UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF COLORADO
Bankruptcy Judge Elizabeth E. Brown

In re: DVR, LLC, Debtor.	Bankruptcy Case No. 16-17064 EEB Chapter 11
In re: UTE LAKE RANCH, INC., Debtor.	Bankruptcy Case No. 16-17054 EEB Chapter 7

ORDER ALLOWING SETTLEMENT HEARING TO PROCEED

THIS MATTER comes before the Court on the Joint Motion to Approve Settlement Agreement with New Lake, LLC (the "Settlement Motion"), filed by the chapter 11 trustee of DVR, LLC ("DVR") and the chapter 7 trustee of Ute Lake Ranch, Inc. ("ULR") (collectively, the "Trustees"). The proposed settlement would compromise the amount of the $2.5 million secured claim that creditor New Lake, LLC ("New Lake") has asserted against both bankruptcy estates. Creditor Bruce Hamon ("Hamon") has filed an objection to the settlement. Prior to Trustees' Settlement Motion, Hamon had filed an adversary against New Lake and New Lake's founder, Barry Freedman ("Freedman"), seeking to entirely disallow or at least equitably subordinate both defendants' claims. As part of his objection to the settlement, Hamon has asserted that this Court must first rule on his objection to New Lake's claim in the adversary proceeding before it considers approval of the Trustees' proposed settlement agreement under Fed. R. Bankr. P. 9019. This raises a legal question of whether the statutory right of a party to object to a creditor's claim conferred by § 502(a)[1] trumps a trustee's right to settle that same claim under Rule 9019.[2] The Court agreed to rule on this potentially legally dispositive issue before conducting an evidentiary hearing on the merits of the Settlement Motion.

I. BACKGROUND

In 1999, Freedman formed DVR and later ULR to own and develop real estate in New Mexico. Freedman served as majority owner and manager of both entities. In 2002, Hamon became involved in the project and eventually acquired minority ownership interests in both Debtors. In 2006, DVR borrowed $2.5 million from First National Bank of New Mexico and

[1] All references to "section" or "§" shall refer to Title 11, United States Code, unless expressly stated otherwise.

[2] All references to "Rule" shall refer to the Federal Rules of Bankruptcy Procedure, unless expressly stated otherwise.

executed a promissory note in the same amount (the "FNB Note"). Freedman and Hamon executed the FNB Note as co-borrowers. Both Debtors granted the bank a mortgage on their real property to secure the FNB Note.

Eventually, disputes arose between Freedman, Hamon, and other equity interest holders. In 2009, Hamon and others filed suit in a Colorado state court against the Debtors and Freedman, seeking judicial dissolution of the Debtors or appointment of a receiver, and alleging claims for breach of fiduciary duty and fraudulent concealment against Freedman. While the state case was pending, DVR defaulted on the FNB Note. Freedman then formed New Lake and, through New Lake, purchased the FNB Note and related mortgages from the bank, allegedly without notice to Hamon.

On November 29, 2012, the state court entered an order for the appointment of a receiver for both entities. Cordes & Company became the Debtors' receiver (the "Receiver"). The Receiver then filed a motion asking the state court to impose a constructive trust over the FNB Note and mortgage for the benefit of the Debtors. On October 24, 2013, the state court issued an order granting that request (the "CT Order"). The CT Order further concluded that New Lake was the alter ego of Freedman and deemed that the money paid by Freedman to purchase the FNB Note and mortgage to be a capital contribution to DVR. It invalidated the liens held by New Lake and required Freedman to execute written releases. Freedman appealed both the receivership Order and the CT Order, but the appellate court dismissed the appeals as interlocutory.

The Receiver then attempted to sell the Debtors' real property. Its efforts were unsuccessful. New Lake had filed notices of lis pendens against the property to thwart the Receiver's efforts. The state court ordered New Lake and Freedman to release them, but they refused to do so. Eventually, the state court convicted Freedman of four counts of criminal and punitive contempt for his actions.

After it became clear that it would be unable to sell the real property, the Receiver filed chapter 11 petitions for both Debtors on July 18, 2016. This Court ruled that the Receiver could not act as the representative of these debtors-in-possession. The Court appointed a chapter 11 trustee in the DVR case and converted the ULR case to a chapter 7 proceeding.

In both bankruptcy cases, New Lake filed a secured proof of claim for $2,529,713.24 for the unpaid balance of the FNB Note. In his adversary proceeding, Hamon argues that New Lake has no basis to allege a secured claim because the CT Order deemed his purchase of the note to be a capital contribution, imposed a constructive trust, and terminated all liens associated with the FNB Note. However, it is unclear to this Court whether the CT Order is now a final order.

Subsequently, the Trustees sold the Debtors' real property. They then negotiated a settlement with New Lake pursuant to which New Lake would have an allowed secured claim but only against the DVR estate and only in the amount of $1.3 million. In return, New Lake agreed to release any further lien against the Debtors' properties and waived any right to appeal the CT Order for the purpose of bringing a claim against the Debtors. The Settlement Agreement specifically states that it does not preclude New Lake or any other party from challenging the CT Order for other purposes. Therefore, this settlement would not prevent New

Lake from appealing the CT Order for the purpose of preserving its claim against Hamon on the remaining balance of the note, as Hamon remains a co-maker of the FNB note.

Moreover, Freedman is not a party to the Trustees' proposed settlement. Its terms do not address the separate proofs of claim that Freedman filed against both bankruptcy estates for unsecured loans he allegedly made to the Debtors. Hamon's adversary proceeding against New Lake and Freedman includes a claim objection against Freedman's proofs of claim, as well as claims against him for equitable subordination and recharacterization of the alleged debt into equity. Since nothing in the settlement pertains to Freedman's claim, the Court is considering only whether it must issue a ruling on the merits on New Lake's claim before it considers approval of the Trustees' settlement of New Lake's claim.

