Granting Derivative Standing to a Creditors’ Committee

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Introduction

A party has “standing” (the right to challenge the conduct of another in court) when that person or entity has suffered an “injury in fact.”¹ “Derivative standing” is when a person or entity other than the harmed party steps in to assert the claim in place of the harmed party.² In a case under Chapter 11 of Title 11 of the United States Code (the “Bankruptcy Code”), a bankruptcy court may grant derivative standing to a creditors’ committee or similar body, rather than the bankruptcy estate itself, to bring a claim on behalf of a debtor’s estate.³ This often occurs when a debtor or bankruptcy trustee is unwilling or unable to assert the claim itself.⁴ Courts support granting derivative standing to a creditors’ committee when doing so will generate value for the estate from litigation recoveries.⁵

In 2000, when the Supreme Court of the United States had the opportunity to answer whether granting derivative standing to a creditors’ committee was allowable, the Court did not

¹ Standing, Black’s Law Dictionary (9th ed. 2009).
³ See id.
⁴ Id. at 569.
⁵ See id. at 554.
directly answer the question.⁶ There, the Court analyzed section 506(c) of the Bankruptcy Code and denied granting a creditor standing to surcharge collateral.⁷ According to the Court, section 506(c) should be read narrowly to apply only to the party listed in the statute, not to other interested parties.⁸ Thus, only a trustee could surcharge collateral.⁹ However, the Court added that its decision “[d]id not address whether a bankruptcy court can allow other interested parties to act in the trustee's stead in pursuing recovery[,]” leaving the question of derivative standing unanswered.¹⁰ The Court’s dicta has led many courts to interpret the Bankruptcy Code broadly.¹¹ These courts, starting with the Eighth Circuit Court of Appeals, have used a four-part test (laid out in Part I of this Memo) to analyze when to grant derivative standing to a creditors’ committee.¹² Other courts have reasoned, consistent with the holding of Hartford, that the Bankruptcy Code should be narrowly construed to prevent an interested party from asserting standing on behalf of a debtor in possession.¹³

This memorandum discusses the justifications accepted by an overwhelming majority of circuits for granting derivative standing in two parts. Part I lays out the requirements for a creditors’ committee seeking to assert derivative standing on a debtor in possession and a breakdown of the most contestable of those requirements. Part II examines bankruptcy courts’ usage of sections 1109(b) and 503(b)(3)(B) to support derivative standing, providing the historical and contextual foundations of these sections. Ultimately, these parts will highlight that

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⁷ Id.
⁸ Id.
⁹ Id. at 8.
¹⁰ See id at n. 5.
¹² See PW Enters., Inc. v. N.D. Racing Comm’n (In re Racing Servs., Inc.), 540 F.3d 892, 900 (8th Cir. 2008).
¹³ See In re Fox, 305 B.R. 912, 917 (B.A.P. 10th Cir. 2004).
most circuits favor granting derivative standing to increase judicial economy, efficiency, and returns for stakeholders and debtors.  

Discussion

I. The Contestable Requirements for Derivative Standing.

Most jurisdictions require a four-part showing to grant derivative standing to a creditors’ committee. In particular, a committee must show that: (1) it made a demand on the debtor to bring a claim; (2) the demand was unjustifiably refused; (3) the claim is colorable; and (4) it sought court permission to bring the claim. Under the second requirement, a debtor in possession most commonly refuses to assert a claim when it either does not want to harm the party it has a claim against or because it does not believe that the claim is valuable enough to pursue. The most frequently litigated requirements of derivative standing are the second and third elements: whether the demand was unjustifiably refused and whether the claim is colorable.

A. Bankruptcy Courts Must Determine Whether a Debtor in Possession Unjustifiably Refused to Assert a Claim Before Granting Derivative Standing.

A creditors’ committee cannot satisfy the requirement that a debtor in possession refused to assert a claim by merely stating it “is ‘too busy,’ ‘lacks funds,’ or ‘just doesn't want to.’”


15 See In re Roman Cath. Church of Archdiocese of Santa Fe, 621 B.R. at 509.

16 Id.


18 See PW Enters., Inc. v. N.D. Racing Comm’n (In re Racing Servs., Inc.), 540 F.3d 892, 900 (8th Cir. 2008) (noting that the remaining two elements, that the committee made a demand on the debtor, and that the committee sought court permission to bring the claim, are rarely contested).

