Business Bankruptcy Newsletter

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Featured Articles

**Hot Topics: Recent Cases on Executory Contracts and Unexpired Leases**
Aisha L. Williams, Washington D.C., and Jessica Gabel, San Francisco, Covington & Burling LLP

The authors present a review of recent decisions that address and discuss executory contracts, unexpired leases, and issues that arise under Section 365 of the Bankruptcy Code.

More...

**Recent Developments in Chapter 15**
Christina M. Moore, Akin Gump Strauss Hauer & Feld, LLP, Los Angeles

Two courts recently issued opinions regarding the interpretation and/or application of Chapter 15. This article examines these decisions and addresses the factors the courts will examine to determine whether a foreign proceeding qualifies as main or nonmain.

More...

**Bankruptcy Court Enforces Prepetition Stay Relief Agreement**
Timothy M. Lupinacci and Matthew M. Cahill, Baker Donelson Beamam Caldwell & Berkowitz, P.C., Birmingham, AL

The Bankruptcy Court for the Southern District of Florida recently held that a prepetition forbearance agreement containing a stay relief provision was enforceable against a chapter 11 debtor. The authors examine this opinion.

More...

**Environmentally Insolvent: Fair Value Measurement of Environmental Liabilities Poses Solvency Risk**
C. Gregory Rogers, Guida, Slavich & Flores, P.C., Dallas

A new approach to valuing contingencies under U.S. and international accounting standards could enable creditors, trustees, shareholders and other interested parties to argue that corporate environmental liabilities are vastly understated. Although the new standards will not be fully phased in for years, litigants need not wait to use these standards to show that seemingly viable companies are in fact insolvent and were insolvent long before. This new approach will certainly play in a role in fraudulent transfer and preferential transfer litigation, as well as in a variety of other disputes involving the "if" and "when" a corporation became insolvent.

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1/2
Can the Creditors Do It?: A Pan-Circuit Review of Creditors' Rights to Derivative Standing Under Chapter 11
Nathan Wheatley, Calfee, Halter & Griswold LLP, Cleveland

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. For a variety of reasons, trustees or debtors-in-possession will not pursue these claims. 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 must first be granted derivative standing to pursue the claims, or risk the outright dismissal of its complaint.

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Hot Topics: Recent Cases on Executory Contracts and Unexpired Leases

By Aisha L. Williams and Jessica Gabel

The following is a review of recent decisions that address and discuss executory contracts, unexpired leases, and issues that arise under Section 365 of the Bankruptcy Code.


In this nonbankruptcy proceeding, Hayes Lemmerz sought a declaration that the Struktur Wheel did not infringe two patents held by Epilogics and Kuhl Wheels. The court granted Hayes’ non-infringement summary judgment motion. In relation to the summary judgment motion the district court made a number of other findings, including the enforceability of some executory contracts.

Hayes argued that Kuhl’s non-patent claims were barred by Hayes’s Chapter 11 bankruptcy proceeding. Hayes specifically argued that the claims were barred because the license was an unenforceable executory contract, and the alleged infringing conduct occurred post-petition. The court found that there was an executory contract (under the Countryman functional approach), and that prior to the filing of the petition Hayes had neither accepted nor rejected the contract between December 5, 2001, the filing of its bankruptcy petition, and January 10, 2003, the date the license was terminated by Kuhl. Moreover since Kuhl did not establish reasonable value of any post-petition benefits it provided to Hayes by a preponderance of the evidence, Kuhl could not recoup any loss under 11 U.S.C. § 503.

**Take Away:** Patent holders with infringement claims should seek an accord with the debtor to reject or accept executory contracts. Terminating a license agreement will only bar recovery.


Action arose out of an agreement between Defendant Bob Cummins Construction and Technomarine (Raddison was Technomarine’s assignee). Cummins subcontracted with Technomarine for the design, manufacture, and delivery of a floating dock system for a marina project. Technomarine’s performance suffered and Cummins had to compensate for Technomarine’s failure to timely pay its own subcontractors and for the failure to undertake

warranty services on its work. Technomarine then filed bankruptcy in Canada and its assignee sought payment from Cummins under the subcontract.

Cummins argued that the assignment of the executory contract from Technomarine to Raddison was invalid under 11 U.S.C. § 365(c)(1). Cummins asserted that the Canadian trustee’s assignment of the subcontract violated Pennsylvania common law stating that a right “may not be effectively assigned where such assignment is prohibited by the writing creating the right.” The court rejected Cummins’ argument. It held that the common law was a public policy exception; one that was not implicated by the facts of the case. In order to be enforced the court held that the non-assignment clause must implicate issues that are so injurious or critical to public health and morals.

