

Stradley Ronon Stevens & Young, LLP
2005 Market Street
Suite 2600
Philadelphia, PA 19103-7018
215.564.8000 Telephone
215.564.8120 Facsimile
www.stradley.com

With other offices in:
Washington, D.C.
New York
New Jersey
Illinois
Delaware



www.meritas.org

Our firm is a member of Meritas. With 189 top-ranking law firms spanning 97 countries, Meritas delivers exceptional legal knowledge, personal attention and proven value to clients worldwide.

Information contained in this publication should not be construed as legal advice or opinion or as a substitute for the advice of counsel. The enclosed materials may have been abridged from other sources. They are provided for educational and informational purposes for the use of clients and others who may be interested in the subject matter.

Copyright © 2020
Stradley Ronon Stevens & Young, LLP
All rights reserved.

Third Circuit Decision Holds Creditors May Pursue Claims Abandoned by Bankruptcy Trustee

Artesanias Hacienda Real S.A. DE C.V. v. North Mill Capital, LLC *(In re Wilton Armetale, Inc.)*

The Third Circuit recently issued its decision in *Artesanias Hacienda Real S.A. DE C.V. v. North Mill Capital, LLC (In re Wilton Armetale, Inc.)* which has important ramifications for creditors in the Third Circuit whose authority to pursue so-called “derivative” claims against non-debtor third parties ordinarily is cut off by a debtor’s bankruptcy filing. To understand the Third Circuit’s decision in *Wilton*, it is necessary to understand two basic underlying premises. First, certain claims a creditor may have against non-debtor third parties, such as fraudulent transfer claims, are “derivative” of claims that the debtor’s estate has against those same parties. When a debtor files for bankruptcy protection, any causes of action held by the debtor become property of the bankruptcy estate, and the Bankruptcy Code gives the bankruptcy trustee the sole authority to pursue those claims, barring creditors from simultaneously pursuing any claims that derive from the estate’s claims. Second, “bankruptcy standing” is not the same as “constitutional standing.” The Bankruptcy Code may terminate a creditor’s “bankruptcy standing” to pursue “derivative” claims against non-debtor third parties, but it does not otherwise extinguish the creditor’s constitutional standing to assert such claims. In *Wilton Armetale*, the Third Circuit, relying on these two underlying principles, held that a chapter 7 trustee’s abandonment of the estate’s direct claims against non-debtor third parties can restore a creditor’s authority to pursue its own claims which derive from the abandoned claims.

“Derivative” Claims in Bankruptcy

Certain claims a creditor may hold against non-debtor third parties are considered “derivative” of a bankruptcy estate’s claims. That is, they do not arise from a particularized harm that is personal to that creditor but instead secondarily arise from harm caused directly to the debtor or its estate. In *Wilton Armetale*, prior to the bankruptcy, the appellant-creditor, Artesanias, had instituted litigation against certain non-debtor parties, alleging they had diluted the assets of the debtor to the detriment of the debtor’s creditors. As the Third Circuit explained, in bankruptcy, such claims are considered “derivative” because they derive from an injury to a debtor’s estate that causes generalized, secondary injury to all of the debtor’s creditors.

Under the Bankruptcy Code, upon filing for bankruptcy, most of a debtor’s property becomes property of the bankruptcy estate, including causes of action the debtor could have asserted prior to the bankruptcy. At the outset, the bankruptcy court appoints a trustee who exercises control over the estate property and has exclusive authority to bring suit on the estate’s behalf.¹ Accordingly, because creditors’ derivative claims against third parties arise from the secondary harm caused by direct injuries to the estate, and the trustee has exclusive authority over estate claims, creditors lose the statutory right to assert such claims in bankruptcy.

Bankruptcy “Standing” v. Constitutional Standing

In some respects, the *Wilton Armetale* decision was made necessary by the bankruptcy courts’ historic use of what the Third Circuit called “some confusing legalese” to describe creditors’ inability to pursue derivative claims in bankruptcy. As the Third Circuit explained, courts have frequently described a creditor’s loss of statutory authority to pursue such claims as a loss of bankruptcy “standing.” However, the U.S. Supreme Court has held that such statutory “standing,” which considers whether a plaintiff has any statutory right to pursue its claim, is not the same as constitutional standing.²

Constitutional standing is a fundamental principle of constitutional law which includes three elements: (1) “a concrete and particularized injury in fact,” (2) that is “fairly traceable” to the defendant’s conduct, and (3) that “a favorable judicial decision” would likely “redress.”³ Constitutional standing is a jurisdictional requirement, meaning that if a plaintiff lacks any of these three elements, it cannot assert its claims in federal court.

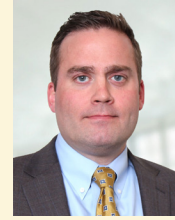
As explained above, because the trustee has the exclusive right to exercise control over the debtor’s property, the filing of a bankruptcy cuts off a creditor’s authority to pursue derivative actions that arise only from direct injuries to the estate.⁴ In *Wilton Armetale*, the Third Circuit acknowledged that in the past, it has described this result as a creditor’s loss of “standing” to pursue such claims in bankruptcy. However, this common usage of the word “standing” refers not to constitutional standing, but to whether Congress has exclusively authorized a bankruptcy trustee to pursue those claims under the Bankruptcy Code. Thus, although the Bankruptcy Code may curtail a creditor’s statutory authority to pursue derivative claims, it does not extinguish the creditor’s “constitutional standing to invoke the federal judicial power.”⁵

