

**Can the Creditors Do It?:  
A Pan-Circuit Review of Creditors' Rights to Derivative Standing  
Under Chapter 11**

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Avoidance actions under Chapter 5 of the Bankruptcy Code remain a fruitful source of recovery on behalf of a bankruptcy estate, and often provide a much needed infusion of cash into an otherwise strapped debtor's coffers. Understandably, therefore, the failure or refusal of a debtor-in-possession to pursue these claims, for whatever reason, generally does not sit well with the unsecured creditors of the debtor. As a result, creditors often seek authorization from the bankruptcy court to take up these claims on behalf of the estate. However, to do so a creditor<sup>2</sup> must first be granted derivative standing to pursue the claims, or risk the outright dismissal of its complaint.

**Creation of the Estate and the Trustee's Standing**

The filing of a petition for reorganization under Chapter 11 of the Code creates a bankruptcy estate, pursuant to section 541, which is comprised of all the property of the debtor, including its legal or equitable interests as of the commencement of the case. *11 U.S.C. § 541*. Section 541 is purposefully very broadly stated and includes potential claims or causes of action that the debtor possessed prior to the filing of the petition for relief. *Id.*

Until a Chapter 11 case can be reorganized or liquidated pursuant to a plan, a trustee, often the debtor-in-possession as trustee, is both authorized to and has the duty to manage the property of the bankruptcy estate. *See, Louisiana World Exposition v. Fed. Ins. Co.*, 858 F.2d 233, 245 (5<sup>th</sup> Cir. 1988). This includes collecting the property of the bankruptcy estate in order to maximize its value. *Id.* at 246. The trustee is duty-bound to assert claims or causes of action on behalf of the bankruptcy estate if doing so will maximize the estate's value. *Id.*

Because the trustee has a duty to manage and maximize the debtor's estate by pursuing claims and causes of action (including avoidance actions) on its behalf, it is also vested with standing to assert these claims on behalf of the estate. *11 U.S.C. § 544*. Therefore, under most circumstances no other party is capable of asserting such claims on their own behalf or on behalf of the bankruptcy estate without authorization from the bankruptcy court. *See e.g., Bank of Cal. v. LMJ, Inc. (In re LMJ, Inc.)*, 159 B.R. 926 (D. Nev. 1993) (stating that the code does not give avoidance powers to creditors); *Larson v. Munoz (In re Munoz)*, 111 B.R. 928, 930 (D. Colo. 1990) (a creditor lacks standing claims under § 544 because the Code specifically limits the § 544 powers to the trustee.)

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<sup>2</sup> "Creditor" in this article refers to an individual creditor or an unsecured creditors' committee.

However, instances will arise where, for various reasons, the trustee is unwilling or unable to assert such a claim or cause of action on behalf of the estate. Perhaps the trustee has determined asserting such claims would run the risk of administrative insolvency, or perhaps the debtor-in-possession is in control and does not wish to pursue claims against its former officers and directors. Under these circumstances, a creditor may wish to pursue the claim or cause of action in lieu of the trustee or debtor-in-possession in order to increase the value of the estate.

But in order to do so, the creditor must first obtain the very status that is initially denied to it by § 544: standing to assert a claim or cause of action on behalf of the estate. More precisely, the creditor must obtain *derivative standing* to pursue such claims in lieu of the trustee or debtor-in-possession. Without first obtaining derivative standing, a creditor faces the risk of having its complaint dismissed out of hand.

### **Whether to grant creditors derivative standing**

While not every Court of Appeals has resolved the question of a creditors' derivative standing in the same degree of particularity, nearly every Circuit Courts of Appeal have addressed the question of derivative standing to some extent. Moreover, in those circuits where the Court of Appeals has, to date, offered little guidance, the bankruptcy and district courts (along with the Bankruptcy Appellate Panels) have forged their own path.

Additionally, while the majority of Circuit Courts of Appeal have held that derivative standing is available to creditors in some form or another, a minority of Circuit Courts of Appeal have either not addressed the question, or have determined that derivative standing is not available to a creditor in a Chapter 11 proceeding. We will first address these Circuits.