**Take Away:** Courts will analyze common law in the context of ipso facto clauses and can require something akin to irreparable harm before they will enforce a non-assignment clause.


Debtor and three affiliates filed a Chapter 11 case and confirmed a plan. The plan provided that, with certain exceptions, debtor's obligations to pay retirees benefits would continue and, further, that all retirement plans and compensation and benefit plans applicable to former employees or retirees would be treated as executory contracts which, on the effective date, would be deemed assumed pursuant to the provisions of §§ 365 and 1123(b). A former executive filed a claim for his Selective Executive Retirement Agreement (“SERP”) payments. At the date of filing, the former executive had retired and had received three of the ten annual payments due under the SERP; the debtor discontinued SERP payments, leaving a claim for the final seven payments.

The executive argued that the plan deemed all retirement plans, including the SERP, to be assumed executory contracts. As a result, the executive argued that the debtor should cure all defaults and continue making payments under the SERP. The Delaware bankruptcy court ruled that the SERP was not an executory contract, the plan could not deem it to be such, and the SERP could not be assumed in the plan. The bankruptcy court noted that the agreement specifically provided that the executive’s benefits were fully vested upon the effective date of his retirement. There was no dispute that the executive’s rights under the SERP thus vested prior to the bankruptcy filing, but the executive had no obligation to continue in the employ of the company in any capacity or to do anything material. Finally, the plan language could not “deem” a nonexecutory contract to be an executory contract so that a debtor could assume it.

**Take Away:** “A debtor cannot change the nature of a contract merely by electing to assume it under § 365.” In other words, the court refused to rewrite the plan of reorganization to “deem a non-executory contract to be an executory contract.”


In this Chapter 7 case, Colvin formed an LLC with others to operate a World Gym franchise in Idaho. The business needed cash infusion from the owners. Colvin could not honor the calls for new capital and the other LLC members made up his difference. A contract was eventually
drafted for the purpose of buying Colvin out (the “Buy-Out Agreement”). The LLC subsequently failed to pay Colvin the money due under the Buy-Out Agreement. Colvin later attempted to lure several key World Gym employees to the new gym where he worked. Colvin eventually filed bankruptcy and the trustee filed an adversary proceeding to recover the $45,000 owed under the Buy-Out Agreement.

The bankruptcy court found that the Buy-Out Agreement was executory because, on the one hand, the LLC owed Colvin money, and, on the other hand, Colvin had a continuing obligation to not hinder, delay, or tarnish the LLC. Ultimately, however, the court deemed the contract rejected by operation of law because the debtor made no motion to assume the contract in the first 60 days of bankruptcy as required by 11 U.S.C. § 365(d). The rejection therefore constituted a breach.

Take Away: Trustees, creditors, and debtors need to pay close attention to the 60-day deadline in §365(d). The court also observed in a footnote that Colvin’s duties under the agreement may have been akin to those of a personal services contract, a type of executory contract that may not be assumed by the trustee. 11 U.S.C. § 365(c)(1).

Prior to the filing of the bankruptcy case, the debtor, to avoid the enforcement of a default judgment by a former employee, entered into a settlement agreement with the employee under which it agreed to make payments for a specified period of time. After filing Chapter 11, the debtor argued that the settlement agreement was an executory contract, subject to rejection under 11 U.S.C. § 365(a).

The Court analyzed the settlement agreement both under the “Countryman” and “functional analysis” definitions of an executory contract and concluded that the agreement did not meet either definition. Under the Countryman definition, the mere right of the former employee to collect payments under the agreement was insufficient for the agreement to be deemed an executory contract. Under the “functional analysis” definition, the agreement was not executory because funds had already been deposited into the registry of the court and earmarked for payment to the former employee. Thus, the employee was a secured creditor and not a party to an executory contract.

Take Away: In order for the debtor to trigger its rights under 11 U.S.C. § 365(a) in the context of a settlement agreement, on the petition date the agreement must contain ongoing obligations for both parties.