II. DISCUSSION

A. The Mandatory Language of § 502

Our analysis must begin with the language of the statute. Section 502(a) provides that "[a] claim or interest, proof of which is filed under section 501 of this title, is deemed allowed, unless a party in interest . . . objects." 11 U.S.C. § 502(a). If a party objects to a claim, then §502(b) provides that the court "shall determine" the amount of the claim and "shall allow" the claim in the determined amount. *Id.* § 502(b). Hamon argues that this mandatory language prohibits the Court from considering the Trustees' proposed settlement because he is entitled to a ruling on the merits of his claim objections. At least two courts agree with him. They have concluded that an objecting party's right to a ruling on the merits cannot be abridged or modified by a trustee's settlement. *In re C.P. Hall Co.*, 513 B.R. 540, (Bankr. N.D. Ill. 2014); *In re CS Mining, LLC*, 574 B.R. 259, 281 (Bankr. D. Utah 2017).

In the first case, *In re CP Hall*, the debtor had been a distributor of asbestos products until it became embroiled in personal injury lawsuits. Its only substantial asset was an insurance policy. Some of the personal injury claimants asserted lien rights against the insurance proceeds. They began battling one another over whose lien rights were valid and superior. One individual creditor, Shipley, filed an adversary proceeding against the other purported lien claimants, objecting to their lien rights. The trustee then reached a settlement with all of the alleged lien claimants, except Shipley, wherein the trustee agreed to the allowed amount of their claims against the estate and they agreed that their claims would be treated as nonpriority unsecured claims. Shipley objected to this settlement. What the court does not explain is why Shipley would oppose a settlement in which all of the other claimants voluntarily surrendered their alleged lien rights – the very thing he sought to achieve in his adversary proceeding. Nothing in this decision indicates the settlement was attempting to invalidate Shipley's assertion of lien rights, but for whatever reason, Shipley opposed any settlement that would leave him without his day in court.

The *CP Hall* court held that § 502(b)'s mandatory language prevented approval of the settlement. "The court's obligation to rule on a claim objection is mandatory, and the creditor's right to a ruling is also unqualified." *Id.* at 544. The only exception is when the objector withdraws or settles his own claim objection. *Id.* at 545.

Perhaps the result in *CP Hall* can be explained by something in the settlement that attempted to compromise Shipley's lien rights. If so, then this case is similar to the *CS Mining* case. In *CS Mining*, several secured creditors disputed the terms of their inter-creditor agreement through claim objections and, in particular, whether that agreement required one creditor, WUMI, to convert its loan into equity. The chapter 11 debtor reached a settlement with WUMI. Its terms provided in part that WUMI would have an allowed secured claim in the amount of $23 million that would not be subject to conversion into equity, or subordinated or recharacterized in any manner. In exchange, WUMI agreed to contribute $1 million to the estate and to subordinate its lien rights to certain priority unsecured creditors. One of the other secured creditors, Waterloo, objected to this settlement. "Waterloo argues that a directly injured creditor who has objected to a claim under § 502 has a right for that objection to be heard and fully adjudicated on the merits without those rights being abridged or modified in a settlement motion under Rule 9019." *CS Mining, LLC,* 574 B.R. at 280. The *CS Mining* court was particularly concerned that insiders in control of the debtor-in-possession (the "**DIP**"), who would benefit economically from the settlement, were causing the DIP to act in bad faith in proposing the settlement. *Id.* at 276. Instead of denying approval on this basis, the court concluded that it could not consider a settlement that compromised another party's claim objection, relying on *In re CP Hall*.

> The result may be that bankruptcy courts would be required to resolve claim objections before approving a settlement. . . . However, the result is not absurd. . . . Concluding otherwise would strip creditors of their claim objection rights under the clear language of the Code. Further, a hearing under Rule 9019 would provide no solace to the objecting creditor. A Rule 9019 hearing is not a full blown trial.

Id. at 281-82 (internal citations and footnotes omitted).

The Court agrees with these courts that use of the word "shall" in § 502(b) imposes a duty on the bankruptcy court to determine the allowed amount of a claim once an objection has been filed. *See Gardner v. New Jerse*y, 329 U.S. 565, 581-82 (1947) ("When objections are made, [the court] is duty bound to pass on them."). However, this Court does not read the phrase "shall determine the amount" in § 502(b) as precluding a settlement. If parties settle a claim objection by agreeing that a creditor will have a claim in a certain amount, and the court, after applying the Rule 9019 standard, approves the settlement, then it has "determined" and "allowed" the claim.

The issue then is not whether a claim objection can be settled, but whether and to what extent a trustee or DIP can step in and halt another party's claim objection with a settlement, thereby supplanting the objecting party's role in the claim allowance process. The answer to this question is that "it depends." It depends on the nature of the claim objection.

Although not articulated, the outcome in the *CP Hall* and *CS Mining* cases may be tied to the nature of the claim objections involved. When a claim objection involves the individual rights of the objecting creditor, such as a dispute over competing lien rights, it is intrinsically different from a claim objection that only disputes a creditor's entitlement to a distribution from an estate or its assets. The *CS Mining* court had to contend with a settlement that compromised the objector's contractual lien rights under an inter-creditor agreement. Before analyzing the intended interplay between § 502 and Rule 9019, it is necessary to take a brief detour and consider further why the nature of the claim objection makes a difference in determining whether a trustee may settle it.