### **The Minority Positions**

**The Fourth Circuit:** The Fourth Circuit is unique in that, not only has the Court of Appeals refused to conclusively address the issue of derivative standing for creditors, but reported case law within the Fourth Circuit demonstrates bankruptcy and district courts have not accepted a creditor's ability to obtain derivative standing. *See e.g., Scott v. Nat'l Century Fin. Enters. (In re Balt. Emergency Servs. II)*, 432 F.3d 557, 561 (4<sup>th</sup> Cir. 2005) (stating that the issue of derivative standing is an open question in the Fourth Circuit). Nor is there any consistently applied test by which courts can determine whether authorizing derivative standing is appropriate under the facts of a specific case.

**The First Circuit:** Like the Fourth Circuit, the First Circuit Court of Appeals has not issued an opinion that directly addresses the issue of a creditor's ability to obtain derivative standing. *But see In re Parque Forestal, Inc.*, 949 F.2d 504, 511 (1<sup>st</sup> Cir. 1991) (affirming that residents had standing to recover under § 506(c) against creditor for the benefit of the estate). Moreover, reported case law on the issue within the First Circuit is somewhat rare.

However, it is evident that at least some of the courts within the First Circuit accept the notion that a creditors' committee, or individual creditors, may assert a cause of action on behalf of, and for the benefit of, the debtor's estate. See *In re Elm Realty, Inc.*, 1995 Bankr. LEXIS 1649, at \*2 (Bankr. D.R.I. October 31, 1995) (“[U]nder the doctrine of derivative standing . . . creditors of the estate may pursue this cause of action, in the Debtor's name, on behalf of the estate, and leave to do so is hereby GRANTED.” (citing *Equitable Gas Co. v. Equibank (In re McKeesport Steel Castings Co.)*, 799 F.2d 91 (3<sup>rd</sup> Cir. 1986)). For example, the bankruptcy court for the District of Massachusetts has permitted a creditor to pursue a claim belonging to the debtor's estate where the facts demonstrated that the trustee lacked funds to bring the suit and where the case “presented a colorable claim or claims for relief that on appropriate proof would support a recovery.” *Campana v. Pilavis (In re Pilavis)*, 233 B.R. 1, 4 (Bankr. D. Mass. 1999) (adopting the legal conclusions of the district court for the District of Vermont as set forth in *Glinka v. Abraham and Rose Co.*, 199 B.R. 484, 493-4 (D. Vt. 1996)). The same court also permitted a creditors' committee to pursue a claim for fraudulent transfer against principals of the debtor where: 1) the defendants were insiders of the debtor; 2) the debtor was fully aware of the committee's intent to file the claim; 3) time was of the essence in filing the complaint; and 4) there was likelihood of confusion as to which party would pursue the claim. *Together Dev. Corp. v. Pappas (In re Together Dev. Corp.)*, 262 B.R. 586, 589-90 (Bankr. D. Mass. 2001) (utilizing the factors originally set forth in *Catwil Corp. v. DERF II (In re Catwil Corp.)*, 175 B.R. 362 (Bankr. E.D. Cal. 1994)).

**District of Columbia:** Similarly, the Court of Appeals for the District of Columbia has yet to rule on the issue of derivative standing for creditors. Nonetheless, the bankruptcy court for the District of Columbia observed that most courts that have permitted a creditor to bring an action under § 544(b) have found it imperative that the creditor first seek approval of the bankruptcy court, demonstrate that the claim is potentially meritorious, and first make a formal demand of the trustee to pursue the claim. *Rockstone Capital, LLC v. Walker-Thomas Furniture Co. (In re Smith)*, 2006 Bankr. LEXIS 737, at \*17-18 (Bankr. D.D.C. February 27, 2006) (denying default judgment, and questioning creditor's standing to assert the claim). Moreover, the District Court for the District of Columbia, in *Plan Committee v. Pricewaterhousecoopers, LLP*, observed that some circuits have authorized derivative standing if (1) the committee or creditor has the consent of the debtor-in-possession or trustee, and (2) the court finds that the suit is (a) in the best interest of the bankruptcy estate and (b) necessary and beneficial to the fair and efficient resolution of the bankruptcy proceeding.) 2007 U.S. Dist. LEXIS 29240, at \*21-23 (D.D.C. April 20, 2007) (finding that plaintiffs had failed to demonstrate that they are entitled to standing).