In re Samaritan Alliance, 2007 WL 4162918 (Bankr. E.D. Ky. Nov. 21, 2007)
Samaritan Alliance (“Samaritan”) entered into an acquisition agreement and a master lease agreement with Ventas Realty LP, under which Ventas acquired a hospital and then leased it back to Samaritan. Samaritan subsequently entered into various agreements with Cardinal Hill Rehabilitation Unit (“Cardinal Hill”), including a sublease agreement which permitted Cardinal Hill to open a nursing facility on the 7th floor of the hospital. In contemplation of its bankruptcy filing, Samaritan and Ventas entered into an agreement terminating the original lease. Simultaneously, Ventas entered into a new lease with the University of Kentucky (the
“University”). Four days later, Samaritan filed its Chapter 11 petition and all of Samaritan’s assets were subsequently sold to the University.

The central issue in the case was whether the Cardinal Hill retained its rights under 11 U.S.C. § 365(h). University argued that even if Cardinal Hill retained such rights, 11 U.S.C. § 365(f) allowed University to purchase the hospital free and clear of all liens and encumbrances, including Central Hill’s rights as a sublessee. The Court disagreed, stating that Cardinal Hill’s interest in the hospital remained pursuant to the sublease under 11 U.S.C. § 365(h) even in the context of a 363(f) sale.

Take Away: Real property of a debtor transferred to another party in a 363(f) sale may still be subject to the rights of a sublessee through the operation of § 363(h).


In this tax court case, the Greenfields were selected by the IRS for audit and the Greenfields consented to the IRS’s request to extend the limitations period under which it could assess further taxes in connection with the audit (the “Consent Agreement”). Six years later, Mr. Greenfield filed a Chapter 11 bankruptcy petition. The IRS filed three proofs of claim in the bankruptcy proceeding. The proceeding was later converted into a Chapter 7 liquidation and the IRS claims were paid. Eighteen years after the date that the Greenfields signed the Consent Agreement with the IRS, the IRS sent a notice of default to the Greenfields assessing taxes in connection with their 1982 tax return.

The Greenfields argued that the Consent Agreement was an executory contract which had been automatically rejected in the bankruptcy case by operation of 11 U.S.C. § 365(d)(1). The IRS argued that this consent was merely a unilateral waiver of the Greenfields’ right to the original period of limitations. The court agreed, reasoning that while this was the first case in which the particular consent form at issue had been considered in the bankruptcy context, courts have consistently found such consent to be a unilateral waiver and there was no reason to carve out a special rule in the bankruptcy context.

Take Away: Contractual waiver of an affirmative defense does not create an executory contract which would be subject to assumption or rejection by a debtor.

In re Nickels Midway Pier, LLC, 2007 WL 4171114 (3d Cir. Nov. 27, 2007)

Wild Waves and Nickels Midway Pier reached an agreement which required Wild Waves to lease a portion of an entertainment pier for three years and thereafter to purchase it in accordance with the terms of an unexecuted agreement.

The court first dealt with the issue of whether the lease and sale agreements were divisible portions of one agreement and held that it was. To prevent the sale agreement from being rejected, Wild Waves argued that, in accordance with New Jersey law, it had the option of treating the agreement as terminated upon the occurrence of an anticipatory repudiation. The
court concluded that there was no factual support for the anticipatory repudiation claim. Wild Waves subsequently argued that even if the sale agreement was executory, it was entitled to remain “in possession” of the pier under 11 U.S.C. § 365(i) because of its lease with Nickels. Again, the court disagreed, reasoning that Wild Waves’ failure to make the appropriate payments toward the purchase of the pier precluded Wild Waves from obtaining the protection of that provision.

**Take Away:** The protection of 11 U.S.C. § 365(i) may be unavailable to putative purchasers of real property who have not made payments toward that purchase.
Recent Developments in Chapter 15
By Christina M. Moore

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 added Chapter 15 of the Bankruptcy Code “so as to provide effective mechanisms for dealing with cases of cross-border insolvency.” 11 U.S.C. § 1501(a). Under this chapter, certain relief may be granted once a petition for recognition as a foreign proceeding has been filed. See generally 11 U.S.C. § 1519. An insolvency proceeding that is pending in a country where the debtor has the center of its main interests is considered a “foreign main proceeding,” while an insolvency proceeding in a country in which the debtor is carrying on “nontransitory economic activity” is considered a “foreign nonmain proceeding.” 11 U.S.C. § 1502 (4) and (5). “In the absence of evidence to the contrary, the debtor's registered office ... is presumed to be the center of the debtor's main interests.” 11 U.S.C. § 1516(c). Additional relief becomes available upon recognition as a foreign nonmain proceeding, and even further relief is available if the proceeding is recognized as a foreign main proceeding. 11 U.S.C. §§ 1520-1521. For example, if the case is determined to be a foreign main proceeding, the automatic stay under 11 U.S.C. § 362 applies with regard to the debtor and its property within the United States. 11 U.S.C. § 1520.

