that *Barton* applies to suits against [Committee] members … ." *Yellowstone*, 2016 U.S. App. LEXIS 21187, *11. Nevertheless, said the Ninth Circuit, other circuits have "extended *Barton* to actors who aren't bankruptcy trustees or receivers." *Id.*, citing *In re DeLorean*

Motor Co., 991 F.2d 1236, 1241 (6th Cir. 1993) (counsel for trustee entitled to *Barton* protection because he is the "functional equivalent of a trustee" for purposes of administering estate); *Carter v. Rodgers*, 220 F.3d 1249, 1251, 1252 n.4 (11th Cir. 2000) (*Barton* protection extended to court-authorized individual sellers of estate property, adopting "functional equivalent" test). The Ninth Circuit is the first appellate court to extend *Barton* protection to Committee members.

Facts

The original owner-developer ("B") of the debtor established a resort in Montana for the "ultra-wealthy." *Yellowstone*, 2016 U.S. App. LEXIS 21187, *3. Claiming to have relied on the advice of his attorney at the time ("S"), he borrowed a large sum of money but used the loan proceeds to pay off personal debts and later settled with the debtor's shareholders for his misconduct, again purportedly on the legal advice of S. *Id.* B also later divorced his spouse and entered into a property settlement where he was represented by S.

The debtor later filed a Chapter 11 petition and S was appointed by the U.S. Trustee to serve as chairman of the Committee. At the time, S was B's "former counsel." *Id.* Nevertheless, B "suspected that [S] used confidential information to [B's] detriment in the bankruptcy [case]," and sued S in the district court. *Id.* at *4. After further procedural litigation setbacks, B eventually "asked the bankruptcy court for permission to bring his claims [against S] in district court," explaining that "a number of his claims against [S] were based on pre-bankruptcy conduct … so they didn't relate to [S's] actions on the [Committee]." The bankruptcy court refused to separate B's pre-bankruptcy claims from S's actions as a member of the Committee, however, denying B permission to sue in the district court and dismissing B's "claims on the merits." The district court affirmed the bankruptcy court on appeal. *Id.* at *5-*6.

Ninth Circuit Analysis

The court rejected B's attempt to distinguish *Barton* and its progeny. First, as a member of the Committee, S was authorized to "maximize recovery for the creditors by increasing the size of the [debtor's] estate … . Because creditors have interests that are closely aligned with those of the bankruptcy trustee, there's good reason to treat the two the same for purposes of the *Barton* doctrine." *Id.* at *8. In addition, reasoned the court, creditors, as Committee members, are required by the Bankruptcy Code ("Code") to "investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business." *Id.*, quoting Code §1103(c)(2). They not only "participate in the formulation of a [reorganization] plan," but also may "examine the debtor." *Id.*, citing Code §§1103(c)(3) and 343. Litigation outside the bankruptcy court, reasoned the Ninth Circuit, "could seriously interfere with already complicated bankruptcy proceedings." *Id.* The mere "fear that such a lawsuit could be filed" and that Committee members would be forced to litigate "in a court unfamiliar with bankruptcy proceedings" might cause these individuals "to be timid in discharging their duties." *Id.* Therefore, found the Ninth Circuit, "*Barton* applies to [Committee] members like [S] who are sued for acts performed in their official capacities," meaning that all such litigation "must be brought in the bankruptcy court" in the first instance. *Id.* at *9. But if a plaintiff wishes to sue in another court, it must obtain "the express permission of the bankruptcy court." *Id.*

Pre-Bankruptcy Claims

The Ninth Circuit also reversed the bankruptcy court's broad dismissal of B's claims based on S's pre-bankruptcy representation. According to B, S "gave dubious legal advice [prior to bankruptcy] about how [B] could use funds from [a lender's] loan," resulting in B's becoming "the target of a shareholder

lawsuit." *Id.* B also challenged S's inadequate representation "during the shareholder litigation and [B's] divorce by overlooking key defenses and [by] drafting" agreements that were later held unenforceable. *Id.*

The Ninth Circuit stressed that B's "pre-petition claims have nothing to do with [S's] position on the [Committee]." *Id.* at *10. Because B had "clearly separated his pre-petition claims from the post-petition claims [implicating S's] activities on the [Committee]," B "didn't need permission from the bankruptcy court before bringing his pre-petition claims in district court," contrary to what the lower courts held. *Id.* at *10.