B. Claim Objections Based on Individual Rights of a Creditor

When the claim objection involves the individual claims of the objector against another creditor, neither the trustee, the DIP, nor the bankruptcy court has the authority to settle the objection, regardless of the powers conferred by Rule 9019. The *CS Mining* court cited to the case of *Overton's, Inc. v. Interstate Fire & Cas. Ins. Co. (In re SportStuff, Inc.)*, 430 B.R. 170 (8th Cir. BAP 2010). This case is instructive. It illustrates well why a court should not allow a trustee or DIP to propose a settlement that infringes on a third party's contractual or other legal rights.

In *SportStuff*, the debtor manufactured inflatable water sport products. One of its products injured in excess of 130 persons. Approximately one-half of these injured parties had already sued the debtor. They also sued the vendors who sold the debtor's product. The debtor had several insurance policies to cover these claims as well as the insurer's duty to defend and cover the costs of defense. These policies named the vendors as additional insureds. Postpetition, the debtor entered into a settlement with its insurers that required them to turnover to the debtor the remaining amount of their policies' proceeds. In exchange, the insurers were to receive an injunction against any further claims of any party, including the vendors. The bankruptcy court approved the settlement over the vendors' objection.

On appeal, the Eighth Circuit Bankruptcy Appellate Panel concluded that the bankruptcy court had exceeded its authority. "[T]o the extent a settlement requires a court to take an affirmative act, such as a Settlement Injunction, that act must be within the approving court's jurisdiction and authority." *Id.* at 177. "[W]hile the bankruptcy court may exercise jurisdiction over (a liability insurance) policy, the interests of the co-insured, a nondebtor, are not property of the estate. To hold otherwise would allow the court to impair a third party's contract and property rights." *Id.* at 178 n.15 (quoting Susan N.K. Gummow, *Bankruptcy and Insurance Law Manual* 166 (2nd ed., ABI 2007)).

Thus, a trustee may not use his settlement power to abridge the individual rights of a non-settling creditor or other party in interest. His settlement power allows him to compromise the claims by and against the estate, but not the claims and obligations that exist between nondebtor parties. This distinction comes up most often in the context of competing secured creditor claims, where secured creditors dispute the validity and priority of one another's liens. When it comes to settling claim objections, courts have long recognized a distinction between secured creditors and unsecured creditors. Although a trustee acts on behalf of all creditors generally, the trustee cannot always adequately represent a secured creditor because of its adverse lien rights against estate property. *See Lawrence v. Steinford Holdings B.V. (In re Dominelli)*, 820 F.2d 313, 317 (9th Cir. 1987) ("The law recognizes . . . that the trustee has interests that on occasion conflict with those of an individual secured creditor."). For this reason, a trustee should not be allowed to compromise a secured creditor's request to determine the validity, priority, or extent of a competing secured creditor's lien, absent that party's consent.

In *Dunlap v. Sentry Finance Co., Inc. (In re Johnston)*, 376 B.R. 611 (W.D. Ky. 2007), the trustee filed an adversary proceeding to determine lien rights of two competing secured creditors. Eventually, she settled the action with one of the secured creditors. In the settlement, both parties agreed that the non-settling secured creditor did not have a valid claim. Of course, this creditor objected to the settlement. The court ruled:

> These adversaries began as a three-party dispute as to certain proceeds. After discovery, two of the parties have now agreed that the third party has no claim. The Trustee states that she has decided that these proceeds correctly fall under First Tennessee's security interest. With all due respect to the Trustee, it is not her job to "decide" lawsuits. Adjudicating the rights of the parties in a lawsuit is exclusively the province of a court. The Court can understand that both the Trustee and First Tennessee want to avoid the cost of a trial, but this is not the correct way to achieve that goal. While it is true that parties are always free and, indeed, encouraged to resolve disputes through compromise and settlement, two parties may not "settle" the interest of a third non-agreeing party. Such a process improperly usurps the role of the court.

Id. at 613. Thus, when asked to approve a settlement, the Court must consider whether it attempts to compromise the rights of nondebtor third parties, without their consent. When it does, the court cannot approve it.

However, when the settlement does not involve the objecting party's individual claims and rights and is *only* attempting to compromise a creditor's claim against the estate, does the mandatory language in § 502 require a court ruling on the claim objection? Or may the estate's representative usurp the claim objection process with a settlement? To answer this question, the Court finds it instructive to consider the wider context of the Bankruptcy Code as a whole and the role it has assigned to the trustee or DIP. Understanding that role sheds light on why Congress gave the estate's representative the power to settle disputes involving the estate and its assets. Understanding the intended use of the settlement power provides greater clarity as to whether that power may be utilized to supplant a particular claim objector's role in the claim allowance process.

C. The Role of the Trustee or DIP in Estate Administration

Trustees have played a central role in bankruptcy cases since the earliest bankruptcy laws. "The bankruptcy trustees of today perform quasi-judicial functions that trace back to their sixteenth-century English predecessors." *Phoenician Mediterranean Villa, LLC v. Swope (In re J & S Prop., LLC)*, 872 F.3d 138, 149 (3d Cir. 2017) (Fisher, J., concurring). Under the Bankruptcy Act of 1867, they were called "assignees." Under the Bankruptcy Act of 1898, they became "trustees." Regardless of their title, they have always played a pivotal role. Bankruptcy is inherently a "collective" process that brings together all of a debtor's debts and assets in a single proceeding to be administered in a manner that best protects the interests of all claimants, rather than serving only the interests of one claimant. *See In re Am. Reserve Corp.*, 840 F.2d 487, 489 (7th Cir. 1988). The bankruptcy trustee serves as the administrator of this collective process. When the debtor acts as a debtor-in-possession in a chapter 11 case, it also assumes the powers and duties of a trustee. 11 U.S.C. § 1107(a).