19 Id. at 899.
Instead, a committee must provide a bankruptcy court with specific reasons that it believes a debtor in possession’s refusal to assert a claim is unjustified. The type of factual showing required differs from case to case. But, most courts agree that a debtor in possession’s refusal is unjustified when allowing a creditor to assert the claim would clearly benefit the estate. This determination becomes more difficult when the benefit to the estate would be marginal. Some factors courts use to determine whether a debtor in possession’s refusal is unjustifiable include: (1) “the probabilities of legal success and financial recovery in event of success”; (2) the creditor's “proposed fee arrangement”; and (3) the “anticipated delay and expense to the bankruptcy estate that the initiation and continuation of litigation will likely produce.”

Bankruptcy courts seek to balance the risk of conferring derivative standing on creditors’ committees against the benefit that the estate would enjoy. Ultimately, a bankruptcy judge has a great deal of discretion in determining when a refusal is unjustifiable because each evaluation is made case-by-case based on the surrounding circumstances.

B. Bankruptcy Courts Must Determine that a Claim is Colorable to Grant Derivative Standing to a Creditors’ Committee.

A creditors’ committee must also prove that the claims a debtor in possession refuses to assert are colorable. To determine whether a claim is colorable, a court will focus on whether

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20 Unsecured Creditors Comm. of Debtor STN Enters., Inc. v. Noyes (In re STN Enters.), 779 F.2d 901, 905 (2d Cir. 1985) (explaining that a request for derivative standing must be supported by competent evidence, such as an affidavit, through oral testimony, or in an evidentiary hearing).

21 Id.

22 In re Racing Servs, 540 F.3d at 900.

23 Id.

24 In re STN Enters., 779 F.2d at 905–906.

25 See In re Baltimore Emergency Servs. II, Corp., 432 F.3d 557, 562 (4th Cir. 2005) (granting derivative standing too easily “could usurp the central role that the…debtor-in-possession plays as the representative of the estate”).

26 In re STN Enters., 779 F.2d at 903.

the claim is sufficiently plausible to survive a motion to dismiss.\textsuperscript{28} Next, a court will weigh the potential benefit to the estate against the costs that will be incurred by the estate in litigation.\textsuperscript{29} This cost-benefit analysis is necessary to “prevent committees and individual creditors from pursuing adversary proceedings that may provide them with private benefits but result in a net loss to the entire estate.”\textsuperscript{30} As such, a bankruptcy court must consider the interests of the entire estate and not merely the interests of any single creditor when determining if a claim is colorable and worth granting to a creditors’ committee.\textsuperscript{31}

II. Many Courts Have Used the Bankruptcy Code and its History to Support Derivative Standing.

The Bankruptcy Code does not explicitly permit courts to grant derivative standing to creditors’ committees.\textsuperscript{32} However, several sections and their historical foundations support the notion of derivative standing and the common law practice of granting creditors' committees the ability to bring claims on behalf of a debtor in possession.\textsuperscript{33} The primary sections that courts use to support derivative standing are sections 1109(b) and 503(b)(3)(B).\textsuperscript{34}


Many bankruptcy courts rely on § 1109(b) to grant derivative standing.\textsuperscript{35} This section states: “[a] party in interest, including the debtor, the trustee, a creditors' committee, an equity security holders' committee, a creditor, an equity security holder, or any indenture trustee, may

\textsuperscript{29} In re STN, 779 F.2d at 905–06.
\textsuperscript{30} In re AppliedTheory Corp., 493 F.3d 82, 86 (2d Cir. 2007).
\textsuperscript{31} Id.
\textsuperscript{32} See Cybergenics, 330 F.3d at 559.
\textsuperscript{33} Id. at 560.
\textsuperscript{34} See In re Trailer Source, 555 F.3d at 241.
\textsuperscript{35} See id.
raise and may appear and be heard on any issue in a case under this chapter.”\textsuperscript{36} The court in \textit{Cybergenics} explained that under “the broad right of participation conferred by § 1109(b), [a bankruptcy] court may authorize a party in interest to commence litigation on behalf of the estate if certain conditions are satisfied.”\textsuperscript{37} Congress drafted this provision broadly to expand the number of parties with authority to assert claims.\textsuperscript{38} Even in the pre-Bankruptcy Code era, courts granted derivative standing to creditors’ committees.\textsuperscript{39} Therefore, many courts have reasoned that Congress’s expansion of the number and type of individuals and entities who can assert claims certainly does not support the abolition of granting derivative standing, it only offers greater support for allowing it.\textsuperscript{40}

