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Appealing an Involuntary: Respect the Chapter 11 Trustee's Authority

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When creditors succeed in obtaining an order for relief in an involuntary Chapter 11 case and the appointment of a Chapter 11 trustee, who controls the appeals for those orders? According to an April 28, 2011 order of the U.S. District Court for the District of Nevada, the correct answer is the Chapter 11 trustee.

In a noteworthy decision offering clear guidance on the scope of a Chapter 11 trustee's powers, U.S. District Court Judge Philip M. Pro granted the motion filed by the Chapter 11 bankruptcy trustee for South Edge, LLC ("South Edge") to dismiss the appeals filed by the debtor "out-of-possession" and a majority of the debtor's members.[1] The court held that the trustee has the sole authority, in the exercise of its fiduciary duties, to unilaterally resolve this litigation by dismissing the appeals.

CHAPTER 11 TRUSTEES AND PETITIONING CREDITORS CAN RELY ON *SOUTH EDGE* FOR THE PROPOSITION THAT ONCE APPOINTED, ONLY THE CHAPTER 11 TRUSTEE CAN ACT FOR THE ESTATE.

Chapter 11 trustees and petitioning creditors can rely on *South Edge* for the proposition that once appointed, only the Chapter 11 trustee can act for the estate. The *South Edge* decision also clarifies the breadth of a bankruptcy estate and confirms the limited rights that a displaced debtor has once a Chapter 11 trustee is appointed.

BACKGROUND

In December 2010, an involuntary Chapter 11 petition was filed against South Edge in the Bankruptcy Court for the District of Nevada[2] by three undersecured lenders under South Edge's prepetition secured credit facility: JPMorgan Chase Bank, N.A. ("JPM"), Credit Agricole Corporate and Investment Bank, and Wells Fargo Bank, N.A. JPM, in its capacities as administrative agent and lender also filed a motion to appoint a Chapter 11 trustee to replace the debtor's existing management (the "Trustee Motion"). South Edge contested both the involuntary petition and the Trustee Motion.

Approximately two months later, following a trial on the merits of the involuntary petition and the Trustee Motion, the Bankruptcy Court entered orders (i) granting the involuntary petition and (ii) appointing a Chapter 11 trustee (the "Bankruptcy Orders"). The debtor "out-of-possession" and a group of its equity members (the "Appellants") filed separate appeals with the District Court (the "Appeals"). After the filing of the Appeals, the Office of the U.S. Trustee appointed, and the Bankruptcy Court approved, the appointment of a Chapter 11 trustee.

Following her appointment, the Chapter 11 trustee moved in the District Court to dismiss the Appeals (the "Motion to Dismiss"), arguing that neither of the Appellants had the standing or authority to decide whether to proceed with the Appeals on behalf of the debtor's estate. The petitioning creditors also supported those dismissals.

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The Importance of C.W. Mining

In support of the Motion to Dismiss, the moving parties relied upon a February 2011 decision from the Court of Appeals for the Tenth Circuit in *C.W. Mining Co. v. Aquila, Inc.*[3] In *C.W. Mining*, an involuntary Chapter 11 petition was filed against C.W. Mining Company ("C.W."), and Chapter 11 relief was granted. Shortly thereafter, C.W. filed a motion to reconsider the decision. In the interim, one of the petitioning creditors moved to appoint a Chapter 11 trustee or to convert the case to a Chapter 7.

The case was converted and a Chapter 7 trustee was appointed—a ruling that C.W. did not contest. After appointment of the Chapter 7 trustee, the debtor's former counsel—purporting to act on behalf of the corporation—appealed the decision to grant the involuntary petition to the Bankruptcy Appellate Panel for the Tenth Circuit (the "B.A.P.").