In administering an estate, a trustee has two primary overarching duties. The first is to maximize the value of the estate. *Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 352 (1985). The second is to foster "the equitable distribution of the debtor's assets amongst his creditors." *Kuehner v. Irving Trust Co*., 299 U.S. 445, 452 (1937). Thus, Congress has given the trustee the power and duty to gather all of the property of the estate, to liquidate it and reduce it to funds, and then to distribute the funds to creditors. 11 U.S.C. § 704(a)(1). To fulfill these goals, the Bankruptcy Code gives the trustee numerous ancillary powers and duties. For example, as the estate's legal representative, the Code gives the trustee the power to sue and be sued. *Id.* § 323. He succeeds to the rights of the debtor to assert defenses to actions against the estate. *Id.* § 558. The Code holds the trustee accountable for all property of the estate, including all causes of action. *Id.* § 704(a)(2). He alone is vested with the power to bring avoidance actions to recover property for the benefit of the estate or to avoid obligations incurred. *See, e.g*., *id.* §§ 544, 545-549, 553(b), 724(a).

To assist the trustee, § 542 requires any entity who holds property of the estate to automatically turn it over to the trustee, absent unusual circumstances. He also has investigative powers. He can investigate the debtor's financial affairs. *Id.* § 704(a)(4). If a purpose would be served in doing so, a trustee must examine proofs of claims and object to the allowance of any improper claim. *Id.* § 704(a)(5). A trustee also has institutional obligations to the bankruptcy process itself, such as objecting to a debtor's discharge and reporting bankruptcy crimes when circumstances warrant such action. *Id.* § 704(a)(6); *see generally* Hon. Steven Rhodes, *The Fiduciary and Institutional Obligations of a Chapter 7 Bankruptcy Trustee*, 80 Am. Bankr. L.J. 147, 154-55 (2006); John T. Roache, *The Fiduciary Obligations of a Debtor In Possession*, 1993 U. Ill. L. Rev. 133, 144-50 (1993).

Sometimes the Code gives the trustee powers but expressly requires prior court authorization. *See, e.g.,* 11 U.S.C. § 364(c), (d) (obtaining credit on an enhanced administrative priority or secured basis); § 365(a) (assuming or rejecting executory contracts or unexpired leases); § 721 (operating the debtor's business for a limited time); § 363(c)(2) (use of cash collateral requires either consent or court authority).

In many instances, the Bankruptcy Code allows the trustee to act autonomously. If the transaction is within the ordinary course of the debtor's business or affairs, the trustee may sell, use, or lease property of the estate without notice or a court order. *Id.* § 363(c)(1). Likewise, he can borrow on an unsecured basis without a court order. *Id.* § 364(a). If the transaction is outside the ordinary course, the trustee is required to give notice but, if no one objects, he does not have to obtain court permission before selling estate property. *Id.* § 363(b)(1). Similarly, if he gives notice that he intends to borrow on an unsecured basis outside the ordinary course of business and no one objects, he does not need to wait to obtain a court order. He can abandon property of the estate without awaiting a court order, if he gives notice and no one objects. Of course, if someone objects, then the bankruptcy court must act as the final arbiter.

Some of the powers and duties of the trustee vary depending on the type of bankruptcy proceeding. In a chapter 7 case where the goal is liquidation, the trustee must collect and reduce property of the estate to money and close the estate as expeditiously as is in the best interests of parties in interest. *Id.* § 704(a)(1). In the chapter 11 context, an appointed trustee has the duty to investigate the financial condition of the debtor and determine whether to continue operating the business and then to file a plan to achieve that goal or otherwise seek conversion or dismissal. *Id.* § 1106(a)(3), (5).

Underlying these statutory duties and powers are the fiduciary duties owed by a trustee to beneficiaries of the bankruptcy estate. Trustees owe a duty of care, a duty of loyalty, and a duty of obedience, among others. *In re Dalen*, 259 B.R. 586, 610 (Bankr. W.D. Mich. 2001), Rhodes, *supra*, at 154-202 (listing twenty categories of a trustee's fiduciary duties). Sometimes these duties work at cross-purposes. For example, a chapter 7 trustee has the duty to close a case as expeditiously as possible while at the same time he has the duty to fully administer all assets of the estate. If realizing value from a particular asset will take substantial time and expense, the trustee has to balance these duties to determine whether liquidating the asset is worth delaying distributions to creditors.

A trustee owes his fiduciary obligations to a diverse group of parties in interest, including creditors (both secured and unsecured), the debtor, and equity holders. *See* Rhodes, *supra*, at 154-55; Roach, *supra*, at 144-45. These parties obviously hold different and frequently conflicting interests in the estate. A trustee will often need to make decisions that benefit the estate but harm some beneficiaries. Indeed some decisions will put the trustee in an adversarial position against beneficiaries, such as when a trustee decides to bring an avoidance action against a creditor. A trustee must also make decisions that benefit some beneficiaries to the detriment of others, such as objecting to the claim of a particular creditor for the benefit of all other creditors. As one commentator described it:

> [T]he duties and powers of the [trustee] incorporate not only the obligation to protect the estate, but also the explicit power to make choices that benefit some claimants and harm others. The [trustee] acts as an agent of loss allocation. This role and the need to choose among beneficiaries of the estate constitute a dilemma that is inherent in the role of the [trustee] in all bankruptcy cases, but which has no counterpart in other trustee or fiduciary relationships. The dilemma is neither inadvertent, nor avoidable. It is inherent in the nature of the role itself. Often, it is best to simply acknowledge the dilemma and rely on the good faith of the [trustee] to resolve it in a reasonable manner.

