

Client Alert

April 27, 2016

UCC Standing Blocked in Recent *Sabine* Decision

By James M. Peck and Benjamin Butterfield

What showing must creditors make to be granted the right to prosecute claims on behalf of the bankruptcy estate? Under the widely recognized standard established by the Second Circuit in *In re STN Enterprises*, a bankruptcy court will grant standing to a creditor where the debtor has “unjustifiably failed” to bring “colorable” claims that are “likely to benefit the reorganization estate.”¹ A recent Southern District of New York Bankruptcy Court decision, *In re Sabine Oil & Gas Corp.*,² demonstrates that these discretionary standards may be applied restrictively and serves as an important reminder that bankruptcy courts take their role as gatekeepers seriously and will not rubber-stamp a request for derivative standing that may materially alter the balance of power between the debtor in possession and its creditors.

SECOND CIRCUIT STANDARD

The doctrine of derivative standing has no express statutory basis in the Bankruptcy Code. In *STN Enterprises*, the Second Circuit agreed with the majority of bankruptcy courts and recognized an implied right of creditors’ committees to initiate adversary proceedings in the name of a debtor in possession. To obtain so-called “*STN* standing,” a creditor must present a colorable claim for relief “that on appropriate proof would support a recovery,” and show that the debtor “unjustifiably failed to bring suit.”³

BACKGROUND

In *Sabine*, the unsecured creditors’ committee (UCC) sought *STN* standing to assert a variety of claims arising from a December 2014 merger between Forest Oil Corporation and Sabine Oil & Gas LLC, as well as from related financing transactions. Both companies were heavily indebted prior to the merger: Forest Oil and Sabine had approximately \$900 million and \$1.6 billion of funded debt, respectively. Sabine’s debt obligations were guaranteed and secured by the assets of its subsidiaries.

Forest Oil and Sabine had initially entered into a merger agreement in May 2014. The merger was put on hold when the companies learned that certain investors were shorting Forest Oil’s unsecured notes (which had risen in value when the companies announced a redemption in connection with the planned merger) and were planning to vote against the merger in an effort to drive down the trading price of the notes. To defeat this strategy, the companies restructured the merger agreement and secured amendments to the various commitment letters required to finance the merger.

¹ *Unsecured Creditors Comm. of Debtor STN Enters. Inc. v. Noyes (In re STN Enterprises)*, 779 F.2d 901, 905 (2d Cir. 1985).

² *In re Sabine Oil & Gas Corp.*, Case No. 15-11835 (SCC), 2016 WL 1320279 (Bankr. S.D.N.Y. Mar. 31, 2016).

³ *STN Enterprises*, 779 F.2d at 905.

Client Alert

After the announcement of the amended merger agreement, both companies faced declining operating performance associated with commodity pricing, which threatened the combined company's ability to comply with financial covenants contained in the commitment letters. The companies again restructured the merger agreement, eliminating the need to redeem Forest Oil's unsecured notes and securing relief from certain of the financial covenants. The merger closed on December 16, 2014. The combined company filed for bankruptcy on July 15, 2015.

The UCC began investigating potential causes of action related to the merger, and filed a motion seeking *STN* standing to assert claims against parties involved with the transaction. The UCC sought, among other things, to assert constructive fraudulent conveyance claims, as well as claims for so-called "bad acts," including intentional fraudulent transfer and breach of fiduciary duty. The UCC's motion was vigorously contested by the debtors and other parties.

STN STANDING DENIED

The hearing on the UCC's motion took place over the course of 15 days, and included nine days of live witness testimony from seven witnesses, over 400 exhibits, and five days of closing arguments. The duration of the hearing is an indication that all parties viewed the standing question as critically important.