Two courts recently issued opinions regarding the interpretation and/or application of Chapter 15. In summary, these decisions reiterated the Sphinx factors for determining the debtor’s center of main interest (COMI) and confirmed the bankruptcy court’s independent duty to weigh the facts and evidence when determining whether a foreign proceeding qualifies as main or nonmain.


In this case, an individual debtor sought recognition by the Bankruptcy Court for the Southern District of Texas of an order from an Israeli bankruptcy court that the debtor was bankrupt. The bankruptcy court denied recognition, finding that the Israeli bankruptcy was neither a foreign main nor a foreign nonmain proceeding. The debtor appealed.

The District Court for the Southern District of Texas, recognizing the Bankruptcy Court’s finding that Houston was the debtor’s center of main interest (COMI), determined that the Bankruptcy Court failed to review proffered evidence, as required by Chapter 15, to determine whether contrary evidence justified a finding that the debtor’s COMI was somewhere other than

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2 In re SPhinX, Ltd., 351 B.R. 103 (Bankr. S.D.N.Y. 2006), aff’d, 371 B.R. 10 (S.D.N.Y. 2007), held the presumption that the debtor's registered office is the COMI may be rebutted by an examination of objective factors, which include a) the location of debtor's headquarters, b) the location of those who actually manage debtor, which, conceivably, could be the headquarters of a holding company, c) the location of debtor's primary assets, d) the location of the majority of debtor's creditors or of a majority of the creditors who would be affected by the bankruptcy case, and e) the jurisdiction the law of which would apply to most disputes. 351 B.R. at 117.
Houston. The District Court thus remanded the case for further findings consistent with its opinion.


A trustee for an English debtor sought recognition of the English bankruptcy proceeding as a foreign main proceeding pursuant to Chapter 15. Prior to filing the petition for recognition, the trustee filed a lis pendens against property held by the English debtor in the United States. The debtor objected to the petition for recognition arguing that the trustee was required to file the petition for recognition prior to filing the lis pendens and his failure to do so stripped the trustee of any rights with respect to the lis pendens or the recognition petition.

The bankruptcy court first recognized that the trustee was a lawful representative of the English bankruptcy proceedings, as evidenced by the certified copy of the English Order declaring the debtor a bankruptcy and appointing the trustee. The bankruptcy court then determined that English proceeding was, in fact, a foreign main proceeding, as evidenced by the following indices of COMI:

- The debtor’s habitual residence was in the United Kingdom;
- The debtor’s United States visa was temporary;
- Almost all the debtor’s creditors were located in the United Kingdom;
- The debtor’s bankruptcy case was filed in the United Kingdom; and
- The debtor’s assets were located in the United Kingdom, the United States and France.

The bankruptcy court then addressed the debtor’s argument that the trustee’s lis pendens was invalid because he failed to obtain recognition of the English bankruptcy before so filing. On this issue, the bankruptcy court disagreed with the debtor, stating that the trustee’s “failure to obtain prior bankruptcy court approval prior to filing the lis pendens…does not prohibit the trustee from now gaining Chapter 15 recognition of the English proceeding.” The bases for this conclusion were twofold.

First, the bankruptcy court recognized the generally accepted principle that filing a petition for recognition is a precursor to such representative taking action that **requires comity or cooperation of a court of the United States.** (emphasis added). Here, however, the lis pendens did not require comity or cooperation of the bankruptcy court, but was merely a ministerial act that provided notice to any party seeking to gain an interest in the real property of the debtor of the trustee’s interest therein. Second, the lis pendens fell within the exception from the requirement of recognition contained in 11 U.S.C. § 1509(f), which allows a representative of a foreign estate to sue in a court of the United States to recover a claim which is property of the foreign debtor. The bankruptcy court also noted that Chapter 15 fails to specify the consequences should a foreign representative fail to commence a Chapter 15 proceeding before taking action related to such proceeding in the United States.
Bankruptcy Court Enforces Prepetition Stay Relief Agreement

By Timothy M. Lupinacci and Matthew M. Cahill

The Bankruptcy Court for the Southern District of Florida recently held that a prepetition forbearance agreement containing a stay relief provision was enforceable against a chapter 11 debtor. See In re Bryan Road LLC, 382 B.R. 844 (Bankr. S.D. Fla. 2008). As a result, the court granted relief from stay for cause under 11 U.S.C. § 362(d)(1).