Raymond T. Nimmera & Richard B. Feinberg, *Chapter 11 Business Governance: Fiduciary Duties, Business Judgment, Trustees and Exclusivity*, 6 Bankr. Dev. J. 1, 27 (1989).[3]

D. The Power to Settle Controversies

1. Rule vs. Statute

As the preceding section shows, the fabric of the Bankruptcy Code is woven throughout with provisions that clothe the trustee with all the powers and duties he needs to manage the administration of a bankruptcy estate. That is, with one notable exception. There is no provision

[3] Although the authors in this article are referring to the role of the debtor-in-possession in a chapter 11 case, who exercises the powers of a trustee in a chapter 11 case, the statement holds true for a chapter 11 trustee or a chapter 7 trustee.

within the Code conferring the power to settle. This power is only set forth in a rule, Rule 9019. The concept and the language of the rule, however, first appeared in statutes in prior bankruptcy acts. The 1867 Act had a provision giving "assignees," the precursor to trustees, the power to settle controversies in the best interests of creditors. Act of March 2, 1867, Ch. 176, § 17, 14 Stat. 517, 525 (repealed 1878). The Bankruptcy Act of 1898 granted trustees the power to settle, with court approval, any controversy "arising in the administration of the estate" upon terms the trustee deemed to be in the best interests of the estate. *See* Law of July 1, 1898, Ch. 541, § 27, 30 Stat. 544, 553-54 (repealed 1979); Law of June 22, 1938, Ch. 575, § 27, 52 Stat. 840, 855 (repealed 1979). Why Congress omitted a statute on the trustee's settlement power from the Bankruptcy Code when it passed the 1978 Act remains a mystery. "[T]he legislative history relating to the repeal of [the settlement statute] affords no insight to the intent behind this discontinuity." *Hicks, Muse & Co. v. Brandt (In re Healthco Int'l, Inc.)*, 136 F.3d 45, 50 n.4 (1st Cir. 1998).

The fact that this power now resides in a rule instead of a statute has significance. Pursuant to 28 U.S.C. § 2075, which implements the Bankruptcy Rules, the Rules cannot "abridge, enlarge or modify any substantive right." 28 U.S.C. § 2075. Thus, Rule 9019 cannot override any of the substantive provisions provided in the Bankruptcy Code and "any conflict between the Bankruptcy Code and the Bankruptcy Rules must be settled in favor of the Code." *United States v. Towers (In re Pac. Atl. Trading Co.)*, 33 F.3d 1064, 1066 (9th Cir. 1994). If the provisions of Rule 9019 contradict the rights granted in § 502, then the statute will trump the rule. As discussed more fully below, however, this Court does not believe these two conflict with one another. Instead, they work in tandem.

2. Settlement Power Resides only with the Trustee or DIP

To understand how the settlement power conferred by Rule 9019 coexists with § 502, we have to first look at how the settlement power itself works. According to the Rule, the power to settle resides solely with the trustee. "*On motion by the trustee* . . . the court may approve a compromise or settlement." Rule 9019(a) (emphasis added). In *Smart World Tech., LLC v. Juno Online Serv., Inc. (In re Smart World Tech., LLC)*, 423 F.3d 166 (2d Cir. 2005), the court addressed the importance of Congress giving the settlement power only to the trustee/DIP, albeit in a different context. In *Smart World,* a purchaser of estate assets sued the DIP and the DIP counterclaimed. These two parties became embroiled in protracted litigation. All settlement attempts failed. To put an end to the fighting, creditors negotiated a settlement with the plaintiff/purchaser, but did not include the DIP. In exchange for a release of all pending claims, plaintiff agreed to make a substantial payment to the debtor's largest secured creditor. The bankruptcy court approved the settlement over the DIP's objection. The Second Circuit reversed on the basis that only the DIP, who holds the rights and powers of a trustee, may seek approval of a settlement under Rule 9019.

The Second Circuit began its analysis with the plain language of Rule 9019, which only gives standing to file a settlement motion to the trustee. It found that this rule, like many provisions in the Code, vested sole authority in the trustee to manage the estate's assets. The Second Circuit concluded that interpreting Rule 9019 to permit only a trustee to move for settlement is in "complete harmony" with the provisions of the Code. *Id.* at 175. "It is the [trustee] who controls the estate's property, including its legal claims, and it is the [trustee] who has the legal obligation to pursue claims or to settle them, based upon the best interests of the estate." *Id.* A creditor or other party in interest may object to a proposed settlement, but it cannot otherwise take control of the decision to litigate or settle a claim. Another court has ruled similarly. "The trustee is not the employee or agent of the creditors; they do not have the right to direct how the trustee chooses to perform the statutory duties of the position." *In re Vazquez*, 325 B.R. 30, 37-38 (Bankr. S.D. Fla. 2005).

Admittedly, *Smart World Tech* involved the settlement of a claim that was property of the estate, as opposed to a claim asserted against the estate. Yet it illustrates well that Congress's intention was to vest settlement authority in only one person, the estate's representative, who is either a trustee or a DIP. Conferring that power on only one person shows that the settlement power is an important tool for use in the overall management of an estate. As the adage goes, every ship has but one captain. This tool must be reserved for the person who has the duty of administering the entire estate in such a way as to maximize the recovery of all creditors in the most expeditious manner possible. If that person is no longer acting in the best interests of the estate, as the creditors in *Smart World Tech* believed, then creditors have remedies they can pursue, such as the removal and replacement of the estate's representative. What they cannot do is to usurp the fiduciary's powers.

E. § 502 Standing to Object to Claims

The settlement power is, therefore, an important arrow in the trustee's quiver. Exercising this power enables the trustee to put an end to litigation that would otherwise drain the estate's resources or delay distributions to creditors. It allows him to maximize the estate's assets while minimizing the risks inherent in litigation. That is why he might seek to compromise a claim objection brought by another party in interest. So why then did Congress give all parties in interest standing to bring a claim objection? Why not reserve that power for the trustee alone? In § 502, Congress gave the broadest possible standing to bring a claim objection to any "party in interest" and there are very good reasons to confer this broad standing. However, there are also very real problems that can arise in estate administration when an objector abuses this power. As a result, some courts have imposed restrictions on standing. This Court does not believe this approach is supported by the Code, which expressly grants broad standing. Instead the solution is to allow the objector to bring his objection, airing any legitimate grounds for doubting the claim's validity, but then to allow the trustee to come along and settle the dispute when doing so is in the best interests of the estate.

