



## Inconsistent Standards to Approve a Settlement Under Rule 9019

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### Introduction

“Settlements and compromises are favored in bankruptcy as they minimize costly litigation and further parties’ interests in expediting the administration of the bankruptcy estate.”<sup>1</sup> In accordance with this policy, Congress promulgated Federal Rule of Bankruptcy Procedure 9019 (the “Bankruptcy Rules”), which governs settlements in a bankruptcy case.<sup>2</sup> Rule 9019 gives a bankruptcy judge discretion to approve a proposed settlement and states in relevant part, that: “[o]n motion by the trustee, the court may approve a compromise or settlement.”<sup>3</sup> Rule 9019 applies to both settlements brought before the court on a standalone basis as well as those presented as part of a chapter 11 plan.<sup>4</sup>

Although settlements are generally preferred in bankruptcy litigation, not all creditors may accept the terms of a given settlement. Rule 9019 settlements are often confirmed over the objection of prepetition unsecured creditors, even when it alters the normal order of priority of distribution. However, prepetition unsecured creditors have rights, albeit limited, and

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<sup>1</sup> *In re Dewey & LeBoeuf LLP*, 478 B.R. 627, 640 (Bankr. S.D.N.Y. 2012).

<sup>2</sup> Fed. R. Bankr. P. 9019(a).

<sup>3</sup> *Id.*

<sup>4</sup> *Motorola, Inc. v. Official Comm. of Unsecured Creditors (In re Iridium Operating LLC)*, 478 F.3d 452, 461 (2d Cir. 2007) (quoting *In re Masters, Inc.*, 141 B.R. 13, 16 (Bankr. E.D.N.Y. 1992)).

settlements between the debtor and other prepetition unsecured creditors can unduly harm their interests in the absence of proper judicial discretion. A question has arisen as to what standard bankruptcy judges must follow in deciding whether to approve a trustee's Rule 9019 settlement proposal over the objection of other unsecured creditors. A separate question has also arisen about whether a bankruptcy judge can ever approve a settlement when it adversely affects rights of parties not involved in the settlement negotiations.<sup>5</sup> Part I of this article defines the standards set out by the Supreme Court and Second Circuit which limit a bankruptcy judge's discretion. Part II discusses the issue of whether a bankruptcy court abuses its discretion if it approves a settlement that adversely affects the rights of parties not involved in the settlement negotiations for a proposed Rule 9019 settlement.

## **I. General Standards for the Approval of a Settlement**

### **A. The Supreme Court's Fair and Equitable Standard**

The purpose of Rule 9019 is to “to prevent the making of concealed agreements that are unknown to the creditors and unevaluated by the court.”<sup>6</sup> The court must learn “all facts necessary for an intelligent and objective opinion of the probabilities of ultimate success should the claim be litigated,” and to “make an informed and independent judgment as to whether a proposed compromise is “fair and equitable.”<sup>7</sup> The Supreme Court has instructed that a bankruptcy judge should form an educated estimate of the “complexity, expense, likely duration of such litigation, the possible difficulties of collecting on any judgment which might be obtained, and all other factors relevant to a full and fair assessment of the wisdom of the proposed compromise.”<sup>8</sup> While the court clearly has an obligation to investigate the factual situation, it is not necessary for the court to conduct a “mini-trial” of the facts or the merits

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<sup>5</sup> *In re Miami Metals I, Inc.*, 603 BR 531, 531 (Bankr. S.D.N.Y. 2019).

<sup>6</sup> *See In re Iridium Operating LLC*, 478 F.3d at 461 (quoting *In re Masters, Inc.*, 141 B.R. at 16).

<sup>7</sup> *See Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson*, 390 U.S. 414, 424 (1968).

<sup>8</sup> *Id.*

underlying the dispute being settled.<sup>9</sup> Rather, the court should "canvass the issues and see whether the settlement fall[s] below the lowest point in the range of reasonableness."<sup>10</sup>

### **B. The Fair and Equitable Standard and its Connection to Section 1129(b)(2)(B)(ii) of the Bankruptcy Code**

Both the Fifth and Second Circuits interpreted the phrase "fair and equitable" to be derived from section 1129(b)(2)(B)(ii) of title 11 of the United States Code (the "Bankruptcy Code"), which describes the conditions under which a plan of reorganization may be approved notwithstanding the objections of an impaired class of creditors, a situation known as a "cramdown."<sup>11</sup> The implication from this interpretation is that "a settlement presented for approval as part of a plan of reorganization, because it constitutes part of the plan, may only be approved if it, too, is 'fair and equitable' in the sense of conforming to the absolute priority rule."<sup>12</sup> The absolute priority rule holds that senior creditors must be paid in full before junior creditors are paid, unless the senior creditors consent to subordinate some of their claims to said unsecured creditors.<sup>13</sup>

