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## Cybergenics II: Precedent and Policy vs. Plain Meaning

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# **CYBERGENICS II: PRECEDENT AND POLICY VS. PLAIN MEANING**

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## CYBERGENICS II: PRECEDENT AND POLICY VS. PLAIN MEANING

### I. INTRODUCTION

The commencement of a bankruptcy case creates an estate.<sup>1</sup> The estate is the personification of the debtor's property: "a separate and distinct legal entity" constructed by federal law.<sup>2</sup> The Bankruptcy Code controls the estate's creation, scope, dissemination, and cessation.<sup>3</sup> The Code delineates who may act for and in relation to the estate, and it assigns the estate an agent, a representative who will act on the estate's behalf.<sup>4</sup> The powers and duties of the "estate representative" are comprehensive; they include, for example, the capacity to sue and be sued and the obligation to act as a fiduciary to the estate and its creditors.<sup>5</sup> In liquidation cases, a trustee assumes these rights and obligations.<sup>6</sup> In a typical reorganization case, where an insolvent business seeks to retain its assets and to continue to operate, a "debtor in possession" fulfills this same role.<sup>7</sup> Bankruptcy law requires the appointed agent, irrespective of his or her identity, to act in the best interests of the bankruptcy estate.<sup>8</sup>

Despite the affirmative "agency" obligations imposed upon bankruptcy trustees and debtors-in-possession, there are routinely disagreements in bankruptcy proceedings as to whether such an "agent" is truly acting in the best interests of his principal.<sup>9</sup> Creditors of a bankruptcy estate often allege that a trustee/debtor-in-

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1. 11 U.S.C. § 541(a) (2000).

2. *Creditor/Committee Derivative Litigation: Of Textualism and Equitable Powers*, BANKR. L. LETTER., 1, 3 (Nov. 2002) (quoting CHARLES JORDAN TABB, *THE LAW OF BANKRUPTCY* § 5.1 (1997)) [hereinafter *Textualism*]. The bankruptcy estate is a creature of the federal Bankruptcy Code; however, bankruptcy law is not wholly federal. DAVID G. EPSTEIN ET AL., *BANKRUPTCY* § 1-3(b) (1993). Principles of federalism "preclude state legislatures from enacting bankruptcy laws, [however] the Bankruptcy Code often expressly incorporates state law" and commonly references state common-law concepts. *Id.*

3. *See, e.g.*, 11 U.S.C. §§ 101, 109, 301, 302, 303 (2000) (controlling commencement); 11 U.S.C. § 541(a)-(b) (identifying what is and is not property of the estate); 11 U.S.C. §§ 503, 506, 507, 510 (2000) (controlling the hierarchy of creditors' claims during a liquidation); 11 U.S.C. §§ 707, 1112, 1208, 1307 (2000) (controlling dismissal).

4. 11 U.S.C. § 323(a) (2000) ("The trustee in a case under this title is the representative of the estate."); 11 U.S.C. § 1107(a) (2000). A debtor-in-possession has, subject to court imposed limitations "all the rights . . . and shall perform all the functions and duties . . . of a trustee serving in a case under this chapter." *Id.*

5. 11 U.S.C. § 323(b) ("The trustee in a case under this title has the capacity to sue and be sued."). *See, e.g.*, 11 U.S.C. § 704 (2000) (listing the duties of a Chapter 7 trustee). *See also* 4 BANKR. SERV. L. ED. § 37:79; 2 BANKR. SERV. L. ED. §§ 15:28, 15:29 (cataloging cases discussing the role of trustee, or debtor-in-possession, as representative of the estate).

6. 11 U.S.C. § 323(a); *see also* Susheel Kirpalani, *The Importance of Being Plain: A Textual Response to Cybergenics II*, AM. BANKR. INST. J. 1, 1 n.5 (Nov. 2002) (collecting Bankruptcy Code provisions that confer authority to act on behalf of the estate to the trustee).

7. 11 U.S.C. § 1107(a); BLACK'S LAW DICTIONARY 412 (7th ed. 1999) (defining debtor-in-possession as "a Chapter 11 or 12 debtor that continues to operate its business as a fiduciary to the bankruptcy estate.").

8. *See id.*; sources cited *supra* note 5.