1. Definition of a Party in Interest

Section 502 allows any "party in interest" to file an objection to a claim, but it does not define this phrase. The 1898 Bankruptcy Act also used this term but did not define it. The current Bankruptcy Code uses this same phrase in forty-six different sections, but none of them provides a definition. *In re N. Am. Oil & Gas, Inc.*, 130 B.R. 473, 479 (Bankr. W.D. Tex. 1990). This omission was intentional. Congress indicated that case law should determine who is a "party in interest" for the particular purposes of the provision in question. *See* H.R. Rep. 95-595, at 352 (1978), *as reprinted in* 1978 U.S.C.C.A.N. 5963, 6308. This phrase is intended to be "an elastic and broad one designed to give the Court great latitude to insure fair representation of all constituencies impacted in any significant way" by the bankruptcy. *In re Public Serv. Co.*, 88

B.R. 546, 550-51 (Bankr. D.N.H. 1988). In interpreting its scope, courts consider the goals of bankruptcy, one of which is to "provide a forum where creditors and debtors could settle their disputes" so that the estate can be effectively administered. *Roslyn Sav. Bank v. Comcoach Corp. (In re Comcoach Corp.)*, 698 F.2d 571, 573 (2d Cir. 1983) (construing "party in interest" for purposes of § 362(d)(1)).

The Tenth Circuit has not yet defined "party in interest" in the context of § 502(a), but in another context, it ruled that "party in interest" means "all persons whose pecuniary interests are directly affected by the bankruptcy proceedings." *Nintendo Company, Ltd. v. Patten (In re Alpex Computer Corporation)*, 71 F.3d 353, 356 (10th Cir. 1995) (construing "party in interest" for purposes of § 1109). Given this definition, a "party in interest" in the claim objection context would include "those who have some interest in assets of the debtor being administered in the case." 4 *Collier on Bankruptcy* ¶ 502.2[d] (Richard Levin & Henry J. Sommer eds., 16th ed. 2017). A creditor clearly falls into this category. "[T]he right of a creditor to object to the allowance of another creditor's claim should be undisputed on principle." *Id.*

2. The Pros and Cons of Conferring Standing on Individual Creditors

There are at least two good reasons to allow individual creditors to file claim objections. Creditors are uniquely incentivized to eliminate unfounded claims. Every dollar the trustee distributes on an invalid claim is a dollar less for the legitimate claims. Conversely, by making the pool of allowed claims smaller, each of the remaining creditor's proportional share of the estate increases. In addition, creditors are often more familiar with the debtor's financial affairs and, therefore, can more readily identify problems with other claims that might not be obvious to a trustee.

On the other hand, sometimes a creditor will file a claim objection for an improper purpose. In this Court's own experience, it has seen parties abuse this privilege. For example, in one case, the former president of a chapter 11 debtor, who also held a claim against the estate, sought to derail confirmation of the debtor's plan. The proposed plan was to be funded by litigation proceeds and the former president was the intended target of that litigation. He lodged numerous claim objections on the eve of the confirmation hearing in order to deny those creditors a vote on the plan. In other cases, the Court has seen mentally ill ex-spouses object to claims as a way to continue to engage with their former spouse through the bankruptcy case. Sometimes the objector is a competitor of the debtor who purchases a claim and then uses the claim allowance process to attempt to derail the debtor's reorganization efforts. The competitor files numerous claim objections against other creditors to distract them with litigation, making it more difficult for the debtor to negotiate with these same creditors. Sometimes a creditor will use a claim objection as a way to continue litigating its preexisting dispute with another creditor. In such instances, the estate would greatly benefit from the trustee's independent judgment as to whether continued litigation is advisable.

3. Judicially-Created Restriction on Standing

In an attempt to police the legitimacy of claim objections and to discourage protracted claims litigation, some courts have adopted a judicially-created restriction on § 502(a) standing. They require the creditor to first ask the trustee to bring the claim objection. *E.g.*, *In re*

Thompson, 965 F.2d 1136, 1147 (1st Cir. 1992); *Rooke v. Reliable Home Equip. Co.*, 195 F.2d 667, 668-69 (4th Cir. 1952); *Pascazi v. Fiber Consultants, Inc.*, 445 B.R. 124 (S.D.N.Y. 2011) (citing cases). Only if the trustee unreasonably refuses to bring the objection will these courts permit the creditor to file its own claim objection.

This procedure is akin to the derivative standing doctrine that some courts apply in deciding whether to allow a creditor to pursue claims on behalf of the estate normally reserved for a trustee, such as avoidance actions. *See Official Comm. of Unsecured Creditors of Cybergenics Corp., on Behalf of Cybergenics Corp. v. Chinery*, 330 F.3d 548 (3rd Cir. 2003). These courts reason that, although the Code explicitly gives only the trustee the power to bring avoidance actions, derivative standing is a necessary equitable remedy to address situations in which "the intended system broke down" due to a trustee's unreasonable refusal to pursue an avoidance action. *Id.* at 568. The "break down" usually occurs because of a conflict of interest. *Id.* at 573. For example, a DIP that initiated preferential or fraudulent transfers prior to the bankruptcy filing may be reluctant to avoid those transfers postpetition. Derivative standing is thought to provide a "critical safeguard" against allowing conflicts to hamper the administration of the estate. *Id.*