However, when a settlement is presented *outside* of a reorganization plan, section 1129 is not implicated by statutory language. In order to provide all unsecured creditors proper protection in both pre-plan and in-plan settlements, both the Fifth and Second Circuits have articulated tests that reflect the importance of the absolute priority rule in a bankruptcy judge's fairness and equitability analysis.<sup>14</sup> While the Fifth Circuit requires that the absolute priority rule apply to pre-plan settlements, the Second Circuit found that approach to be too rigid and denied

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<sup>9</sup> *In re Adelpnia Comm'ns Corp.*, 327 B.R. 143, 158 (Bankr. S.D.N.Y. 2005).

<sup>10</sup> *In re WT. Grant Co.*, 699 F.2d 599, 608 (2d Cir. 1983).

<sup>11</sup> *In re Iridium Operating LLC*, 478 F.3d at 462; 11 USC § 1129(b)(2)(B)(ii) ("the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property, except that in a case in which the debtor is an individual, the debtor may retain property included in the estate under section 1115, subject to the requirements of subsection (a)(14) of this section.").

<sup>12</sup> *See TMT Trailer Ferry*, 390 U.S. at 424; *In re Iridium Operating LLC*, 478 F.3d at 463.

<sup>13</sup> 11 U.S.C. § 1129(b)(2)(B)(ii).

<sup>14</sup> *In re Iridium Operating LLC*, 478 F.3d at 463-65.

to adopt a per se rule, even though that same court noted that rejection of a per se rule creates a heightened risk that the parties to a settlement may engage in “improper collusion.”<sup>15</sup>

### **C. The Fifth Circuit’s Rigid Per Se Rule**

The Fifth Circuit recognized that “[w]ithout the requirement that [out of plan] settlements conform to the absolute priority rule, only the bankruptcy court’s invocation of Rule 9019 factors would protect the interests of any nonsignatory intermediate or impaired creditors.”<sup>16</sup> In an effort to mitigate this concern, it adopted a per se rule where the “absolute priority rule should also apply to pre-plan settlements, concluding that ‘a bankruptcy court abuses its discretion in approving a [pre-plan] settlement with a junior creditor unless the court concludes that priority of payment will be respected as to objecting senior creditors.’”<sup>17</sup> The ruling requires strict adherence to the absolute priority rule, and therefore, “a bankruptcy court abuses its discretion in approving a settlement with a junior creditor unless the court concludes that priority of payment will be respected as to objecting senior creditors.”<sup>18</sup> The court reasoned that if the standard had no application before confirmation of a reorganization plan, then bankruptcy courts would have the discretion to favor junior classes of creditors so long as the approval of the settlement came before the plan.<sup>19</sup>

### **D. The Second Circuit’s Less Rigid Seven Factor Test**

In *In re Iridium Operating LLC*, the Second Circuit held that a bankruptcy court may approve a settlement that does not fully comply with the absolute priority rule if other factors weigh in favor of approval and the parties give sufficient justification.<sup>20</sup> In a chapter 11 case, whether a settlement’s distribution scheme complies with the Bankruptcy Code’s priority

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<sup>15</sup> *Id.* at 464.

<sup>16</sup> *Id.* at 463.

<sup>17</sup> *In re AWECO, Inc.*, 725 F.2d 293, 298 (5th Cir. 1984).

<sup>18</sup> *Id.* at 298.

<sup>19</sup> *Id.*

<sup>20</sup> *In re Iridium Operating LLC*, 478 F.3d at 465.

requirements is the most important factor in deciding whether a settlement is fair and equitable, although it is not dispositive.<sup>21</sup> A creditor's committee has a fiduciary duty to maximize recovery of an estate's assets, and if in pursuit of that duty it reaches a settlement that in some way impairs the rule of priorities, then it must state "specific and credible grounds to justify the deviation."<sup>22</sup>

With this policy of judicial deference in mind, the court articulated seven factors that must be considered in analyzing the fairness and equitability of a proposed settlement. Those factors are: (1) the balance between the litigation's possibility of success and the settlement's future benefits; (2) the likelihood of complex and protracted litigation, "with its attendant expense, inconvenience, and delay," including the difficulty in collecting on the judgment; (3) "the paramount interests of the creditors," including each affected class's relative benefits "and the degree to which creditors either do not object to or affirmatively support the proposed settlement"; (4) whether the parties in interest support the proposed settlement; (5) the "competency and experience of counsel" supporting, and "[t]he experience and knowledge of the bankruptcy court judge" reviewing the settlement; (6) "the nature and breadth of releases to be obtained by officers and directors"; and (7) "the extent to which the settlement is the product of arm's length bargaining."<sup>23</sup>

In *In re Iridium*, a former subsidiary of Motorola, Inc. ("Motorola"), Iridium Operating LCC ("Iridium"), filed for protection under chapter 11 of the Bankruptcy Code.<sup>24</sup> There, a group of lenders represented by JPMorgan Chase Bank, N.A. ("Lenders"), asserted liens over most of the assets that Iridium still owned.<sup>25</sup> However, the Official Committee of Unsecured Creditors

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<sup>21</sup> *Id.* at 464.

