

Commercial Fraud Task Force Committee

The ABI Commercial Fraud Task Force Committee facilitates information sharing, training, and education between ABI members and the public-private sector to combat commercial bankruptcy fraud.



The Doctrine of Derivative Standing – Alive and Well?

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What can a creditor do when it has information indicating that the debtor, prior to going into bankruptcy, transferred or concealed assets? The first thing is to ask the trustee to act to recover the assets under the trustee's avoiding powers (*e.g.*, 11 U.S.C. §§508, 544(b) and 550). What if the trustee refuses to do so? The answer is to seek a court order granting derivative standing to the creditor to act in the trustee's stead.

The doctrine of derivative standing is not new. In *In re Godon Inc.*, 275 B.R. 555, 558 (Bankr. E.D. Cal. 2002), a chapter 7 case, Judge Klein traced the history of the doctrine that "creditors may recover property for the benefit of the estate and have their attorneys' fees reimbursed by the estate."

It has been a settled feature of bankruptcy law since 1898 that creditors may recover property for the benefit of the estate and have their attorneys' fees reimbursed by the estate. Under the former Bankruptcy Act, the reimbursable creditor recovery doctrine started as judge-made law. *See, e.g., Chatfield v. O'Dwyer*, 101 Fed. 797, 799-800 (8th Cir. 1900); 3A JAMES WM. MOORE ET AL, COLLIER ON BANKRUPTCY P 64.104 n.6 (14th ed. rev. 1975) ("COLLIER 14th ed.").

Then, in 1903, Bankruptcy Act §64 was amended to make explicit what had already been determined to be implicit:

- (a) The debts to have priority, in advance of the payment of dividends to creditors, and to be paid in full out of bankrupt estates, and the order of payment, shall be: (1) ...; where property of the bankrupt, transferred or concealed by him either before or after the filing of the petition, is

recovered for the benefit of the estate of the bankrupt by the efforts and at the cost and expense of one or more creditors, the reasonable costs and expenses of such recovery;...

Bankruptcy Act §64(a)(1), 11 U.S.C. §104(a)(1) (redesignated from §64b(2) in 1938) (repealed 1978). *In re Godon, Id.* at 561.

The Ninth Circuit, in a chapter 7 case, has held that "it is a well settled principle that avoidance powers may be assigned to someone other than the debtor or trustee . . . [and] that the principles . . . apply to both chapter 7 and chapter 11 cases." *Duckor Spradling & Metzger v. Baum Trust (In re P.R. T.C. Inc.)*, 177 F.3d 774, 781 & 782 (9th Cir. 1999).

The Ninth Circuit is not alone. Every other circuit that has considered the issue has held that granting derivative standing is appropriate under certain circumstances.¹ Those circumstances as generally recognized are:

1. Demand has been made upon the trustee;
2. The demand is declined

¹ Every circuit, including the Eighth Circuit, which has addressed the issue has recognized the possibility of derivative standing to pursue avoidance actions on behalf of a bankruptcy estate under certain circumstances. *Nangle v. Lauer (In re Lauer)*, 98 F.3d 378, 388 (8th Cir. 1996); *Scott v. Nat'l Century Fin. Enter. Inc. (In re Baltimore Emergency Services II Corp.)*, 432 F.3d 557 (4th Cir. 2005); *Official Comm. of Unsecured Creditors of 'Cybergenics Corp. v. Chinery*, 330 F.3d 548 (3rd Cir. 2003); *Commodore Int'l Ltd v. Gould (In re Commodore Int'l Ltd.)*, 262 F.3d 96 (2nd Cir. 2001); *Fogel v. Zell*, 221 F.3d 955 (7th Cir. 2000); *Avalanche Maritime Ltd. v. Parekh (In re Parmetex Inc.)*, 199 F.3d 1029 (9th Cir. 1999); *Canadian Pac. Forest Prod. Ltd. v. J.D. Irving, Ltd. (In re Gibson Group, Inc.)*, 66 F.3d 1436 (6th Cir. 1995); *Louisiana World Exposition v. Fed. Ins. Co.*, 858 F.2d 233 (5th Cir. 1988); *Unsecured Creditors Committee v. Noyes (In re STNEnter.)*, 779 F.2d 901 (2nd Cir. 1985).

In re Racing Services Inc., ___ B.R. ___, 2007 WL704984, p. 4 (8th Cir. B. A.P. 2007), 47 Bankr.Ct.Dec. 246

3. A colorable claim that would benefit the estate if successful exists; and
4. The inaction is unjustified

Canadian Pac. Forest Prods. Ltd. v. J.D. Irving Ltd. (In re The Gibson Group Inc.), 66 F.3d 1436, 1438 (6th Cir. 1995).

Section 506(c) of the Bankruptcy Code says a "trustee may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property...." Under this section, Hartford Underwriters Insurance Co. sought to recover its expenses incurred in preserving property of the estate of Hen House Interstate Inc., upon which Union Planters Bank's predecessor bank held a lien. In an opinion by Justice Scalia, the U.S. Supreme Court said no, stating:

When "the statute's language is plain, 'the sole function of the courts'" – at least where the disposition required by the text is not absurd – "is to enforce it according to its terms." *United States v. Ron Pair Enterprises Inc.*, 489 U.S. 235, 241, 103 L. Ed. 2d 290, 109 S. Ct. 1026 (1989).