On appeal before the B.A.P., the Chapter 7 trustee filed a motion to dismiss on the grounds that (i) C.W. lacked standing because it was "hopelessly insolvent" and (ii) the debtor's former counsel was not authorized to file the appeal. The trustee argued that he was the only party with standing to appeal because after a trustee is appointed "in a corporate bankruptcy, former management is completely ousted."[4]

The B.A.P. rejected the trustee's standing argument, holding that the debtor (acting through its former counsel) had standing to appeal the bankruptcy court decision. Nevertheless, the B.A.P. affirmed the bankruptcy court's order on the merits. The debtor's former managers then appealed to the Court of Appeals for the Tenth Circuit. The Chapter 7 trustee cross-appealed, repeating the same standing arguments rejected by the B.A.P.

The Tenth Circuit reversed the B.A.P.'s decision and held that the former managers lacked the authority to appeal on the debtor's behalf following appointment of a trustee.[5] Nevertheless, the court recognized C.W.'s standing to appeal the order for relief, since the debtor met the "person aggrieved" standard for standing. The court noted: "the order putting [C.W.] into involuntary bankruptcy certainly appears to have affected [C.W.'s] pecuniary interests directly and adversely…"[6]

Authorized Agent is the Trustee

Notwithstanding C.W.'s standing, the Tenth Circuit framed the issue as whether the debtor's former managers had authority to assert the appeal. The court noted that corporations can only act through authorized agents; in the case of a Chapter 7 bankruptcy following the appointment of a trustee, the court held that such authorized agent is the Chapter 7 trustee.

In reaching its decision, the court reviewed United States Supreme Court precedent[7] holding that only a Chapter 7 trustee—not a debtor's former management—has the power to waive the attorney-client privilege on behalf of a corporate Chapter 7 debtor. In *Weintraub*, the Court determined that only active managers may exercise attorney-client privilege on behalf of a corporation because former managers no longer have any role. In the Chapter 7 context, the trustee is effectively the debtor's management. The role and powers of the debtor's former management are "severely limited"—confined to the role of turning over the debtor's property to the trustee.[8] Following appointment of a Chapter 7 trustee, the "debtor's directors are 'completely ousted.'"[9]

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Only Trustee Has Ability to Appeal

Relying on *Weintraub*, the Tenth Circuit concluded that the B.A.P. confused "C.W.'s right to appeal with C.W.'s former management's right to bring C.W.'s appeal."[10] The court agreed with the B.A.P. that "the Bankruptcy Code gives a putative involuntary debtor the right to challenge the involuntary petition." However, the operative issue involved who had the ability to bring C.W.'s appeal. The court held that "the decision to appeal must be made by the [Chapter 7 trustee] after identifying the best interests of the estate."[11]

Moreover, in response to the former manager's "equity arguments," the court asserted that its ruling was not "unfair, because we are not denying C.W. the right to appeal . . . we merely reaffirm that only the [Chapter 7] has the right to bring C.W.'s appeal."[12]

SOUTH EDGE DECISION

In granting the Motion to Dismiss, Judge Pro held that only the Chapter 11 trustee (not the debtor "out-of-possession", South Edge, or its equity members) had the authority to decide whether to continue pursuing the appeals of the Bankruptcy Orders. Although the Court of Appeals for the Ninth Circuit had never addressed the issue of whether a Chapter 11 trustee could dismiss an appeal filed by a debtor before a trustee was appointed, Judge Pro presumed, "if the Ninth Circuit did address the issue, it would follow the reasoning in the Tenth Circuit's opinion in *C.W. Mining*."[13]

No Meaningful Distinction Between Chapter 7 and Chapter 11 Trustees

The Appellants proffered numerous reasons why the Appeals should not be dismissed, but Judge Pro rejected each of their points and adopted the arguments proffered by JPM, Credit Agricole, and the Chapter 11 trustee, respectively. For example, in response to the debtor's argument that *C.W. Mining* recognized differences between Chapter 7 and Chapter 11 bankruptcies, Judge Pro noted that "A chapter 11 trustee displaces former management just as a chapter 7 trustee does, and no basis exists to permit ousted management to appeal over the chapter 11 trustee's objection anymore than in a chapter 7 case."[14]

Moreover, Judge Pro stated that even though former managers could appeal a decision *before* a trustee is appointed, once the trustee is appointed, only the trustee has the authority to decide whether to continue to pursue an appeal on the debtor's behalf.[15]