The court explained that the inquiry as to whether a claim is colorable under *STN* is similar to that undertaken by a court on a motion to dismiss. While the issue of colorability is not designed to truncate the discovery process if a lawsuit is viable, consistent with the common meaning of colorable, the claims to be asserted must be "plausible" and "not without some merit."⁴ A court will deny *STN* standing to pursue meritless claims, because estate funds "ought not be squandered through continued litigation" of such claims.⁵ When evaluating a request for *STN* standing, a court should weigh the likelihood of success, the anticipated costs of litigation, and the basis for recovery. In addition, a court is also permitted to consider "common sense" factors, including whether granting standing to the committee will allow the debtor to concentrate its resources on reorganization, whether the committee's interests conflict with those of the estate, and whether the arrangement would prejudice distribution rights among creditors.⁶

The court ultimately denied the UCC's request for *STN* standing in its entirety. Viewing the various steps of the merger as one transaction, the court found that the majority of the UCC's claims for constructive fraudulent transfer were not colorable, because the two companies had simply refinanced their pre-merger debt with post-merger debt. With respect to the UCC's claims for various "bad acts" related to the merger transaction, the court determined that the UCC's theory—that Sabine's private equity sponsor and the combined companies' lenders had re-engineered the merger transaction to shift losses to unsecured creditors—was "implausible," "at odds with common sense," and "overwhelmingly contradicted by the voluminous record established" during the proceeding.⁷

⁴ *Sabine*, 2016 WL 1320279, at *4 (citing *In re Adelpia Commc'ns Corp.*, 330 B.R. 364, 376 (Bankr. S.D.N.Y. 2005)).

⁵ *Id.* (citing *In re Am.'s Hobby Ctr., Inc.*, 223 B.R. 275, 288 (Bankr. S.D.N.Y. 1998)).

⁶ *Id.* (citing *Adelpia*, 330 B.R. at 375).

⁷ *Id.* at *28.

Client Alert

With respect to the colorable claims, which belonged to the estates of Sabine's subsidiaries, the court observed that, while the value of those claims could not be quantified, it likely would not exceed \$68 million, while the cost of litigating the claims would be \$20 million to \$30 million. Weighing the costs and benefits, as well as the potential litigation risk, the court concluded that the *Sabine* debtors had justifiably refused to bring the claims.⁸

THE STRUGGLE OVER STANDING IS NOT OVER

The UCC has appealed the decision of the bankruptcy court and continues in its quest for derivative standing. Within the past week, the bankruptcy court denied the UCC's motion for a stay pending appeal to the district court, stating that issuance of a stay would lead to the "absurd" result of ceding control of cases to "disappointed litigants." Oral argument on the appeal has been scheduled for June 10, 2016. These developments are indicative of the challenges faced by parties seeking to overcome an adverse bankruptcy court decision.

TAKEAWAYS

The decision in *Sabine* is a warning to creditors' committees that may reflexively seek *STN* standing to prosecute estate claims: The routine request for derivative standing does not mean that standing will be granted. Application of the *STN* standard is fact-specific and heavily dependent on subjective judicial assessment.

In *Sabine*, perception of the UCC's motives may have played an important role in the court's decision. The court seemed to be influenced by the fact that the UCC had requested standing to assert selected claims, but not other claims based on the same legal theories, and noted that the proposed claims would simply reallocate proceeds from one creditor to another without augmenting the *Sabine* estate. This suggests that *STN* standing may be more difficult to achieve in settings where the claim does not aim to bring assets into the estate. The court distinguished the facts in *Sabine* from those in *Adelphia*, where *STN* standing was granted, noting that the *Adelphia* debtors supported the UCC's bid for standing, while the *Sabine* debtors did not. Finally, the court seemed unimpressed with the potential for recovery on the UCC's claims, particularly in light of the massive amount of estate resources that would be deployed to prosecute them.

In short, the *Sabine* decision is a reminder that the *STN* standards provide a bankruptcy judge with significant discretion to deny a creditor's request for standing if the court believes that pursuing the claims is not in the best interest of the estate or could materially impede the reorganization process.

Contact:

James M. Peck
(212) 468-8094
jpeck@mofo.com

Benjamin Butterfield
(212) 336-4157
bbutterfield@mofo.com

⁸ *Id.* at *48.

Client Alert

About Morrison & Foerster:

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life science companies. We've been included on *The American Lawyer's* A-List for 12 straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations. Prior results do not guarantee a similar outcome.