Florida Bankruptcy Court: Chapter 11 Creditors' Committee Has No Unconditional Right to Intervene in Adversary Proceeding

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Bankruptcy and appellate courts disagree over whether a creditors' committee has the unconditional right to intervene in an adversary proceeding commenced during a chapter 11 case. The issue has created a split among the circuit courts of appeals, a majority of which have concluded that the Bankruptcy Code does provide for such a right.

The U.S. Bankruptcy Court for the Southern District of Florida recently weighed in on the controversy in *Dillworth v. Diaz (In re Bal Harbour Quarzo, LLC)*, 638 B.R. 660 (Bankr. S.D. Fla. 2022). The court rejected the majority approach, ruling that a creditors' committee established under a chapter 11 liquidating trust did not have an unconditional right to intervene in an adversary proceeding commenced by the liquidating trustee to avoid fraudulent transfers. The court also denied the committee's request for permissive intervention, finding that the committee's interests as well as the interests of the trust's beneficiaries were adequately represented by the trustee in the litigation.

Right to Be Heard in a Chapter 11 Case

Section 1109(b) of the Bankruptcy Code provides that "[a] party in interest, including the debtor, the trustee, a creditors' committee, an equity security holders' committee, a creditor, an equity security holder, or any indenture trustee, may raise and may appear and be heard on any issue in a case under this chapter."

This provision expressly provides any party in interest, including a creditors' committee, with an unconditional right to participate in a chapter 11 "case." "Case" refers to "litigation commenced by the filing with the bankruptcy court of a petition under the appropriate chapter of Title 11." *Term Loan Holder Comm. v. Ozer Grp., L.L.C. (In re Caldor Corp.)*, 303 F.3d 161, 167 (2d Cir. 2002) (internal quotation marks and citations omitted). By contrast, an "adversary proceeding" in bankruptcy is discrete litigation commenced during a bankruptcy case to, among other things: recover money or property (e.g., avoid fraudulent or preferential transfers); determine the validity, priority, or extent of a lien or other interest in property; revoke an order confirming a chapter 11 plan; or obtain injunctive relief. See Fed. R. Bankr. P. 7001.

Intervention

"Intervention" is a procedure that permits a nonparty to join ongoing litigation, either as a matter of right or at the discretion of the court, without the permission of the original litigants, generally because a judgment in the case may impact the rights of the nonparty intervenor. The ability to intervene in federal litigation is generally governed by Fed. R. Civ. P. 24, which is made applicable in its entirety to adversary proceedings commenced in a bankruptcy case by Fed. R. Bankr. P. 7024.

Fed. R. Civ. P. 24(a) provides that, on timely motion, the court *must* permit anyone to intervene who:

(1) is given an unconditional right to intervene by a federal statute; or

(2) claims an interest relating to the property or transaction that is the subject of the action, and is so situated that disposing of the action may as a practical matter impair or impede the movant's ability to protect its interest, unless existing parties adequately represent that interest.

Pursuant to Fed. R. Civ. P. 24(b), the court *may* permit anyone to intervene who:

(A) is given a conditional right to intervene by a federal statute; or

(B) has a claim or defense that shares with the main action a common question of law or fact.

Fed. R. Bankr. P. 2018 governs permissive intervention in a bankruptcy "case." It provides in part that "[i]n a case under the Code, after hearing on such notice as the court directs and for cause shown, the court may permit any interested entity to intervene generally or with respect to any specified matter."

Because section 1109(b) says nothing about "proceedings," some courts, noting the general distinction between cases and proceedings in the Bankruptcy Code and other federal statutes, have concluded that the provision applies only to bankruptcy cases and not create an unqualified right to intervene in adversary proceedings. *See Fuel Oil Supply & Terminaling v. Gulf Oil Corp.*, 762 F.2d 1283 (5th Cir. 1985). Two other circuits have, in dicta, suggested that they agree with the *Fuel Oil* approach. *See Richman v. First Women's Bank (In re Richman)*, 104 F.3d 654, 658 (4th Cir. 1997); *Vermejo Park Corp. v. Kaiser Coal Corp. (In re Kaiser Steel Corp.)*, 998 F.2d 783, 790 (10th Cir. 1993).