Courts that read a derivative standing requirement into the § 502 context also do so with the goal of preventing conflicts of interest and ensuring effective administration of the estate. These courts emphasize that the trustee, who is charged with the fiduciary duty to administer the estate expeditiously in the best interests of *all* creditors, is better suited than an individual creditor to judge whether to pursue a claim objection. To allow a creditor the unfettered right to institute claim objections against other creditors, these courts reason, "enables one creditor at his own pleasure to subject any one of the other creditors, or all the other creditors, to the inconvenience and expense of unnecessary litigation, and to unduly protract the settlement of the estate." *Rooke v. Reliable Home Equip. Co.*, 195 F.2d 667, 668 (4th Cir. 1952). The Advisory Committee Notes to Fed. R. Bankr. P. 3007 echo these same concerns. "While the debtor's other creditors may make objections to the allowance of a claim, the demands of orderly and expeditious administration have led to a recognition that the right to object is generally [to be] exercised by the trustee." Fed. R. Bankr. P. 3007 advisory committee note to 1983 amendment.

In this Court's view, this judicially created restriction on standing is contrary to the plain language of § 502(a). The only limitation the statute imposes is its requirement that the objector must be a "party in interest." Moreover, the Supreme Court has stated (albeit in dicta) that it would interpret § 502(a) standing broadly. In *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1 (2000), the Supreme Court reviewed the various ways in which Congress has granted standing to parties within the Bankruptcy Code. In so doing, it stated that when Congress intended a provision of the Code to be "broadly available" it simply "said so, as it did in describing the parties who could act under . . . [§] 502(a), . . . [which] provides that a claim is allowed unless 'a party in interest' objects." *Id.* at 7.

Rather than restricting standing, a better safeguard against unnecessary claims litigation is found in recognizing the role of the trustee to settle claim objections initiated by a creditor. Allowing the creditor to initiate the claim objection brings to light possible flaws or shortcomings of the claim of which the trustee may be unaware. Once initiated, the trustee can then evaluate the merits of the claim objection. If he concludes the objection is well founded, he does nothing more and allows the objector to continue the litigation. If he finds the objection not well founded or that further litigation will cause unnecessary delay or risk to the estate, then he might propose a settlement of the claim objection. This tag-team approach allows the estate to realize a benefit that could otherwise be lost through do-or-die litigation. As long as that settlement does not abrogate the objector's individual rights, as discussed above, then the objector's due process rights are preserved. The creditor will continue to have a voice in the claim allowance process through his ability to lodge an objection to the settlement. Overall, this tandem approach promotes a quick and efficient claims administration process, which as discussed below, was Congress' intention.

F. The Goals of the Claims Allowance Process

To understand the Bankruptcy Code's current claim allowance process, we have to review its evolution over time. Under the Bankruptcy Act of 1867, claims did not enjoy a presumption of validity. Every creditor had to "prove" its claim in the bankruptcy proceeding. This process involved either a deposition in writing or on oath before the bankruptcy "register," the precursor to bankruptcy judges. Act of March 2, 1867, Ch. 176, § 22, 14 Stat. 517, 527-28. Before deciding whether to allow or reject the claim, the district court, on its own motion, or upon the application of another creditor or the bankruptcy assignee (the precursor to trustees), could summon testimony on the validity of the claim. *Id.* Under this system, creditors did not have standing to file a claim objection.

With the Bankruptcy Act of 1898, Congress shifted the paradigm. It provided that claims were allowed "unless objection to their allowance shall be made by parties in interest." Law of July 1, 1898, Ch. 541, § 57(d), 30 Stat. 544, 560 (repealed 1979). Similar to the current version of § 502(b), the 1898 Act provided that the bankruptcy court "shall" hear and determine objections to claims "as soon as the convenience of the court and the best interests of the estates and the claimants will permit." *Id.* § 57(f).

The legislative history of the 1898 Act reflects awareness of both the need to allow creditors to have a say in claims administration as well as the desire for a prompt and efficient process.

> [T]he estate, considering the nature of the property of which it consists, will be as quickly reduced to cash as possible and distributed to the creditors; that creditors will have an opportunity at each stage of the proceedings to be heard in favor of or in opposition to any proposed proceeding; that the claims of creditors will be carefully scrutinized and such as are just will be promptly allowed, at trivial expense, and such as are unjust will be rejected; that inexpensive compromises will be substituted for expensive litigation, and, all in all, that the misfortunes of men as relating to bankruptcy will be assuaged as far as possible.

31 Cong. Rec. H.1788 (Feb. 16, 1898) (statement of Rep. Henderson).

The drafters of the 1898 Act also commented on the statute conferring the settlement power on trustees. They viewed this provision as "[a]nother arm of this law for securing speed and saving expense." *Id.* Thus, the drafters of the precursor to our modern Code practice viewed the claims allowance process and the settlement power of the trustee as working in tandem.

Likewise, the Supreme Court recognized that the "settlement and compromise of claims" in bankruptcy is a "useful and fitting function" exercised by the bankruptcy court and the trustee "so that interminable litigation might be ended." *Gardner v. New Jersey*, 329 U.S. 565, 581 (1947). "Through the appropriate exercise of [the settlement] power, the court may authorize the trustee to compromise claims, secured or unsecured, and may approve equitable adjustments of them, and so reduce or otherwise affect the participation that the claimant . . . may have in the [estate]." *Id.* at 581-82. "There frequently will be situations involving conflicting claims to specific [estate] assets which may, in the discretion of the court, be more wisely settled by compromise rather than by litigation." *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106, 130 (1939).