**The Tenth Circuit:** Finally, in an interesting development, the Tenth Circuit Court of Appeals, in an early decision, recognized that a creditor, or creditors' committee, may initiate avoidance actions on behalf of the estate with leave of the bankruptcy court and where the trustee or debtor in possession has failed to do so. *Starzynski v. Sequoia Forest Indus.*, 72 F.3d 816, 821 (10<sup>th</sup> Cir. 1995); *Hall v. Walter (In re Hall)*, 1998 U.S. App. LEXIS 2866, at \*10-11 (10<sup>th</sup> Cir. 1998). However, subsequent decisions of the Court of Appeals and the circuit's lower courts have called this into question.

In *Hill v. Akamai Technologies, Inc. (In re MS55, Inc.)*, the Tenth Circuit Court of Appeals called the ability of creditors to assert such actions into question in light of the Supreme Court's decision in *Hartford Underwriters Insurance Co. v. Union Planters Bank, N.A.*, where the Supreme Court held that statutory language granted certain powers to the trustee and did not grant the same powers to un-named entities, such as a creditors' committee. 477 F.3d 1131, 1139 n.9 (10<sup>th</sup> Cir. 2007) (citing *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1 (2000)). Additionally, the 10<sup>th</sup> Circuit Bankruptcy Appellate Panel, in *United Phosphorus, Ltd. v. Fox (In re Fox)*, denied a creditor standing to assert avoidance claims on behalf of the estate because the plain language of the Bankruptcy Code did not authorize it, and because of the Supreme Court's decision in *Hartford Underwriters Insurance Co.* 305 B.R. 912, 914-17 (B.A.P. 10<sup>th</sup> Cir. 2004). Therefore, despite the *Starzynski* decision, the ability of a creditor to obtain derivative standing within the Tenth Circuit remains an open question.

### **The Majority Positions**

As previously stated, the majority of Circuit Courts of Appeal have held that derivative standing is available to creditors. However, the Courts of Appeal vary among themselves as to the degree of specificity they provide to their lower courts as to the procedure for determining whether derivative standing is appropriate. As a result, the decision of the Courts of Appeal can be loosely classified into two categories: those that offer little by way of universally applicable tests; and those that require one or more elements to be met before derivative standing will be granted.<sup>3</sup>

The first category consists of those decisions that have barely progressed beyond recognizing derivative standing at all. These courts offer very little guidance to their lower courts as to when a grant of derivative standing is appropriate, seemingly choosing to rely instead upon each court's review of the unique facts of each case. Among the circuit courts taking this position are the 8<sup>th</sup>, 9<sup>th</sup>, and 11<sup>th</sup> Circuits.

**The Eighth Circuit:** In *Nangle v. Lauer (In re Lauer)*, the Eighth Circuit Court of Appeals stated that, absent evidence that the trustee cannot be relied upon to assert such a claim, claims to avoid preferential transfers may not be brought by creditors. 98 F.3d 378, 388 (8<sup>th</sup> Cir. 1996). The Bankruptcy Appellate Panel for the Eighth Circuit reaffirmed this position in *PW Enterprises v. North Dakota (In re Racing Services)*. 363 B.R. 911, 915 (B.A.P. 8<sup>th</sup> Cir. 2007). However, when considering whether derivative standing should be granted, the courts of the Eighth Circuit have also employed the Sixth Circuit's requirement from *Gibson*, that there be a colorable claim, and have generally used a piecemeal application of other circuits' tests. *E.g., In re Newcorn Enters.*, 287 B.R. 744, 750 (Bankr. E.D. Mo. 2002).

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<sup>3</sup> Obviously, such a division is somewhat arbitrary, as distinct cases within each circuit may fall into either category. However, these categories are useful in summarizing the relevant decisions of the Circuit Courts of Appeal.