The debtor in Bryan Road owned a dry stack boat storage facility containing 210 boat storage spaces, each of which constituted a separate condominium unit. Id. at 845-46. Florida Community Bank (the “Bank”) had loaned the debtor over $8,000,000.00 secured by a mortgage, security agreement (which granted the Bank a security interest in substantially all of the debtor’s personal property), and assignment of rents. Id. at 846. Debtor defaulted under the loan documents by failing to make payments, and the Bank began foreclosure proceedings. Id. at 847.

On the morning of the foreclosure sale, debtor and Bank entered into a forbearance agreement pursuant to which the foreclosure sale was delayed for two months. Id. at 848. The forbearance agreement provided that in the event the debtor filed for bankruptcy protection, the Bank would be accorded relief from the automatic stay as consideration for entering into the forbearance agreement. Id. The court noted that the debtor’s experienced bankruptcy attorney was present when the agreement was executed.

One day before the rescheduled foreclosure sale, the debtor filed for protection under chapter 11. The Bank moved for relief from the stay, arguing, among other things, that the debtor validly waived protection under the automatic stay by executing the forbearance agreement. Id.

Recognizing that prepetition agreements waiving automatic stay protection are not per se enforceable or self-executing, the court analyzed four factors in deciding to grant relief from the stay: “(1) the sophistication or the party making the waiver; (2) the consideration for the waiver, including the creditor’s risk and the length of time the waiver covers; (3) whether other parties are affected including unsecured creditors and junior lienholders; and (4) the feasibility of the debtor’s plan. Id. at 848-49 (citing In re Desai, 282 B.R. 527, 532 (Bankr. S.D. Ga. 2002)).

The court found that the first factor weighed in favor of enforcing the agreement and granting relief because the debtor’s experienced bankruptcy attorney was present for the negotiation of the agreement. Id. at 849. Regarding the second factor, the court initially noted that a two month reprieve from foreclosure is not “particularly great.” Id. The court found,

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however, it was sufficient in light of the fact that the debtor had expected to refinance within that period.

The court considered the third and fourth factors together. To determine the likely effect of stay relief on two junior mortgagees and various holders of almost $1,000,000 in total unsecured claims, the court considered the proposed treatment of such creditors under the debtor’s plan and compared the likely results with what was likely to happen if the court granted the Bank relief from the stay. *Id.*

Significantly, the court found that the debtor’s valuation premises were flawed. First, the court found that the projected sales prices for the storage units were greatly inflated compared to what the debtor actually received for the units he recently sold. *Id.* at 853. Second, the court found that the plan called for the debtor to sell 10 times as many storage units in the next two years as he had sold in the previous two years without any justification for the increase. *Id.*

The court also found that the debtor’s plan was “largely premised on litigation” that the court predicted would be quite time consuming. *Id.* at 849. For example, the debtor was planning on disputing over two-thirds of the unsecured claims as well as challenging the validity of the Bank’s mortgage, while simultaneously attempting to sell the storage units free and clear of any liens. *Id.* at 849-850.

The flaws in the debtor’s plan led the court to conclude that the plan was not feasible. *Id.* at 853. The court further found that, even if the plan was implemented, there was unlikely to be enough value in the project to provide recovery to any creditors other than the bank. *Id.* at 854. Therefore, with the third and fourth factors in the court’s analysis weighing in favor of granting relief from the stay, the court found the forbearance agreement enforceable and granted the Bank’s motion for relief from the automatic stay. *Id.* at 855.
Environmentally Insolvent: Fair Value Measurement of Environmental Liabilities Poses Solvency Risk

By C. Gregory Rogers

A new approach to valuing contingencies under U.S. and international accounting standards could enable creditors, trustees, shareholders and other interested parties to argue that corporate environmental liabilities are vastly understated. Asarco, which filed bankruptcy in 2007 with unfunded and undisclosed environmental cleanup liabilities estimated between $500 million and $1 billion, is a case in point.

Older accounting standards that favored certainty over projections are being replaced with standards that favor (market-based) projections over certainty. The result will be more recorded liabilities and higher estimates. Although the new standards will not be fully phased in for years, litigants need not wait to use these standards to show that seemingly viable companies are in fact insolvent and were insolvent long before. This new approach will certainly play in a role in fraudulent transfer and preferential transfer litigation, as well as in a variety of other disputes involving the “if” and “when” a corporation became insolvent.