Thus, settlements proposed by a trustee have long been an important part of the claims administration process. A trustee is required to reach an informed judgment, after diligent investigation, as to whether continued litigation of a claim objection is in the best interests of the estate and other parties in interest. This is especially important when a creditor has initiated the claim objection. A creditor owes no duty, fiduciary or otherwise, to the any other party involved in the bankruptcy case. A creditor can and will act in a manner that protects its own self-interests. Sometimes those interests will align with those of the estate, other times they will not. The trustee is required to balance the conflicting needs of the estate against those of particular creditors. In balancing those interests, it is not merely a question of the cost of continued litigation. If the creditor is funding the litigation, the estate will have little exposure for the cost. Nevertheless, the delay that litigation entails may hold up the trustee's distribution to creditors interminably. With a settlement, the estate may realize tangible benefits that rolling the dice in litigation would otherwise jeopardize. Thus, the trustee's settlement power allows him to protect the interests of the overall estate. To hold otherwise, would permit a creditor to hold the estate hostage to protracted litigation. As set forth above, however, this does not allow the trustee to settle the non-consenting objector's individual claims and rights.

G. Application of these Principles to the Present Matter

Section 502(a) and Rule 9019 do not conflict but instead work together harmoniously. This case presents a perfect illustration of the compatibility of these two provisions. Hamon has played an important part in objecting to New Lake's claim. This brought the CT Order and its rulings on New Lake's claim to the Trustees' attention. The Trustees then investigated and eventually negotiated with New Lake. It is their judgment that the estate would be best served by compromising New Lake's claim to approximately one-half of its original amount and allowing it as a secured claim. It is their belief that the CT Order is not yet final. They perceive risk to the estate with continued litigation. If Hamon were to lose, then New Lake will have a \$2.5 million secured claim against the estate and there would be nothing left for the unsecured creditors. Certainly, with continued litigation, there would be significant delay in any distribution to creditors. If the CT Order is not final, then the parties would have to return to the state court, complete the trial level, and then likely proceed with appeals. At least these are some of the arguments the Trustees have raised. The Court will need to conduct an evidentiary hearing to determine the merits of these assertions.

In addition, this case demonstrates how a particular objector may be pursuing an objection based on an interest that conflicts with the interests of the estate as a whole. Hamon may be motivated solely by his belief that New Lake's claim has no validity. On the other hand, he may be motivated in part by his need to prevent New Lake from suing him as a co-maker of the FNB Note. The Trustees do not suffer from this conflict of interest.

Conducting the settlement hearing will not deny Hamon due process. The proposed settlement does not attempt to release any claims that New Lake has against Hamon nor any claims that Hamon has against New Lake. Those rights are preserved for further litigation in the state court, if that is what those parties choose to pursue. Hamon's objection to Freedman's claim is also preserved. If Hamon believes he has suffered individual injuries as an equity holder of the Debtors due to Freedman's actions, then he can bring those claims in state court. On the other hand, if Hamon's objection to Freedman's claim is based on claims or injuries that pertain to all creditors, then his claim objection against Freedman may continue in the adversary proceeding. All that is compromised in this settlement is New Lake's right to recover from the sale proceeds held by these estates. Whether that is a fair compromise in light of the CT Order is a question for another day.

Nevertheless, Hamon asserts that his individual rights are affected by the proposed settlement. He argues that the Trustees' settlement would effectively moot his equitable subordination claim against New Lake. Unlike the subordination claim in the *CS Mining* case, Hamon has asserted a subordination claim based on an alleged injury to all creditors, not a particularized injury to Hamon. At least he has not articulated an individual claim in the Complaint, which states: "[t]he New Lake Claim should be equitably subordinated to *every other claim in this bankruptcy estate*, including without limitation, the Hamon Claim." Complaint ¶ 94 (emphasis added). Courts are divided on whether an individual creditor has standing to assert this type of equitable subordination claim. The vast majority of cases conclude that individual creditors do not have such standing. *See NM Enter., Inc. v. Harrington (In re Flying Star Cafes, Inc.)*, 568 B.R. 129, 135 (Bankr. D.N.M. 2017) (citing cases); *White Family Co., Inc., v. PNC Bank (In re Dayton Title Agency, Inc.)*, 527 B.R. 289, 298 (Bankr. S.D. Ohio 2015). *But see Bunch v. J.M. Capital Fin., Ltd. (In re Hoffinger Indus., Inc.)*, 327 B.R. 389, 413-14 (Bankr. E.D. Ark. 2005). Regardless of whether he had standing to assert it, it is a claim based on alleged injury to all the creditors and, as such, the Trustees have the power to settle it.

At one time, Hamon might have also argued that he and New Lake have competing secured claims, and that he has an individual claim to protect his lien rights. However, the Trustees have now repaid Hamon's secured claim from the sales proceeds. He now only holds an unsecured claim.

Moreover, Hamon will still have his day in court. Under Rule 9019, this Court cannot approve the Trustees' settlement without first ruling on Hamon's objection to it. The Trustees will bear the burden of proving to the court that their settlement is fair and in the best interests of the estate. The standard for approval of a settlement requires the Court to weigh "the probable success of the underlying litigation on the merits, the possible difficulty in collection of a judgment, the complexity and expense of the litigation, and the interests of creditors in deference to their reasonable views." *Kopp v. All Am. Life Ins. Co. (In re Kopexa Realty Venture Co.)*, 213

B.R. 1020, 1022 (10th Cir. BAP 1997). If the Trustees fail to demonstrate all of these requirements, then court will not approve it and Hamon may resume his litigation.

III. CONCLUSION

For these reasons, the Court concludes that it may conduct an evidentiary hearing and rule on the Trustees' proposed settlement of Hamon's claim objections against New Lake, even though it has not yet ruled on the merits of Hamon's claim objections.

DATED this 26th day of March, 2018.

BY THE COURT:

Elizabeth E. Brown

Elizabeth E. Brown, Bankruptcy Judge