**The Ninth Circuit:** In *Avalanche Maritime, Ltd. v. Parekh (In re Parmetex, Inc.)*, the Ninth Circuit Court of Appeals held that a creditor could sue on behalf of a trustee with the trustee's stipulation and approval of the bankruptcy court. 199 F.3d 1029, 1031 (9<sup>th</sup> Cir. 1999). Subsequently, in *Stewart v. Rosenblum (In re Sun Cho)*, the Ninth Circuit Court of Appeal also stated that, in limited circumstances, a creditor may move the bankruptcy court to pursue litigation on behalf of the estate even without the trustee's approval. 9 Fed. Appx. 633, 636 (9<sup>th</sup> Cir. 2001). However, the *Sun Cho* court did not identify what those circumstances might be. It is worth noting that, prior to the *Avalanche* case, the bankruptcy court for the district of Montana applied the *Gibson* tests to the facts at issue, and granted the unsecured creditors' committee authority to pursue avoidance actions on behalf of the bankruptcy estate. *In re Valley Park, Inc.*, 217 B.R. 864, 866-67 (Bankr. D. Mont. 1998). This indicates that the courts of the Ninth Circuit are willing to look outside of their circuit for guidance on this issue.

**The Eleventh Circuit:** The Eleventh Circuit Court of Appeals, in *Nordberg v. Sanchez (In re Chase & Sanborn Corp.)*, held that a creditor can assert an avoidance action on behalf of the estate if appointed by the bankruptcy court or via confirmation of a bankruptcy plan that provides such authority. 813 F.2d 1177, 1180 n.1 (11th Cir. 1987). Subsequent decisions within the circuit have expanded the scope of derivative standing beyond the narrow window identified by the Court of Appeals. *E.g., Maxfield v. Quarles & Brady LLP (In re Jennings)*, 378 B.R. 678, 682 (Bankr. M.D. Fla. 2006) (noting some courts have allowed derivative standing if the pursuit of the litigation promotes the bankruptcy objective of collecting a potential asset of the estate or furthers Congress' purpose in creating the bankruptcy laws); *In re iPCS, Inc.*, 297 B.R. 283, 290-91 (Bankr. N.D. Ga. 2003) (finding that courts have authorized derivative standing where the suit is (a) in the best interest of the estate and (b) necessary and beneficial to the fair and efficient resolution of the bankruptcy proceeding; and that a court must consider whether the claim is "colorable" and may consider the probability of financial recovery and the anticipated costs of litigation).

The second category consists of circuits in which the court of appeals has chosen to offer at least limited guidance in the form of one or more distinct factors or elements that must universally be satisfied before a creditor may be found to qualify for derivative standing. The decisions of these courts seem to recognize the need for consistently applied tests to determine derivative standing, while reserving a degree of flexibility to its lower courts. Among the circuit courts taking this approach are the 2<sup>nd</sup>, 3<sup>rd</sup>, 5<sup>th</sup>, 6<sup>th</sup> and 7<sup>th</sup>.

**The Second Circuit:** The Second Circuit Court of Appeals first recognized the doctrine of derivative standing in *Unsecured Creditors Committee of Debtor STN Enterprises v. Noyes (In re STN Enterprises)*, 779 F.2d 901 (2<sup>nd</sup> Cir. 1985). Therein the Court of Appeals observed that, while there is no explicit authority under the bankruptcy code for creditors' committees to initiate adversary proceedings, most courts have found an implied, but qualified right for creditors' committees to initiate adversary proceedings in the name of the debtors-in-possession. *Id.* at 904. The *STN* court held that there is a qualified right for creditors' committees to initiate suit with the approval of the bankruptcy court and that, where the trustee or debtor-in-possession unjustifiably failed

to bring suit or abused its discretion in not suing to avoid a preference transfer, the creditors' committee presents a colorable claim for relief, and the action asserting such claim is likely to benefit the estate then the committee should be permitted by the bankruptcy court to pursue the claim. *Id.* at 905.

Subsequently, in *Commodore International, Ltd. v. Gould (In re Commodore International, Ltd.)*, the Second Circuit Court of Appeals held that a creditors' committee may also sue on behalf of a debtor, with the approval and supervision of a bankruptcy court, where the trustee or debtor-in-possession consents, if the suit by the committee is in the best interest of the estate and is "necessary and beneficial" to the fair and efficient resolution of the bankruptcy proceedings. 262 F.3d 96, 100 (2<sup>nd</sup> Cir. 2001).