Under new accounting standards that will take effect in 2009, the surviving company in a business merger or acquisition must report certain types of contingencies, including most environmental liabilities, at market value. For example, the new standards will require recognition of environmental cleanup obligations without regard to the likelihood of government enforcement or the probability that the company will ever spend money to clean up the site. Whereas existing accounting standards do not require recognition of liabilities that cannot be “reasonably estimated,” the new standards assume that any contingency, no matter how uncertain, has a market value. As corporations, attorneys, accountants, and environmental professionals become experienced with fair value measurement of environmental liabilities, expect to see litigants and interested parties making the case those companies with a history of polluting activities are “environmentally insolvent.”

Determining Solvency

Solvency issues arise under a myriad of corporate and bankruptcy laws. When determining solvency, courts are not restricted to valuing only the debtor’s loans and trade payables. They also can consider contingent and off-balance sheet liabilities. A finding of insolvency can serve as the basis for legal and contractual claims, including fraudulent and preferential transfers under the Bankruptcy Code and state laws, the commencement of an involuntary bankruptcy, pursuit of illegal dividends or wrongful distributions, and enforcement of loan covenant violations.

There are two distinct tests for determining solvency: (1) the “balance sheet” test, and (2) the “cash flow” or “equity” test. The balance sheet test compares the fair value of the debtor’s liabilities to the fair market value of its assets. The cash flow test compares a debtor’s ability to generate cash (from continuing operations, disposition of assets, or other capital raising

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activities) to the payments required to satisfy its obligations as they mature. Both tests consider off-balance sheet liabilities and contingencies, as well as recorded liabilities.

A loss contingency is an existing condition, situation, or set of circumstances involving uncertainty as to possible loss to an entity that will ultimately be resolved when one or more future events occur or fail to occur. Examples of loss contingencies include pending or threatened litigation, actual or possible claims and assessments, product warranties, standby letters of credit, and guarantees. Environmental liabilities generally are considered loss contingencies arising from litigation, claims, or assessments.

Although courts uniformly agree that loss contingencies must be included in a solvency determination, there is no clear standard for measuring them. Most courts apply a “probability discount” approach to determine the fair value of contingent liabilities. This method values a loss contingency based on the likelihood of an actual loss. It is relatively straightforward when applied to a financial contingency with a face value such as a standby letter of credit. Its application in valuing non-financial contingencies with no face value is more problematic.

Valuation of non-financial contingent liabilities such as pending or threatened litigation is highly complex and subject to professional judgment. Valuation of environmental liabilities involves special considerations that can compound this complexity. Uncertainties may exist as to whether a site is actually contaminated, whether there is a legal duty to perform an investigation, whether knowledge of contamination imposes a legal obligation to perform cleanup, whether a government agency or private party will ever compel cleanup, whether related claims for bodily injury, property damage, or natural resource damages will arise, the scope of the contamination, the technology that will be required to remediate the site, and how long the cleanup will take. These uncertainties, among others, present a difficult challenge to any litigant or judge seeking to estimate a company’s environmental liabilities for purposes of determining solvency.

It might seem reasonable to expect that valuation of contingencies for solvency purposes should be guided by generally accepted accounting principals ("GAAP"). However, historical accounting standards for contingencies avoid the complexity of market-based valuation in favor of simplistic models that can be more easily applied. Consequently, accounting standards have been of little relevance to solvency determinations, until recently. As explained below, the application of “fair value measurement” to contingencies under recently adopted accounting standards promises to better align the valuation of contingencies for accounting and solvency purposes.

**Fair Value**

Financial Accounting Standard Board (FASB) Statement 5, *Accounting for Contingencies*, provides a two-prong test for recognition of contingent liabilities. A reporting entity should recognize a liability when information available prior to issuance of the financial statements indicates that it is probable that a liability has been incurred (the “probability” criterion) and the amount of the loss can be reasonably estimated (the “reasonably estimable” criterion). In practice, the probability criterion is interoperated to mean there is a high likelihood of future expenditures. Likelihood of loss rather than the existence of a legal obligation is the determining factor.
According to FASB Interpretation No. 14 (FIN 14), the reasonably estimable criterion is met when a range of loss (low end and high end) can be reasonably estimated. Thus, a loss contingency for which the high end of the range of possible loss cannot be determined should not be recognized as a liability under FIN 14.