9. *Textualism*, *supra* note 2, at 4.

possession is not pursuing available claims against third parties that, if realized, are likely to add value to the estate.<sup>10</sup> When such allegations arise, bankruptcy practice has, for over a century, provided creditors with a “qualified right” to act in the name of an estate representative who has failed to fulfill his fiduciary obligations to an estate.<sup>11</sup> Courts have operated as the “gatekeepers” of this practice, using broad discretion to adjudge whether the “best interests” of a bankruptcy estate will in fact be served by allowing another party to step into the shoes of the estate representative and commence a legal action on behalf of the estate.<sup>12</sup> The practice has no express statutory basis; however, it was not notably challenged until late 2002.

On September 20, 2002, the U.S. Court of Appeals for the Third Circuit issued a panel opinion concluding that a court may not authorize a creditors’ committee to commence an avoidance action in the trustee’s name, on behalf of a bankruptcy estate.<sup>13</sup> The decision shocked the bankruptcy bar and raised such a stir that many commentators raised it to the status of one of the “top cases of the year.”<sup>14</sup> Fur-

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10. Such allegations are anticipated in Chapter 11 reorganization proceedings where a debtor-in-possession is likely to encounter conflicts of interest. Kirpalani, *supra* note 6, at 38 (“In a quest to maximize [the] value [of the estate], the parties who are best positioned to rehabilitate a company’s operating performance may not be the best parties to investigate the pre-bankruptcy malfeasance of their colleagues or the board.”). For further discussion of potential conflicts of interest confronting a debtor-in-possession and their potential impact upon that party’s abilities to fulfill its obligations as representative of the estate, see *infra* notes 206-50 and accompanying text.

11. Kirpalani, *supra* note 6, at 38 nn.7-9 (collecting cases dating as early as 1900); Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery, 330 F.3d 548, 569-71 (3rd Cir. 2003) (collecting cases) [hereinafter Cybergenics III].

12. Kirpalani, *supra* note 6, at 38.

13. Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery, 304 F.3d 316 *passim* (3d Cir. 2002), *vacated, reh’g en banc granted*, 310 F.3d 785 (3d Cir. 2002) [hereinafter Cybergenics II]. The Cybergenics’ bankruptcy estate appeared before a panel of the Third Circuit Court of Appeals twice on discrete issues. The first appeal, decided in June 2000, is commonly referred to as Cybergenics I, and the second, more controversial opinion at issue in this Comment, is referred to as Cybergenics II. Cybergenics II was vacated in November of 2002 and reheard by the Third Circuit *en banc* on February 19, 2003. On May 29, 2003, the Third Circuit “re-issued” Cybergenics II. For purposes of clarity and consistency the “new Cybergenics II” will be referred to as Cybergenics III in this Comment. Cybergenics III came down after this Comment had already been submitted for publication. It is acknowledged in this Comment, but it has not been substantively integrated into the arguments raised forthwith.

14. *Top Cases—in our humble opinion—of 2002*, BANKR. CT. DECISIONS, December 24, 2002, at 1, 1. See also Michael A. Bloom & Joel S. Solomon, *Cybergenics II: Ignoring both Precedent and Pragmatism*, 11 J. BANKR. L. & PRAC. 417, 417 (“[Cybergenics II] is certain to have a reverberating and detrimental impact . . . the court . . . ignored history, pragmatism, positive experience, and long-standing precedent in favor of unwarranted, literal statutory interpretation.”); Thomas A. Draghi & Mickee M. Hennessy, ‘Cybergenics II’ Threatens Derivative Standing of Creditors’ Committees, 229 N.Y.L.J. 11, 11 (“ . . . [Cybergenics II] threatens the vitality of the well established practice of allowing, under certain circumstances, a creditors’ committee to prosecute fraudulent conveyance actions on behalf of a debtor.”); *Cybergenics Decision Leaves Many Stunned, Scrambling to Find Solution*, BANKR. CT. DECISIONS, November 19, 2002, at 1, 1 (“[Cybergenics II] has reverberated throughout the entire country and left many in the circuit itself scratching their heads.”); Shannon P. Duffy, *3rd Circuit Grants En Banc Review in Cybergenics Case*, at <http://www.law.com/jsp/article.jsp?id=1036630464156> (Nov. 21, 2002) (“Bankruptcy lawyers everywhere are breathing a sigh of relief now that the 3rd U.S. Circuit Court of Appeals has vacated [Cybergenics II].”).