More recently, in *Official Committee of Unsecured Creditors of AppliedTheory Corp. v. Halifax Fund, L.P. (In re AppliedTheory Corp.)*, the Second Circuit Court of Appeals re-emphasized that creditors must obtain the consent of the bankruptcy court prior to commencing any actions on behalf of the bankruptcy estate. 493 F.3d 82, 86 (2<sup>nd</sup> Cir. 2007). Therein, the court of appeals held that a claim for equitable subordination is not a "direct" claim that may be asserted by a creditor, creditors or a creditors' committee without bankruptcy court approval. *Id.* The *Appliedtheory* court reasoned that, because the proposed claim does not arise from any particular injury to any creditor, a creditor cannot demonstrate an interest of its own in subordination separate and apart from the interests of the estate as a whole. *Id.* at 87

**The Third Circuit:** In *in re McKeesport Steel Casting Co.*, the Third Circuit Court of Appeals permitted a creditor to proceed with a claim to recover expenses under § 506(c), despite not being the trustee or debtor-in-possession, where the creditor had: 1) a colorable claim and 2) no other statutory party had a reason to zealously pursue the claim. 799 F.2d 91, 94 (3<sup>rd</sup> Cir. 1986). In a subsequent decision, the court, in *Official Committee of Unsecured Creditors of Cybergenics Corp. v. Chinery*, determined that the bankruptcy code, historical precedent, and the inherent equitable powers of the bankruptcy courts authorized the bankruptcy courts to bestow derivative standing upon creditors' committees to assert claims on behalf or, and for the benefit of, a bankruptcy estate. 330 F.3d 548 (3<sup>rd</sup> Cir. 2003). Interestingly, neither of these cases makes mention of any requirement that the creditor make demand upon the trustee or debtor-in-possession, or seek approval from the bankruptcy court, prior to pursuing its claim.

Nonetheless, while recognizing that the *Cybergenics* court did not expressly set forth the procedures that must be employed to determine whether it is appropriate to grant a creditor derivative standing, the courts of the Third Circuit seem to have adopted the tests set forth by the Second and Seventh Circuit courts. *E.g., Infinity Investors Ltd. v. Kingsborough (In re Yes! Entm't Corp.)*, 316 B.R. 141, 145 (D. Del. 2004). Under these guidelines, a creditor must demonstrate that: (i) the creditor has alleged a colorable claim that would benefit the estate; (ii) the debtor has unjustifiably refused to pursue the claim itself; and (iii) the creditors' committee has obtained permission from the bankruptcy court to initiate the action on behalf of the estate. *Official Comm. of Unsecured Creditors of Nat'l Forge Co. v. Clark (In re Nat'l Forge Co.)*, 326 B.R. 532, 543 (W.D. Pa. 2005).

**The Fifth Circuit:** In *Louisiana World Exposition v. Federal Insurance Co.*, the Fifth Circuit Court of Appeals observed that the law is well-settled that in some circumstances, a creditors' committee has standing under the Bankruptcy Code to file suit on behalf of a debtor-in-possession or a trustee. 858 F.2d at 247. The *Louisiana World Exposition* court then provided a loose checklist of circumstances under which such relief may be granted: 1) that the claim at issue be colorable; 2) that debtor-in-possession or trustee have refused, unjustifiably, to pursue the claim; and 3) that the committee first receive leave from the bankruptcy court to assert the claim. *Id.* The position of the 5<sup>th</sup> Circuit Court of Appeals is well summarized by the statement, “[w]here the debtor-in-possession is unable or unwilling to fulfill its obligations . . . the Committee may assert the cause of action on behalf and in the name of [the debtor] if authorized to do so by the bankruptcy court.” *Id.* at 252.