However, the First, Second, and Third Circuits have rejected the reasoning in *Fuel Oil*, ruling instead that section 1109(b) provides a statutory right to intervene in adversary proceedings for purposes of Fed. R. Civ. P. 24(a)(1). *See Assured Guaranty Corp. v. Fin. Oversight & Mgmt. Bd. for Puerto Rico*, 872 F.3d 57 (1st Cir. 2017); *Caldor*, 303 F.3d at 176; *Phar-Mor, Inc. v. Coopers & Lybrand*, 22 F.3d 1228, 1240 (3d Cir. 1994); *see also Smart World Techs., LLC v. Juno Online Servs., Inc. (In re Smart World Techs., LLC)*, 423 F.3d 166, 180–81 (2d Cir. 2005) (although a creditors' committee has an unconditional right to intervene in an adversary proceeding, that right does not extend to settlement of the proceeding). *See generally* Collier on Bankruptcy ¶ 1109.04 (16th ed. 2022) (discussing controversy).

In *Caldor*, the Second Circuit explained that "the plain text of § 1109(b) does not distinguish between issues that occur in ... different types of proceedings within a Chapter 11 case" and concluded that the provision applies to adversary proceedings as well as bankruptcy cases. *Caldor*, 303 F.3d at 169. According to the Second Circuit, " [a]lthough the bankruptcy rules and the [accompanying] advisory committee notes envision separate formalities for intervening in cases and adversary proceedings, they do not necessitate that the term 'case' in § 1109(b) be construed to exclude adversary proceedings." *Id.* at 173.

In *Phar-Mor*, the Third Circuit held that, consistent with its previous ruling in *In re Marin Motor Oil, Inc.*, 689 F.2d 445 (3d Cir. 1982), *cert. denied*, 459 U.S. 1207 (1983), in which it held section 1109(b) gives a creditors' committee an unconditional right to intervene in an adversary proceeding, the provision "allows creditors' committees to intervene in non-core, 'related to' proceedings pending in a bankruptcy court." According to the Third Circuit, "interests of efficiency and fair play underlie § 1109(b), and the driving force behind the Marin decision was the belief that allowing intervention into adversary proceedings would best serve those interests." *Phar-Mor*, 22 F.3d at 1240. Moreover, the court wrote, "[t]here is no reason to think that the interests underlying § 1109(b) are limited or should be limited by the jurisdictional limitations imposed on the bankruptcy courts" by the U.S. Supreme Court's decision in *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982), where the Court held that the existing grant of jurisdiction to bankruptcy courts, including the power to decide proceedings "related to those arising under the bankruptcy laws," violated Article III of the Constitution.

In *Assured Guaranty*, the First Circuit abandoned its prior citation in dicta to *Fuel Oil* in *Kowal v. Malkemus (In re Thompson)*, 965 F.2d 1136 (1st Cir. 1992), for the proposition that section 1109(b) does not afford a right to intervene under Fed. R. Civ. P. 24(a)(1). It ruled that section 1109(b) gave an unsecured creditors' committee appointed in the quasi-bankruptcy cases filed on behalf of certain Puerto Rico instrumentalities an unconditional right to intervene, within the meaning of Fed. R. Civ. P. 24(a)(1), in an adversary proceeding commenced during a case filed pursuant to the Puerto Rico Oversight, Management, and Economic Stability Act. The First Circuit explained that the text of section 1109(b) applies generally to "cases," a term that encompasses all litigation commenced by the filing of a chapter 11 petition. It agreed with a leading commentator that, "[b]ecause every issue in a case may be raised and adjudicated only in the context of a proceeding of some kind, it is apparent that the reference ... to 'any issue in a case' subsumes issues in a proceeding." *Assured Guaranty*, 872 F.3d at 63 (citing Collier on Bankruptcy ¶ 1109.04[1][a][i] (16th ed. 2016)).

Bal Harbour

In February 2018, a receiver for Florida luxury hotel development company Bal Harbour Quartzo LLC ("BHQ") filed a chapter 11 petition on BHQ's behalf in the Southern District of Florida. The bankruptcy court confirmed a liquidating chapter 11 plan for BHQ in April 2019. For the benefit of BHQ's creditors, the plan created a liquidating trust to which the estate's causes of action were transferred. The plan also created a post-confirmation creditors' committee (the "committee") to "represent the interests of the Trust Beneficiaries during the existence of the Trust."