thermore, within two months, the Second Circuit came down with a squarely contrary decision, reaffirming the validity of the practice within the Second Circuit and failing to even acknowledge recent events in the Third Circuit.<sup>15</sup> The resulting circuit split “pit[] two powerhouse bankruptcy jurisdictions against one another in a battle” of bankruptcy law, policy and statutory construction.<sup>16</sup> The Third Circuit, in reaching its conclusion, adopted a “plain meaning” interpretation of the Bankruptcy Code, purporting to follow the recent directive of the Supreme Court towards strict construction of the Bankruptcy Code.<sup>17</sup> The court found that the express language of the Bankruptcy Code gives the trustee, and only the trustee, the authority to bring avoidance actions on behalf of the bankruptcy estate.<sup>18</sup> In contrast, the Second Circuit employed a “best interest of the estate” approach, asserting that courts have the authority to actualize the broad policies and purposes of the Bankruptcy Code.<sup>19</sup> Accordingly, a court may authorize creditors to pursue avoidance actions in the trustee’s name, for the benefit of the estate, when such a suit is “necessary and beneficial” to the “fair and efficient” resolution of bankruptcy proceedings.<sup>20</sup>

The Third Circuit panel premised *Cybergenics II* upon *Hartford Underwriters Insurance Co. v. Union Planters Bank*,<sup>21</sup> issued by the Supreme Court in 2000.<sup>22</sup> *Hartford Underwriters* espoused a “plain meaning approach” to the Bankruptcy Code, interpreting the language “the trustee may” to be an exclusive grant of power.<sup>23</sup> In this case, an individual creditor had unilaterally commenced an action seeking direct compensation for services that it performed for the benefit of a bankruptcy estate.<sup>24</sup> The Supreme Court foreclosed this action because the right to pursue administrative claims is specifically conferred to the trustee and to no other party; the language *the trustee may* did not imply that the trustee *and any other party in interest may*.<sup>25</sup> The Court found that an exclusive grant of authority could not be implicitly extended to any party other than the grantee.<sup>26</sup> In *Cybergenics II*, the Third Circuit applied the reasoning of *Hartford Underwriters* to the provisions of the Code that grant a bankruptcy trustee the power to commence adversarial proceedings, known as the trustee’s “strong arm” powers.<sup>27</sup> These provisions all begin with the language “the trustee may.”<sup>28</sup> Accordingly, the court concluded

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15. *Banque Nationale de Paris v. Murad (In re Housecraft Indus. USA, Inc.)* 310 F.3d 64 (2d Cir. 2002) [hereinafter *Housecraft*]. See also *infra* Part VI (B) (discussing *Housecraft*).

16. *In Housecraft, Second Circuit Stands Its Ground on Derivative Fraudulent Transfer Actions in Spite of Controversial Third Circuit Cybergenics II Holding*, COM. ADVISOR (Hale and Dorr LLP), December 2002, at 1 [hereinafter *Hale and Dorr*].

17. *Cybergenics II*, 304 F.3d at 319 (3d Cir. 2002); see also *Hartford Underwriters Ins. Co. v. Union Planters Bank*, 530 U.S. 1 (2000).

18. *Cybergenics II*, 304 F.3d at 319. In this context the concept of the “trustee” includes debtors-in-possession. See 11 U.S.C. § 1107(a).

19. *Housecraft*, 310 F.3d at 70.

20. *Id.*

21. 530 U.S. 1 (2000).

22. *Cybergenics II*, 304 F.3d at 319.

23. See generally *Hartford Underwriters Ins. Co. v. Union Planters Bank*, 530 U.S. 1 (2000). See also *infra* Part II.

24. *Hartford Underwriters Ins. Co. v. Union Planters Bank*, 530 U.S. at 3-6.

25. *Id.* at 6.

26. *Id.*

27. *Cybergenics II*, 304 F.3d at 319.

28. See, e.g., 11 U.S.C. § 544(b)(1) (2000).

that there is no implicit statutory authority for any other party in interest to exercise these powers.<sup>29</sup>

In *Cybergenics III*, the Third Circuit sitting en banc, ultimately determined that *Hartford Underwriters* should be narrowly construed, appropriately considered in circumstances where a nontrustee tries “unilaterally to circumvent the Code’s remedial scheme.”<sup>30</sup> The appellate court found that, in contrast, *Cybergenics III* concerned “a bankruptcy court’s equitable power to craft a remedy when the Code’s envisioned scheme breaks down.”<sup>31</sup> The court determined that the two settings were not analogous.<sup>32</sup> Therefore, the Supreme Court’s construction of the language “the trustee may” was inapposite.<sup>33</sup> However, Judge Fuentes, the author of *Cybergenics II* and the *Cybergenics III* dissent, has argued that the Supreme Court’s strict construction of language “the trustee may” in *Hartford Underwriters* forecloses any other interpretation of that plain statutory language irrespective of the factual setting at hand, because, “when the language of a statute is plain, . . . the sole function of the courts—at least where the disposition required by the text is not absurd—is to enforce it according to its terms.”<sup>34</sup>