Post-Bankruptcy Claims

The Ninth Circuit agreed with the bankruptcy court's application of the *Barton* doctrine to B's post-bankruptcy claims because he had sought "a personal judgment against [S]." *Id.* at *11. B had attacked S's "acts done … within [S's] authority as an officer of the court." *Id.* at *10. According to the Ninth Circuit, bankruptcy courts "have applied a five-factor test to decide whether to grant leave to sue in another forum pursuant to *Barton*, or to retain jurisdiction over the claims in the bankruptcy court." *Id.* at *11. Among the criteria that bankruptcy courts have considered are: whether the allegations relate to the carrying on of the debtor's business; the actions of the officer in administering the estate; whether the officer is entitled to quasi-judicial or "derived judicial immunity"; and whether the plaintiff was seeking to hold the officer personally liable for, among other things, "either negligent or willful" breach of fiduciary duty. *Id.*

The Bankruptcy Court's Power to Hear the Dispute

The Ninth Circuit quickly rejected B's challenge to the bankruptcy court's power to decide his claims against S. Although B never consented to having his tort and contract claims heard by the bankruptcy court, his "suit against a bankruptcy court officer for actions undertaken in his official capacity necessarily 'stems from the bankruptcy itself.'" *Id.* at *14, quoting *Stern v. Marshall*, 564 U.S. 462, 499 (2011). Thus, the bankruptcy court had the requisite power to hear the post-bankruptcy claims.

But the Ninth Circuit remanded to the bankruptcy court the issue of whether S had "derivative judicial immunity for actions taken as [Committee] Chair … ." *Id.* at *14. S did not have "immunity for *all* actions as Chair." *Id.* (emphasis in original). To have such immunity, S "must have acted within the scope of his authority and 'candidly disclosed [his] proposed acts to the bankruptcy court'" with notice to the debtor and with bankruptcy court approval. *Id.*, citing *In re Harris*, 590 F.3d 730, 742 (9th Cir. 2009). If S did lack immunity, B would be allowed to conduct "discovery on his claims." *Id.*

Comments

1. The dispute in *Yellowstone* is, according to the Ninth Circuit, "but the latest chapter in the long-running saga of the Yellowstone … bankruptcy litigation." *Id.* at *3, citing *Blixseth v. Yellowstone Mountain Club, LLC*, 742 F.3d 1215, 1221-22 (9th Cir. 2014) (per curiam) (affirmed denial of B's motion to recuse bankruptcy judge; noted B's "scorched earth litigation tactics"; B's "claims are a transparent attempt to wriggle out of an unfavorable decision by smearing the reputation of the judge who made it."); *In re BLX Grp., Inc.*, 419 B.R. 457 (Bankr. D. Mont. 2009). Because of this negative litigation history, B undoubtedly wanted to litigate outside the bankruptcy court.

2. The result in *Yellowstone* is undoubtedly correct. One rationale for the *Barton* doctrine supports the result here: The "trustee in bankruptcy is an officer of the court that appoints him," which

"has a strong interest in protecting him from unjustified personal liability for acts taken within the scope of his official duties." *In re Lehal Realty Assocs.*, 101 F.3d 272, 276 (2d Cir. 1996); 1 Collier, *Bankruptc*y, ¶ 10.01[1][a], at 10-4 (16th ed. 2016). As one bankruptcy court put it, the leave requirement "enables the bankruptcy court to maintain control over the estate and furthers the goal of centralizing all creditors' claims so they can be efficiently administered." *In re Ridley Owens, Inc.*, 391 B.R. 867, 871 (Bankr. N.D. Fla. 2008). Courts have cited the need to obtain capable court officers and to ensure the cost-effective administration of estates. A further purpose of the *Barton* rule is "to prevent a party from obtaining 'some advantage over the other claimants upon the assets' in the trustee's hands." *Ridley*, 391 B.R. 867, 871, quoting *Muratore v. Darr*, 375 F. 3d 140, 147 (1st Cir. 2004). "If dissatisfied parties in bankruptcy [cases] can freely sue the trustee in another court for discretionary decisions made while administering the estate, 'that court would have the practical power to turn bankruptcy losers into bankruptcy winners and vice versa.'" *Ridley*, 391 B.R., 871, quoting *In re Linton*, 136 F.3d 544, 546 (7th Cir. 1998). According to the Seventh Circuit, the *Barton* rule "enables bankruptcy judges to monitor the work of the trustees more effectively. It does this by compelling suits growing out of that work to be as it were pre-filed before the bankruptcy judge that made the appointment; this helps the judge decide whether to approve this trustee in a subsequent case." *Linton*, 136 F.3d 544–545.

Authored by Michael L. Cook.

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or the author.

Schulte Roth&Zabel
New York | Washington DC | London
www.srz.com