One hurdle, however, in relying on section 1109(b) to grant derivative standing to creditors’ committees is the dicta by the Supreme Court in \textit{Hartford Underwriters}.\textsuperscript{41} The Court explained, “we do not read § 1109(b)'s general provision of a right to be heard as broadly allowing a creditor to pursue substantive remedies that other [Bankruptcy] Code provisions make available only to other specific parties.”\textsuperscript{42} Certain courts have interpreted the Supreme Court’s statement to mean section 1109(b) does not give bankruptcy courts the power to authorize derivative suits.\textsuperscript{43} But most courts have responded to this by adding that section 1109(b) does permit granting derivative suits to creditors’ committees as long there is no evidence that the committee has attempted to “usurp the trustee’s role as representative of the estate.”\textsuperscript{44}

\textsuperscript{36} 11 U.S.C. § 1109(b) (2018).
\textsuperscript{37} 330 F.3d at 561.
\textsuperscript{38} \textit{In re Pursuit Capital Management}, 595 B.R. at 655–656.
\textsuperscript{39} \textit{Cybergenics}, 330 F.3d at 571.
\textsuperscript{40} \textit{Id}.
\textsuperscript{41} Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A., 530 U.S. 1, 9 (2000).
\textsuperscript{42} \textit{Id}.
\textsuperscript{43} \textit{See In re Fox}, 305 B.R. 912, 917 (B.A.P. 10th Cir. 2004).
\textsuperscript{44} Wooley v. Haynes & Boone, L.L.P. (\textit{In re SI Restructuring Inc.}), 714 F.3d 860, 863 (5th Cir. 2013). (citing \textit{Cybergenics}, 330 F.3d at 561).

Section 503(b)(3)(B) of the Bankruptcy Code provides a statutory basis for derivative standing. Specifically, 503(b)(3)(B) states: “[a]fter notice and a hearing, there shall be allowed administrative expenses . . . including . . . the actual, necessary expenses . . . incurred by . . . a creditor that recovers, after the court's approval, for the benefit of the estate any property transferred or concealed by the debtor . . . .”45 Many courts have explained that by section 503(b)(3)(B) recognizing and monetarily rewarding creditors, the text permits granting creditors’ committees, with court authorization, the authority to pursue derivative actions.46 Section 503(b)(3)(B) is often cited alongside section 1109(b) to clarify that only a bankruptcy court, not a bankruptcy trustee, can authorize derivative standing.47

Some courts, on the other hand, have explained that § 503(b)(3)(B) “only authorizes recovery of expenses to a creditor who successfully recovered property, which is to say, a creditor who had standing in the first place.”48 These courts found that section 503(b)(3)(B) only grants creditors’ committees the ability to assist a debtor in locating property, a privilege that already existed under Bankruptcy Rule 2004.49 This reading of section 503(b)(3)(B) does not align with congressional intent as it would make this section superfluous.50 Under existing law, a creditors’ committee cannot recover or assist in recovering any property beyond that necessary to

46 See Cybergenics, 330 F.3d at 565.
49 See id.
50 See *Cybergenics*, 330 F.3d at 566.
satisfy its own claim, and therefore, the only way a “creditor” (which includes creditors and creditors’ committees) can recover property for the benefit of the estate is to sue derivatively.  

Conclusion

Most courts recognize that when Congress enacted the Bankruptcy Code in 1978, it expanded on the already acceptable practice of allowing creditors' committees to pursue actions for the benefit of the estate. The purpose of derivative standing is to increase judicial economy, efficiency, and returns for stakeholders and debtors. The four-part showing to grant derivative standing to a creditors’ committee has been accepted by many circuits to accomplish these purposes. When analyzing the four-part showing for derivative standing, courts typically conduct a cost-benefit analysis on the part of the estate and ultimately determine if the interests of stakeholders, debtors, and the judiciary are satisfied.

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51 Id.
52 Id.
53 In re Commodore Int'l Ltd., 262 F.3d 96, 100 (2d Cir. 2001).
54 See In re Roman Cath. Church of Archdiocese of Santa Fe, 621 B.R. 502, 514 (Bankr. D.N.M. 2020) (noting that the derivative standing requirements help prevent unnecessary litigation costs).