If a loss contingency meets the dual recognition criteria under Statement 5, the amount of the liability must be estimated and recorded. FIN 14 provides a simplistic measurement technique for estimating the amount of the liability. When one amount within the range of loss is a better estimate than any other amount (the “most likely value”), that amount is used. When no amount within the range of loss is a better estimate than any other amount the low end of the range of estimates (the “known minimum value”) is used. In practice, most environmental liabilities are recorded at their known minimum value.

Statement of Position (SOP) 96-1, Environmental Remediation Liabilities, applies the principles of Statement 5 and FIN 14 to environmental cleanup obligations arising under environmental laws such as the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA or “Superfund”). Statement 5 and FIN 14, as well as SOP 96-1, which favor certainty over projections, have been criticized for delaying recognition of contingent liabilities, understating recognized liabilities, and failing to provide users of financial statements with useful, transparent, and timely information.

The simplistic recognition and measurement approach in Statement 5, FIN 14, and SOP 96-1, which excludes consideration of contingencies that are not deemed highly likely to result in a reasonably estimable loss, is incompatible with the probability discount approach (discussed above) used by courts in solvency determinations. When determining solvency, courts are required to consider the fair value of all of the debtor’s contingent liabilities. This requires consideration of all contingencies, regardless of the probability of loss, and a more robust valuation methodology. These requirements are met by an emerging accounting principle called “fair value measurement.”

Fair value measurement, also known as “mark-to-market,” has emerged as the favored measurement principle under U.S. and international financial reporting standards over the past decade. In recent years, the FASB has adopted numerous standards requiring fair value measurement of liabilities and impairments, including:

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<td>2007</td>
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<td>2006</td>
<td>Statement 157, Fair Value Measurements</td>
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<td>2005</td>
<td>Interpretation 47, Accounting for Conditional Asset Retirement Obligations: An Interpretation of FASB Statement No. 143</td>
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<td>2002</td>
<td>Statement 146, Accounting for Costs Associated with Exit or Disposal Activities</td>
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<td>Interpretation 45, Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others</td>
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Under the fair value measurement principle, a liability is recognized for a loss contingency whenever there is a present obligation, regardless of the likelihood of loss. Fair value eschews the notion of a “possible liability” that has yet to become “fixed.” For example, whereas courts typically regard a guarantee as a possible liability that may never become an actual liability, under the fair value measurement principle, a guaranty represents an unconditional obligation to stand ready to perform in the event of specified future circumstances. Thus, a present liability exists and uncertainties about the probability, timing, and amount of potential loss are factored into the measurement.

The fair value of a liability is the price that would be paid to transfer the liability in an orderly transaction between market participants at the measurement date (exit price). A quoted price for the identical liability in an active market is the best evidence of fair value. If an active market does not exist, companies must estimate the exit price based on the assumptions that market participants would use in pricing the liability, including probabilistic analysis, risk premium, and profit margin.

In contrast to the Statement 5/FIN 14 approach, the fair value measurement principle favors (market-based) projections over certainty. It has the effect of accelerating recognition of contingent liabilities, thereby bringing previously off-balance sheet liabilities onto the financial statements. In addition, market-based estimates of the exit price for a contingent liability can be higher, sometimes much higher, than estimates produced under FIN 14 and SOP 96-1.

The following hypothetical examples help illustrate the application of fair value measurement to environmental liabilities assumed in a business merger or acquisition. Beginning in 2009, acquirers must account for assumed contingencies at fair value. Under Statement 141R, Business Combinations, all contract-related contingencies assumed in a merger or business acquisition will have to be recognized at their acquisition-date fair value. Non-contractual contingencies also will have to be recorded at their acquisition-date fair value, but only if legal counsel determines that it is “more likely than not” that a liability exists as of the acquisition date. The determination of liability does not consider the probability of future expenditures to settle an existing obligation.