<sup>22</sup> *Id.* at 466.

<sup>23</sup> *Id.* at 462 (quoting *In re WorldCom, Inc.*, 347 B.R. 123, 137 (Bankr. S.D.N.Y. 2006)).

<sup>24</sup> *In re Iridium Operating LLC*, 478 F.3d at 456.

<sup>25</sup> *Id.*

("Committee") contested those liens, and especially objected to the Lenders' claim to the remaining cash in Iridium's Chase accounts.<sup>26</sup> The Committee also attempted to pursue litigation against Motorola, Iridium's former parent company, but did not have the funds.<sup>27</sup> Ultimately, the Committee and the Lenders negotiated a pre-plan settlement (the "Settlement").<sup>28</sup> The Settlement's terms included concession of the liens, distribution of estate cash to the Lenders, as well as distribution of cash to fund a litigation vehicle ("ILLLC") designed to sue Motorola.<sup>29</sup> Motorola was an administrative creditor and objected on the grounds that the Settlement would distribute estate property to lower priority creditors before any payments were made to Motorola.<sup>30</sup> The bankruptcy court approved the settlement, holding that it was "fair, reasonable, and in the best interests of the estate," even though it violated the absolute priority rule.<sup>31</sup> Motorola subsequently appealed to the district court, and the District Court reversed.<sup>32</sup>

With regard to the first two factors, the District Court favored the Settlement because it determined that litigation was unlikely to be successful for the estate and that the Settlement offered far more benefits. Furthermore, the litigation would be complex and drawn out and would cost the parties more than if they agreed to settle.<sup>33</sup> Essentially, with litigation being an expensive venture which offered little reward, the first two factors weighed in favor of approving the Settlement.<sup>34</sup> The third and fourth factors required the court to evaluate the creditors' interests as well as their amenability to the proposed Settlement. The court recognized that every

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<sup>26</sup> *Id.*

<sup>27</sup> *Id.*

<sup>28</sup> *Id.* at 458.

<sup>29</sup> *Id.* at 459.

<sup>30</sup> *Id.*

<sup>31</sup> *Id.* at 460.

<sup>32</sup> *Id.*

<sup>33</sup> *Id.* at 465.

<sup>34</sup> *Id.*

creditor except Motorola was in favor of the Settlement, which indicated that creditors believed the Settlement was in their interests.<sup>35</sup>

With respect to the fifth and seventh factors, counsel on both sides, as well as the bankruptcy court judge, are competent and experienced, and the Settlement was “negotiated in good faith and at arms-length by the parties.”<sup>36</sup> When counsel is effective and the settlement is negotiated in good faith, the court is more likely to look favorably upon a settlement, as it further supports factors (3) and (4).<sup>37</sup> However, the court noted that while not dispositive, whether the settlement’s terms adhere to the absolute priority rule is extremely important in determining whether the settlement is fair and equitable.<sup>38</sup> Furthermore, a creditor’s committee has a fiduciary duty to maximize recovery of an estate’s assets, and if in pursuit of that duty it reaches a settlement that in some way impairs the rule of priorities, then it must state “specific and credible grounds to justify the deviation.”<sup>39</sup> Here, the Settlement would not have adhered to the rule of absolute priority and the Creditor’s Committee who would benefit most from the settlement could not provide the court with any reasoning for why they should be allowed to deviate from the rule of priorities.<sup>40</sup> Even though almost all of the factors weighed in favor of approving the Settlement (including near unanimous support), the fact that the Settlement did not adhere to the rule of priorities pushed the court to remand the case for clarification of why the Settlement requires a deviation from the rule.

## **II. Rule 9019 Requires Settlements to be Fair and Equitable to Non-Settling Parties**

“Where the rights of one who is not a party to a settlement are at stake, the fairness of the settlement to the settling parties is not enough to earn the judicial stamp of approval . . . [I]f

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<sup>35</sup> *Id.*

<sup>36</sup> *Id.*

<sup>37</sup> The court did not do a factor (6) analysis.