The differences between *Cybergenics II* and *III* call attention to an ideological tension between two competing styles of Bankruptcy Code construction: one that allows the text to be construed in order to give effect to the broad purposes and policies of bankruptcy, as opposed to one that adheres to a strict reading of the text, giving effect to the plain meaning of the words as set forth by Congress. This Comment explores the competing approaches. Part II looks at *Hartford Underwriters*, the Supreme Court opinion that the *Cybergenics II* court found to be controlling upon the issue of derivative standing<sup>35</sup> and which *Housecraft* chose not to even mention.<sup>36</sup> Parts III and IV examine the evolution of *Cybergenics II*: how the issue came before the Third Circuit, the court’s disposition of the arguments, and the court’s controversial conclusion. Part V explores the immediate effect of the *Cybergenics II* opinion both upon the case at bar and upon other cases pending at the time. Part VI looks at the theoretical split “in action,” reviewing the issue’s disposition in a sampling of bankruptcy, district and appellate courts.

Finally, Part VII concludes that in light of the statutory approach espoused by the Supreme Court in *Hartford Underwriters*, the controversial and arguably impractical result of the *Cybergenics II* decision is correct. And, although there are many well reasoned, principled arguments for allowing the practice of derivative creditor avoidance actions, none of them can be effectively reconciled with the strict constructionist mandate of *Hartford Underwriters*. The arguments for distinguishing *Hartford Underwriters*, this Comment concludes, are, in fact, arguments that “plain meaning” statutory construction is inapt for bankruptcy jurisprudence. Opponents of *Cybergenics II* are ultimately advocating that, despite the Supreme Court’s edict in *Hartford Underwriters*, courts may subjectively reject

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29. *Cybergenics II*, 304 F.3d at 319.

30. *Cybergenics III*, 330 F.3d 548, 552-53 (3d Cir. 2003) (emphasis added).

31. *Id.* (emphasis added).

32. *See generally id.*

33. *See generally id.*

34. *Id.* at 580-82 (internal citations and quotations omitted).

35. *Cybergenics II*, 304 F.3d at 319.

36. *See generally Housecraft*, 310 F.3d 64 (2d Cir. 2002).

"plain meaning" statutory construction depending upon the type of bankruptcy proceeding at hand.<sup>37</sup>

## II. THE HARTFORD UNDERWRITERS DECISION

*Hartford Underwriters* was decided in 2000 by a unanimous Court.<sup>38</sup> This case, often referred to as "Hen House,"<sup>39</sup> arose out of the bankruptcy proceeding of Hen House Interstate, Inc.<sup>40</sup> Hen House initially filed a voluntary petition under Chapter 11 of the Bankruptcy Code in September 1991, and, operating as a debtor-in-possession, continued to control its assets and business for approximately two and a half years.<sup>41</sup> The reorganization was not successful; the case was converted to a Chapter 7 liquidation proceeding and a trustee was appointed in January 1993.<sup>42</sup> Unaware of any bankruptcy proceedings, Hartford Underwriters Insurance Co. unwittingly provided Hen House with workers' compensation insurance during its attempted reorganization, and, at the time liquidation commenced, Hen House owed Hartford more than fifty thousand dollars in unpaid insurance premiums.<sup>43</sup> Hartford attempted to recover the expense by charging the premiums to Union Bank, Hen House's primary secured creditor.<sup>44</sup> Hen House attempted to gain priority over Union Bank's secured claims by filing an "Application for Allowance of Administrative Expense," pursuant to 11 U.S.C. § 503 and a "Charge Against Collateral," pursuant to 11 U.S.C. § 506(c).<sup>45</sup>

Section 503 allows parties who incur expenses while trying to preserve or maintain the value of an estate in bankruptcy to petition for the recovery of these "administrative expenses."<sup>46</sup> These administrative claims ordinarily have priority over pre-bankruptcy petition unsecured claims.<sup>47</sup> Section 506 expands the recovery allowed under section 503 by giving administrative claims, in limited circumstances, priority over secured claims as well.<sup>48</sup> It provides in pertinent part: "*The trustee may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim.*"<sup>49</sup> Hartford alleged that its provision of insurance had served to preserve the value of Union Bank's collateral, and, accordingly, was trying to recover its administrative expenses from the value of Union's collateral.<sup>50</sup> The Court assumed for the purposes of its decision that

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37. *Hartford Underwriters* was not the first Supreme Court decision to espouse a "plain meaning" approach to Bankruptcy Code construction. See, e.g., *United States v. Ron Pair Enters., Inc.* 489 U.S. 235, 240-41 (1989) ("As long as the statutory scheme is coherent and consistent, there generally is no need for a court to inquire beyond the plain language of the statute.")