**Example 1:** Buyer plans to purchase the stock of Seller. Seller owns an industrial facility with soil and groundwater contamination resulting from historical releases of chlorinated solvents (TCE) caused by Seller. Seller estimates that a thorough site investigation will cost $250,000. Depending on the extent of contamination, cleanup costs are expected to range between $2 million and $10 million. In accordance with SOP 96-1, Seller has used the reasonably estimable cost of the investigation as a surrogate for the known minimum value of the total cleanup and booked a contingent liability in the amount of $250,000. Buyer estimates that it would charge $5 million to assume cleanup liability for the facility in a stand-alone transaction. This estimate is comparable to a quote obtained from a liability buy-out company. Upon acquisition of Seller, instead of recording a $250,000 liability, Buyer records a contingent liability in the amount of $5 million representing its estimate of the acquisition-date fair value of the cleanup liability.
Example 2: Same facts as above, except that preliminary investigation indicates that TCE in groundwater has migrated offsite under a residential neighborhood at concentrations posing a risk of vapor intrusion. As of the acquisition date, Seller has not notified the government or the adjacent property owners and no claims have been asserted against Seller. In accordance with SOP 96-1, Seller has not recorded a contingent liability for unasserted claims for property damage or bodily injury because Seller does not consider litigation to be probable (highly likely) and it believes the amount of the potential loss cannot be reasonably estimated. Based on existing information, Buyer’s legal counsel concludes it is more likely than not that Seller is liable for trespass and related property damages (but not for bodily injury). Considering possible outcomes of potential litigation, including possible out-of-court settlement, Buyer’s counsel estimates the reasonable worst-case outcome for property damage claims is a loss of $15 million. Buyer obtains three quotes for 10-year environmental insurance policies with limits of $15 million that would respond in the event of lawsuits by offsite impacted property owners arising from pre-existing pollution conditions (bodily injury and cleanup cost coverage is excluded). Upon acquisition of Seller, Buyer records a contingent liability in the amount of $1.5 million — the average of the three insurance premium quotes — as its estimate of the acquisition-date fair value of Seller’s offsite property damage liability.

Example 3: Same facts as above, except that Seller recently sold the facility in 2001 and gave the current owner an unlimited contractual indemnity for third-party claims for cleanup costs, property damages, or bodily injury arising from pre-existing pollution conditions. At the time of the acquisition, no third-party claims have been asserted and the current owner has made no demand against Seller under the indemnity. In accordance with SOP 96-1, Seller has not recorded a contingent liability for its contractual indemnity obligation because Seller does not consider a claim to be probable (highly likely) and it believes the amount of the potential loss cannot be reasonably estimated. Based on available information and experience with vapor intrusion litigation in other parts of the country, Buyer’s counsel estimates the reasonable worst-case outcome for bodily injury and property damage claims is a loss of $100 million. Buyer obtains a quote in the amount of $10 million for a 10-year, $100 million environmental insurance policy that would respond in the event of claims for bodily injury or property damage arising from pre-existing pollution conditions (cleanup cost coverage is excluded). Only one carrier was willing to underwrite the risk. Upon acquisition of Seller, Buyer records a contingent liability in the amount of $15 million — $5 million for cleanup (see Example 1) plus the insurance premium quote for bodily injury and property damage coverage — as its estimate of the acquisition-date fair value of Seller’s contractual indemnity obligation.

Conclusion

Judicial approaches to determining solvency contemplate market-based estimates of contingent environmental liabilities. Most parties, however, lack experience in estimating the market value of such liabilities. Litigants face even greater challenges in identifying unrecognized off-balance sheet environmental liabilities. As noted by a Wall Street analyst after independently researching the environmental liabilities of a major U.S. corporation, “our research reflects not a lack of effort or comprehensiveness, but the fundamental impossibility to uncover the liabilities, big or small, that the company may one day be forced to deal with.” Consequently, interested parties rarely seek to comprehensively inventory and value a company’s environmental liabilities to show insolvency.
Fair value accounting will draw attention to the historical understatement of corporate environmental liabilities and generate a cadre of environmental valuation experts. As reporting entities and practitioners become experienced with fair value measurement of environmental liabilities, more interested parties will seek to show “environmental insolvency” as a basis for a variety of legal and contractual claims and to support causes of action under the Bankruptcy Code and state laws.
Can the Creditors Do It?:
A Pan-Circuit Review of Creditors’ Rights to Derivative Standing
Under Chapter 11

By Nathan Wheatley

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 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 (5th 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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2 “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 (4th 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 (1st 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 (3rd 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 (10th Cir. 1995); Hall v. Walter (In re Hall), 1998 U.S. App. LEXIS 2866, at *10-11 (10th 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 there 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 (10th Cir. 2007) (citing *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1 (2000)). Additionally, the 10th 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. 10th 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.³

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 8th, 9th, and 11th 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 (8th 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. 8th 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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³ 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 (9th 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 (9th 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 2nd, 3rd, 5th, 6th and 7th.

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 (2nd 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 (2nd 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 (2nd 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 (3rd 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 (3rd 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 5th 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 (6th 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 (6th 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 (7th 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 (7th 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.