<sup>38</sup> *Id.*

<sup>39</sup> *Id.*

<sup>40</sup> *Id.* at 467.

third parties complain to a judge that a decree will be inequitable because it will harm them unjustly, he cannot just brush their complaints aside.”<sup>41</sup> Notwithstanding the factors set out in *In re Iridium*, the Second Circuit has made it clear “that when the rights of non-settling parties are implicated by the terms of a settlement, the court cannot approve it without considering the interests of those non-settling parties.”<sup>42</sup>

In *In re Miami Metals I, Inc.*, a New York bankruptcy court held that a settlement could not be approved because it adversely affected rights of non-parties thereto.<sup>43</sup> In that case, Miami Metals I, Inc. filed a voluntary petition for relief under chapter 11 of the Bankruptcy Code.<sup>44</sup> The official committee of unsecured creditors (the “Creditors’ Committee”) and the senior lenders agreed on terms of a settlement, which required entry into a plan support agreement (“PSA”).<sup>45</sup> Thereafter, the debtors, the Creditors’ Committee and senior lenders requested bankruptcy court approval of the settlement under Rule 9019.<sup>46</sup> A separate group of unsecured creditors who were not part of the Creditors’ Committee and therefore not signatories to the PSA objected to confirm the settlement and PSA.<sup>47</sup>

The *In re Miami* court denied the motion to approve the PSA because of: (i) the potential prejudice to the unsigned parties’ rights, and (ii) the timing of the benefits under the settlement.<sup>48</sup> First, the PSA was premised on a plan of reorganization (“Plan”) that would create a reserve of all proceeds generated by the sale of precious-metal inventory other than undisputed collateral. Although there were monies earmarked on reserve to distribute to the unsigned parties as ownership disputes were resolved, the PSA imposed a cap on the recovery of customers holding

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<sup>41</sup> *In re Masters Mates & Pilots Pension Plan & IRAP Litig.*, 957 F.2d 1020, 1026 (2d Cir. 1992).

<sup>42</sup> *Stanwich Fin. Servs. Corp. v. Pardee (In re Stanwich Fin. Servs. Corp.)*, 377 B.R. 432, 437 (Bankr. D. Conn. 2007) (citing *In re Drexel Burnham Lambert Grp.*, 995 F.2d 1138, 1146-47 (2d Cir. 1993).

<sup>43</sup> *In re Miami Metals I, Inc.*, 603 B.R. at 531.

<sup>44</sup> *Id.*

<sup>45</sup> *Id.*

<sup>46</sup> *Id.* at 532.

<sup>47</sup> *Id.*

<sup>48</sup> *Id.* at 532.



ownership claims of the precious metals (the “Customers”); a cap that could have been inadequate if the Customers prevailed on their ownership claims of the precious metals.<sup>49</sup> The PSA did not provide for any cap on the Creditors’ Committee’s recovery.<sup>50</sup> Second, the court was concerned about the timing of the benefits under the Settlement because certain benefit features were triggered automatically, whereas others would have only been triggered if the Plan was confirmed.<sup>51</sup> Effectively, the Settlement ensured that Senior Lenders would reap the full benefit of the PSA on the effective date of the Settlement, regardless of whether the Plan was confirmed, while the unsigned parties’ benefits were contingent on the Plan becoming effective.<sup>52</sup> Accordingly, the court rejected the Settlement and Plan because neither would be “fair and equitable” to the Customers under Rule 9019. The court decided that the non-settling parties would be unduly harmed by the implications of the Settlement and declined to approve it or to even do a full *In re Iridium* analysis.

## **Conclusion**

Determining whether a Rule 9019 settlement proposal is fair and equitable requires an in depth balancing test that ultimately relies on significant judicial discretion. While bankruptcy courts must follow the Supreme Court’s fair and equitable language, the Second and Fifth Circuits set out materially different tests. While the Fifth Circuit has enforced a per se absolute priority rule for pre-plan settlements in the chapter 11 context, the Second Circuit has taken a less firm approach, allowing further judicial discretion through a seven-factor balancing test set forth in *In re Iridium*. Still, deviation from the absolute priority rule is not looked upon favorably by bankruptcy courts, and parties who seek to do so much provide the court with a convincing reason. Finally, when the rights of parties not involved in settlement negotiations are

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<sup>49</sup> *Id.*

<sup>50</sup> *Id.*

<sup>51</sup> *Id.*

<sup>52</sup> *Id.*

adversely affected, a bankruptcy court must protect the rights of those objecting unsecured creditors and cannot simply ignore their interests. A settlement must be fair and equitable to non-settling parties as well.