38. *Hartford Underwriters Ins. Co. v. Union Planters Bank*, 530 U.S. 1, 2 (2000).

39. Bloom & Solomon, *supra* note 14, at 419 n.16.

40. *Hartford Underwriters Ins. Co. v. Union Planters Bank*, 530 U.S. at 3.

41. *Id.* at 3-4.

42. *Id.* at 4.

43. *Id.*

44. *Id.*

45. See *id.* at 4. These provisions operate to alter the priority scheme of claims in bankruptcy.

46. 11 U.S.C. § 503(a)-(b)(1)(A) (2000), (providing that an entity may recover "the actual, necessary costs and expenses," other than claims allowed under section 502(f).")

47. *Hartford Underwriters Ins. Co. v. Union Planters Bank*, 530 U.S. at 4-5 (citing 11 U.S.C. §§ 507(a)(1), 726(a)(1), 1129(a)(9)(A) (2000)).

48. *Id.* at 5.

49. 11 U.S.C. § 506(c) (emphasis added).

50. *Hartford Underwriters Ins. Co. v. Union Planters Bank*, 530 U.S. at 3-4.

workers' compensation insurance constituted a "benefit" to Union's security interest by allowing the continued operation of Hen House's business and thereby preserving the value of Union's collateral.<sup>51</sup> The only issue the Court contemplated was whether an administrative claimant was unilaterally empowered by the Bankruptcy Code to seek recovery under section 506(c).<sup>52</sup>

Focusing intently on the plain language of the statute, specifically the phrase "the trustee may," the Court found that *only* the trustee was empowered to invoke section 506(c).<sup>53</sup> The Court supported its conclusion that Congress intended section 506 to be an exclusive conveyance of authority with textual arguments.<sup>54</sup> First, the express statutory language authorized a specific action and empowered a particular party to take that action; and, second, the particular party named, the trustee, is one with very unique rights and responsibilities in the bankruptcy process.<sup>55</sup> The Court contrasted the specificity of section 506(c) with the broad phrasing of recovery powers granted in other sections of the Bankruptcy Code.<sup>56</sup> And, the Court rejected the argument that the lack of explicit exclusionary language, such as "*only* the trustee may" could sensibly be interpreted as a reason to ignore that specificity.<sup>57</sup>

After reviewing the text-based arguments, the Court turned to Hartford's arguments that pre-Code practice and policy considerations justified an expanded reading of the language "the trustee may."<sup>58</sup> Discounting early precedents, the Court asserted that

[although] pre-Code practice informs our understanding of the language of the Code, it cannot overcome that language. It is a tool of construction, not an extratextual supplement. We have applied it to the construction of provisions which were subject to interpretation, or contained ambiguity in the text. [W]here the meaning of the Bankruptcy Code's text is itself clear . . . its operation is unimpeded by contrary . . . prior practice. In this case, we think the language of the Code leaves no room for clarification by pre-Code practice.<sup>59</sup>

Policy considerations, such as a lack of trustee incentive to pursue payment, were discounted as well.<sup>60</sup> The Court found the trustee was bound to seek recovery whenever its fiduciary duties required him to do so and that allowing others an independent right to seek recovery would interfere with the trustee's abilities to manage the estate, possibly impairing the coordination of the proceedings as a whole.<sup>61</sup> Ultimately, the Court did not want "to assess the relative merits of differ-

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51. *Id.* at 5-6.

52. *Id.*

53. *Id.* at 6. The Court noted that "[d]ebtors-in-possession may also use the section, as they are expressly given the rights and powers of a trustee by 11 U.S.C. § 1107." *Id.* at 6 n.3.

54. *Id.* at 6-7.

55. *Id.*

56. *Id.* at 7 (discussing sections 502(a) and 503(b)(4) which provide claims for relief without naming specific parties empowered to act on them).