The Third Circuit’s Decision in *Wilton Armetale*

In *Wilton Armetale*, Artesanias had obtained a judgment against the debtor and the debtor’s former owner, who had guaranteed the debtor’s obligations after the debtor failed to pay for certain goods. In addition, Artesanias obtained all of the owner’s shares in the debtor. The judgment also gave Artesanias a lien on a warehouse owned by the debtor. Artesanias alleged that after taking control of the debtor, it learned that the debtor was insolvent and that the former owner, a friendly creditor, North Mill Capital, and a law firm retained by the owner, had plundered the debtor’s assets by, among other things, selling the debtor’s non-real estate assets to North Mill even though other bidders had offered more for the assets. In addition, Artesanias alleged that the owner and the law firm had allowed North Mill to file inflated judgments against the debtor resulting in a competing lien on the warehouse on which North Mill tried to foreclose. Prior to the debtor’s bankruptcy, Artesanias sued North Mill and the law firm, alleging that they had fraudulently



Gretchen Santamour



Daniel M. Pereira

For more information, contact Gretchen Santamour at 215.564.8523 or gsantamour@stradley.com or Daniel M. Pereira at 215.564.8747 or dpereira@stradley.com.

hindered Artesanias’s ability to collect its judgment. Artesanias sought damages and to stop North Mill’s foreclosure of the warehouse. The debtor subsequently filed for chapter 7 bankruptcy, staying the warehouse foreclosure.⁶

In separate settlements reached by the chapter 7 trustee with Artesanias and North Mill, the trustee agreed to split the proceeds from a sale of the warehouse between Artesanias and North Mill, release the bankruptcy estate’s claims against North Mill, and not interfere with Artesanias’s claims against North Mill and others. After the sale of the warehouse, the bankruptcy estate had few remaining assets, among them the causes of action against North Mill and others who allegedly misappropriated the debtor’s assets. With limited funds to pursue such claims and the outcome of litigation uncertain, the trustee elected, with the approval of the bankruptcy court, to abandon most of the estate’s claims.

Thereafter, Artesanias’s lawsuit against North Mill and the law firm continued and the district court referred the litigation to the bankruptcy court, finding it sufficiently related to the bankruptcy case to do so. The bankruptcy court subsequently dismissed Artesanias’s claims on the ground that only the chapter 7 trustee had standing to sue because Artesanias’s claims were derivative of the claims held by the bankruptcy estate. The district court affirmed.

On appeal, the Third Circuit concluded that although the filing of the chapter 7 bankruptcy had cut off Artesanias’s statutory authority to pursue its claims, such bankruptcy “standing” had no effect on its constitutional standing and, accordingly, Artesanias retained constitutional standing throughout the bankruptcy case. Further, although the court’s appointment of the chapter 7 trustee vested the trustee with the sole authority to pursue the estate’s claims from which Artesanias’s claims were derived, once the trustee expressly abandoned those claims, Artesanias was free to pursue those claims in its own right. As the Third Circuit explained, once a bankruptcy trustee abandons property of the estate, including causes of action, possession of that property reverts back to any party that held a possessory interest in it prior to the bankruptcy. Therefore, Artesanias’s

derivative interests in the estate's claims against the non-debtor third parties were revived by the trustee's abandonment of the estate's own interests in the claims.

Takeaway

The Third Circuit's opinion should be a welcome development to those creditors who may have derivative claims against non-debtor third parties such as owners, directors, officers and other creditors. Previously a creditor may have understandably assumed that any right it had to assert derivative claims, such as fraudulent transfer claims, against non-debtor third parties was extinguished upon the debtor's filing for bankruptcy protection; however, the Third Circuit's decision means that the termination of such right may not be permanent. It is important to note that the Third Circuit relied, in part, on the trustee's express abandonment of the estate's claims, as reflected by the bankruptcy court's order approving the abandonment. As the Third Circuit noted, evidence of abandonment must be clear and unambiguous. Further, because a chapter 7 trustee has an independent interest in pursuing estate claims because the trustee is entitled to a portion of any recoveries he or she obtains for the estate, a trustee's abandonment of such claims may indicate that the claims are too speculative, lack merit, or simply do not justify the cost of litigation. Nevertheless, it will often be the case that a trustee, with fiduciary obligations to a debtor's creditors and a limited personal stake in the claims, is simply more risk-averse than an injured creditor who might have a greater appetite for pursuing the litigation.

As a result of this decision, it is important that creditors in the Third Circuit who have viable "derivative" claims against non-debtor third parties continue to closely monitor the bankruptcy proceedings. In the event that the trustee unambiguously abandons the estate's underlying claims, a creditor should consider whether to pursue such claims.

¹ 11 U.S.C. § 323(a), (b).

² *Lexmark Int'l, Inc. v. Static Control Components, Inc.*, 572 U.S. 118, 125-28 & n.4 (2014).

³ *In re Wilton Armetale, Inc.*, No. 19-2907, 2020 WL 4460000, at *4 (3d Cir. Aug. 4, 2020) (quoting *Lexmark Int'l*, 572 U.S. at 125).

⁴ In a chapter 11 bankruptcy, a debtor may continue to operate its business as a "debtor-in-possession" in which case a trustee will not be appointed; however, the same general rights that inure to a bankruptcy trustee, including the exclusive right to pursue causes of action held by the estate, also inure to a debtor-in-possession.

⁵ *Wilton Armetale*, 2020 WL 4460000, at *4.

⁶ Section 362 of the Bankruptcy Code imposes an automatic stay that immediately, upon the filing of the bankruptcy, halts the continuation of all actions against a debtor's property.