In 2020, the liquidating trustee (the "trustee") commenced an adversary proceeding against various defendants seeking, among other things, to avoid certain fraudulent transfers. Two years afterward, the committee moved to intervene in the adversary proceeding under section 1109(b) of the Bankruptcy Code and Fed. R. Civ. P. Rules 24(a) and 24(b). According to the committee, as interpreted by the courts in *Assured Guaranty*, *Caldor*, *Marin*, and various lower courts, section 1109(b) gave it an unconditional right to intervene.

The Bankruptcy Court's Ruling

The bankruptcy court denied the committee's motion to intervene.

U.S. Bankruptcy Judge Scott M. Grossman explained that the question was whether the phrase "in a case under this chapter" in section 1109(b) means only a main chapter 11 case or also encompasses adversary proceedings within a main chapter 11 case.

Judge Grossman respectfully disagreed with the majority approach exemplified by *Caldor*. Instead, he concluded that the Fifth Circuit's reasoning in *Fuel Oil* was both more persuasive and supported by the language of section 1109(b). He reached this determination in part on the basis of "another provision of the Bankruptcy Code which clearly shows that Congress knows how to distinguish between a case and a proceeding." In particular, he explained, section 307, which is similar but not identical to section 1109(b), provides that "[t]he United States Trustee may raise and may appear and be heard on any issue in any case or proceeding *under this title* but may not file a plan pursuant to section 1121(c) of this title." *Bal Harbour*, 638 B.R. at 666 (citing 11 U.S.C. § 307 (emphasis added))

Accordingly, Judge Grossman wrote, "this Court concludes that section 1109(b) does not create an unconditional right to intervene by a creditors' committee." *Id.*

He noted that practical considerations supported the minority view:

> Under the majority view, any creditor, equity security holder, or other party in interest would have the unconditional right to intervene in any adversary proceeding associated with a chapter 11 case. This could result in erosion of the procedural due process protections afforded to litigants in an adversary proceeding, wreak havoc on any efforts at efficient case management, and ultimately render an adversary proceeding virtually indistinguishable from a main bankruptcy case.

Id. at 666 n.41. Judge Grossman also explained that creditors, committees, and other stakeholders are not without recourse if a debtor or trustee is unwilling or unable to prosecute an adversary proceeding because they can: (i) seek derivative standing to do so on the estate's behalf; or (ii) support a chapter 11 plan that transfers causes of action to a post-confirmation entity and negotiate to have a fiduciary selected who will prosecute those claims. *Id.* at 666 n.42.

Judge Grossman also denied the committee's motion for intervention under Fed. R. Civ. P. 24(a)(2). According to the judge: (i) the committee's motion was not timely (having been filed more than two years after commencement of the adversary proceeding); (ii) while the creditor beneficiaries of the trust had an economic interest in the outcome of the litigation, the committee itself did not, nor did it have any "legally cognizable interest" because those rights were specifically given to the trustee under the plan and the liquidating trust agreement, and the committee sought to intervene merely to oversee and consult with the trustee (although it reserved the right to take positions on any issues that might arise during the litigation); and (iii) because the trustee was the plaintiff, the committee could not show that its interest or the interests of the creditor beneficiaries would not be represented adequately.

In addition, Judge Grossman concluded that the committee failed to demonstrate that permissive intervention was warranted under Fed. R. Civ. P. 24(b)(1)(B). Among other things, he found that the committee had "no claim or defense in its own right that it share[d] with the adversary proceeding as a common question of law or fact." *Id.* at 669.

Finally, Judge Grossman held that the committee failed to comply with Fed. R. Civ. P. 24(c), which requires that a motion to intervene be accompanied by a pleading that sets forth the claims or defenses for which intervention is sought.

Outlook

Bal Harbour indicates that the dispute regarding whether section 1109(b) creates an unconditional right to intervene in an adversary proceeding is alive and well. The arguments on both sides of the issue are persuasive and have been fully developed by the courts in thoughtful opinions. The resulting circuit split on the issue could be an invitation to Congress or the U.S. Supreme Court to resolve the issue.

The parade of horribles alluded to by the bankruptcy court in *Bal Harbour* and *Fuel Oil* regarding the risk that adherence to the majority view could open the intervention floodgates is likely overstated. In the majority of chapter 11 cases and related adversary proceedings, committees and other stakeholders would have little incentive to burden the estate with additional expense by intervening in litigation commenced by an estate fiduciary.

Finally, as noted by the *Bal Harbour* court, stakeholders in venues embracing the minority view on intervention have other recourse if an estate fiduciary is either unwilling or unable to prosecute estate causes of action.

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