Hartford Underwriters Ins. Co. v. Union Planters Bank N.A., 530 U.S. 1; 120 S. Ct. 1942; 147 L. Ed. 2d 1 (2000).

Moving on to sections that contain the trustee's avoiding powers (11 U.S.C. §§11 U.S.C. §§544, 545, 547(b), 548(a), 549(a) and 550), all of them use the words, "the trustee may," the same as does §506(c). Is the necessary implication that a strict construction of the words of the Code according to their plain meaning leads inexorably to the conclusion that derivative standing is dead? Maybe. Maybe not. The Supreme Court clearly thought about this issue, for in footnote 5 of the opinion in *Hartford*, the Court stated its ruling did not apply to the validity "of allowing creditors or creditors' committees a derivative right to bring avoidance actions when the trustee refused to do so."²

Several circuit courts have considered whether or not *Hartford* precludes granting of derivative standing. This year The Eighth Circuit B.A.P. noted:

Every circuit court that has addressed this issue since the *Hartford Underwriters* opinion was decided has recognized the possibility of derivative standing to pursue avoidance actions on behalf of a bankruptcy estate. *Scott v. Nat'l Century Fin. Enter. Inc. (In re Baltimore Emergency Services II Corp.)*, 432 F.3d 557 (4th Cir. 2005); *Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery*, 330 F.3d 548 (3rd Cir. 2003); *Commodore Int'l Ltd v. Gould (In re Commodore Int'l Ltd.)*, 262 F.3d 96 (2nd Cir. 2001); *Fogel v. Zell*, 221 F.3d 955 (7th Cir. 2000). None has gone so far as to say a bankruptcy court cannot authorize derivative standing.

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A recent district court case in the Middle District of Tennessee held unequivocally that "the only plausible construction of the Supreme Court's language in *Hartford* is that the practice of allowing creditors derivative standing to pursue claims on behalf of the estate, as set

² The Supreme Court's footnote 5 in its entirety reads as follows:

We do not address whether a bankruptcy court can allow other interested parties to act in the trustee's stead in pursuing recovery under §506(c). Amici American Insurance Association and National Union Fire Insurance Co. draw our attention to the practice of some courts of allowing creditors or creditors' committees a derivative right to bring avoidance actions when the trustee refuses to do so, even though the applicable Code provisions, see 11 U.S.C. §§544, 545, 547(b), 548(a), 549(a), mention only the trustee. See, e.g., *In re Gibson Group, Inc.*, 66 F.3d 1436, 1438 (CA6 1995). Whatever the validity of that practice, it has no analogous application here, since petitioner did not ask the trustee to pursue payment under §506(c) and did not seek permission from the Bankruptcy Court to take such action in the trustee's stead. Petitioner asserted an independent right to use §506(c), which is what we reject today. Cf. *In re Xonics Photochemical, Inc.*, 841 F.2d 198, 202-203 (CA7 1988) (holding that creditor had no right to bring avoidance action independently, but noting that it might have been able to seek to bring derivative suit).

Hartford Underwriters, supra, 530 U.S. 1, n5.

forth in *Gibson Group*, 66 F.3d at 1438, is still valid. The court reversed the bankruptcy court's denial of derivative standing. *Hyundai Translead v. Jackson Truck and Trailer Repair Inc., et al (In re Trailer Source Inc.)*, ___B.R. ___, 2007 U.S. Dist. LEXIS 23816 (2007).

A few bankruptcy courts have held that *Hartford* precludes the granting of derivative standing. See, e.g., *In re Fox*, 305 B.R. 912, 915 (B.A.P. 10th Cir. 2004); *In re Pro Greens*, 297 B.R. 850, 856 (M.D. Fla. 2003). Yet as noted above, every circuit court that has considered the issue since *Hartford* has concluded that *Hartford* does not preclude derivative standing.

Strange to say, no court, save Bankruptcy Judge Klein in the Eastern District of California, has pointed out what to this author seems obvious: that the doctrine of derivative standing was expressly approved in the Bankruptcy Code.³

Let's take a look at §503(b)(3) and (4):

(b) After notice and a hearing, there shall be allowed administrative expenses, . . . , including

(3) the actual, necessary expenses . . . incurred by

(B) a creditor that recovers, after the court's approval, for the benefit of the estate any property transferred or concealed by the debtor; [and]

(4) reasonable compensation for professional services rendered by an attorney or an accountant of an entity whose expense is allowable under subparagraph . . . (B) . . . of paragraph (3) of this subsection

Sections 503(b)(3) and (4) would be meaningless unless granting derivative standing to a creditor were appropriate.

There are not a lot of creditors seeking derivative standing. It may be some time before the Supreme Court has an opportunity to clarify the issue. In the meantime, the weight of case authority, and, most important, §§503(b)(3) and (4) point to what seems an inescapable

³ [T]he authorization for creditors to sue on behalf of the estate to recover property transferred or concealed by the debtor was carried forward into the 1978 Bankruptcy Code as §§503(b)(3)(B) and (4). *In re Godon, supra*, at 561 - 562.

conclusion: the doctrine of derivative standing is alive and well.