**The Sixth Circuit:** The Sixth Circuit has traditionally held that, in bankruptcies filed under Chapter 7 or Chapter 11, a creditor that believes a suit should be commenced has the right to petition the bankruptcy court to compel a trustee to act or for leave to prosecute the suit in the interests of the estate. *William B. Tanner Co. v. United States (In re Automated Business Sys.)*, 642 F.2d 200, 201 (6<sup>th</sup> Cir. 1981). Subsequently the controlling case on this issue within the Sixth Circuit was issued by its Court of Appeals. In *Canadian Pacific Forest Products, Ltd. v. J.D. Irving, Ltd. (In re Gibson Group, Inc.)*, the court determined that Congress did not intend to confer exclusive authority to file an action to avoid preferential or fraudulent transfers on a trustee or debtor-in-possession in a Chapter 11 reorganization and held that a creditor or creditors' committee may have derivative standing to initiate an avoidance action where: 1) a demand has been made upon the statutorily authorized party to take action; 2) the demand is declined; 3) a colorable claim that would benefit the estate if successful exists, based on a cost-benefit analysis performed by the court; and 4) the inaction is an abuse of discretion (“unjustified”) in light of the debtor-in-possession’s duties in a Chapter 11 case. 66 F.3d 1436, 1438-1446 (6<sup>th</sup> Cir. 1995). Finally, the Bankruptcy Appellate Panel for the Sixth Circuit has held that the United States Supreme Court’s decision in *Hartford Underwriters Insurance Co. v. Union Planters Bank, N.A.*, 530 U.S. 1, 147 L. Ed.2d 1 (2000), is not inconsistent with the decision in *In re Gibson* and did not, therefore, overrule *In re Gibson*.

**The Seventh Circuit:** In *In re Perkins*, the Seventh Circuit Court of Appeals observed that the authority to collect the debtor’s assets is vested exclusively in the trustee, but that the trustee can be divested of this exclusive authority in narrow circumstances. 902 F.2d 1254, 1257-1258 (7<sup>th</sup> Cir. 1990). Such circumstances exist when a) the trustee unjustifiably refuses a demand to pursue the action; b) the creditor establishes a colorable claim or cause of action; and c) the creditor seeks and obtains leave from the bankruptcy court to prosecute the action for and in the name of the trustee. *Id.* at 1258. The analysis was continued in *Fogel v. Zell*, wherein the Court of Appeals permitted a creditor to pursue a claim on behalf of the bankruptcy estate where the trustee did pursue a claim, but failed to preserve a right of recovery for a late filing creditor. 221 F.3d 955, 965 (7<sup>th</sup> Cir. 2000). As a result, the Court of Appeal found that the trustee had

unjustifiably failed to bring a colorable cause of action, and therefore the creditor was entitled to assert such cause of action in lieu of the trustee. *Id.* at 965-966.

Finally, in *Qualitech Steel Corp. Qualitech Steel Holdings v. GE Supply Co. (In re Qualitech Steel Corp. Qualitech Steel Holdings)*, the Seventh Circuit Court of Appeals, without expressly adopting the requirements of the *Gibson* case, applied these elements to determine whether a creditor was entitled to assert a claim against third-party defendants. 2003 U.S. Dist. LEXIS 9427, at \*53-54 (S.D. Ind. May 9, 2003) (reversed on other grounds). After applying these factors, the Court of Appeals ultimately held that the creditor failed to show a colorable claim that would benefit the bankruptcy estate. *Id.* at \*56. Therefore, the creditor was denied derivative standing to pursue the claim. *Id.* at \*65-66.

## **Conclusion**

As demonstrated by the foregoing, the majority of the Federal Circuit Courts of Appeal have held that derivative standing is available to creditors in a Chapter 11 proceeding, at least under certain circumstances. Moreover, there are some consistent themes among the decisions of these courts, such as: 1) the requirement that the bankruptcy court approve the creditor's standing; 2) that the trustee is found to be unwilling or unable to assert the claims or causes of action on behalf of the estate; and 3) that granting a creditor derivative standing to pursue the claims is likely to benefit the estate.

Given the importance of the prosecution of such claims to the bankruptcy estate, particularly its unsecured creditors, and in light of the clear trend among both the Circuit Courts of Appeals and the lower courts of the circuits, it is reasonable to assume that eventually all of the circuits will permit a creditor to obtain derivative standing to pursue avoidance action on behalf of the estate under limited circumstances.