Right of Appeal Is Estate Property

Judge Pro also rejected the debtor's argument that the appeal belonged to a Chapter 11 debtor and not its estate, holding instead that the right to appeal is not post-petition property of the debtor, rather it belongs to the estate.[16]

No Denial of Constitutional Right to Appeal

South Edge and the members contended that granting the Motion to Dismiss would deny their constitutional right to appeal. Judge Pro rejected this argument, finding that the entity, South Edge, retained its appeal right. The issue was who controlled the appeal, and that issue did not raise constitutional concerns. Judge Pro also agreed with the Chapter 11 trustee, Credit Agricole and JPM that South Edge was not deprived of its constitutional right to an appeal because it had the opportunity to seek a stay of the Bankruptcy Orders pending appeal, but failed to do so.

THE RIGHT TO APPEAL IS NOT POST-PETITION PROPERTY OF THE DEBTOR, RATHER IT BELONGS TO THE ESTATE.

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Similarly, South Edge argued that in practical effect it was being deprived of its appeal rights because a chapter 11 trustee would never pursue an appeal of a decision providing for its own appointment. Judge Pro rejected this argument, because it presumed that a trustee would breach its' fiduciary duties. To the extent South Edge believed the Chapter 11 trustee breached her fiduciary duties by failing to pursue an appeal the court noted that the proper remedy would be to seek removal of the Trustee, not to pursue an appeal on South Edge's behalf.[17]

Bankruptcy Court Retains Jurisdiction

Finally, South Edge contended that because it appealed the Bankruptcy Orders prior to the actual appointment of the Chapter 11 trustee, the Bankruptcy Court was deprived of jurisdiction to enter the order that actually appointed the Chapter 11 trustee. Judge Pro found this argument unavailing, citing to Ninth Circuit precedent that clearly provides a trial court with the right to enforce a judgment or order absent a stay of same. To rule otherwise would "permit appellants to obtain a de facto stay" of the underlying order or judgment in dispute.

CONCLUSION

Although currently on appeal to the Ninth Circuit, for now the *South Edge* decision provides petitioning creditors with much-needed clarification on the scope of a Chapter 11 trustee's powers to direct and control appellate matters commenced before the trustee assumes control of the debtor's estate. It remains to be seen whether the decisions in *C.W. Mining* and *South Edge* will become the prevailing view among the circuit courts nationwide.

For now, creditors can take some comfort: even if the underlying decision to grant an involuntary petition or appoint a Chapter 11 trustee is appealed, the petitioners may not have to undertake a multi-front defense of those issues. *South Edge* stands for the premise that only the Chapter 11 trustee will be able to dictate the future course of those matters.

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[1] *South Edge LLC v. JPMorgan Chase Bank, N.A.,* No. 11-CV-00240, 00301, 2011 WL 1626567 (D. Nev. Apr. 28, 2011).

[2] *In re South Edge, LLC*, No. 10-32968 (Bankr. D. Nev. Dec. 9, 2010).

[3] *C.W. Mining Co. v. Aquila, Inc. (In re C.W. Mining Co.)*, 636 F.3d 1257 (10th Cir. 2011).

[4] *C.W. Mining Co. v. Aquila, Inc. (In re C.W. Mining Co.)*, BAP No. UT-08-102 2009 Bankr. LEXIS 3943, at *11 (B.A.P. 10th Cir. Dec. 14, 2009), aff'd sub nom *Std. Indus. v. Aquila Inc. (In re C.W. Mining Co.)*, 625 F.3d 1240 (10th Cir. 2010).

[5] *C.W. Mining*, 636 F.3d at 1263.

[6] *Id*. at 1261.

[7] *See Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343 (1985).

[8] *Id*. at 352.

[9] *Id*. at 352-3

[10] *C.W. Mining Co.*, 636 F.3d at 1263.

[11] *Id.*

[12] *Id.* at 1264 (internal citations omitted).

[13] 2011 WL 1626567, at *5.

[14] *Id.*

[15] *Id*. at *6.

[16] *Id*. (citations omitted).

[17] *Id.* at *9 (citations omitted).

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