57. *Id.* at 8 (discussing sections of the Code granting authority to the trustee without explicit exclusion of other parties in interest where it is, nonetheless, clear that the authority is exclusive to the trustee).

58. *Id.* at 10-13.

59. *Id.* at 10-11 (alterations in original) (internal citations and quotations omitted).

60. *Id.* at 11-13.

61. *Id.* at 13.



ent approaches to various bankruptcy problems.”<sup>62</sup> The *Hartford Underwriters* decision resulted from the “natural reading of the text,” and avowed that “[a]chieving a better policy outcome . . . is a task for Congress, not the courts.”<sup>63</sup>

### III. THE EVOLUTION OF *CYBERGENICS II*

In 1985, Scott Chinery established L & S Research Corporation and operating under the brand name “Cybergenics,” marketed nutritional food supplements for body-building and weight loss programs.<sup>64</sup> Lincolnshire Management, Inc. reached a leveraged buyout agreement with Chinery and L & S in 1994 and founded Cybergenics Corporation<sup>65</sup> in order to acquire the majority of L & S’s assets.<sup>66</sup> Cybergenics Corporation faltered within two years and filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code.<sup>67</sup> Cybergenics operated as a debtor-in-possession and, as is usual, a bankruptcy trustee was not appointed.<sup>68</sup> Seven of Cybergenics’ unsecured creditors were appointed to the Committee of Unsecured Creditors.<sup>69</sup> In 1997, despite having filed a Chapter 11 petition, the Cybergenics estate opted to auction all its assets rather than reorganize.<sup>70</sup> After a court supervised auction of all its assets to a third party for 2.65 million dollars, Cybergenics moved to dismiss the bankruptcy case.<sup>71</sup> The Committee objected, contending that transactions relating to Lincolnshire’s leveraged buyout could give rise to viable fraudulent transfer claims.<sup>72</sup> Cybergenics declined to pursue any such claims, and the Committee sought leave of the bankruptcy court to pursue a fraudulent transfer action on behalf of the debtor-in-possession.<sup>73</sup> The bankruptcy court authorized derivative standing and allowed the Committee to commence proceedings in the name of debtor-in-possession and on behalf of the estate.<sup>74</sup>

In 1998, the Committee filed a complaint in the United States District Court for the District of New Jersey, “seeking to avoid allegedly fraudulent transfers made by and liabilities incurred by Cybergenics in connection with the leveraged buyout and post-buyout transactions and to have the value of the avoided transactions returned to the bankruptcy estate.”<sup>75</sup> On defendants’<sup>76</sup> motion, the district court dismissed the proceeding, holding that “the fraudulent transfer claims were

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62. *Id.*

63. *Id.* at 13-14.

64. *Cybergenics II*, 304 F.3d 316, 319 (3d Cir. 2002).

65. *Id.* Lincolnshire, in fact, established Cybergenics Acquisition, Inc. and this entity later became Cybergenics Corporation. *Id.*

66. *Id.*

67. *Id.* at 320.

68. *Id.* A trustee is rarely appointed in Chapter 11 cases. See DAVID G. EPSTEIN ET AL., *supra* note 2, at § 10-8.

69. *Cybergenics II*, 304 F.3d at 320.

70. *Id.*

71. *Id.*

72. *Id.*

73. *Id.*

74. *Id.*

75. *Id.*

76. There were three groups of defendants in *Cybergenics II*: the lenders who were involved in financing the leveraged buyout; Lincolnshire Management—the purchaser of L & S; and Chinery. *Id.* at 319-20. One count was brought under 11 U.S.C. § 544 against each group and all three filed motions to dismiss. *Id.* at 319.

assets of the debtor, and that because the 1996 bankruptcy asset sale sold off all of Cybergenics's assets, the claims were no longer property of the bankruptcy estate and the Committee could not raise them on the estate's behalf."<sup>77</sup>

The Third Circuit Court of Appeals reversed the New Jersey District Court's first dismissal of the avoidance proceeding in September 2000.<sup>78</sup> The Third Circuit held that state law deemed the fraudulent transfer claims to be the property of the creditor, and, therefore, the claims could not have been sold as part of the bankruptcy asset sale in 1996.<sup>79</sup> The court found that although debtors-in-possession are "endowed" with the responsibility of "bring[ing] certain claims on behalf of, and for the benefit of, all creditors," this power in no way "shift[s] ownership of the fraudulent transfer action to the debtor[-]in[-]possession."<sup>80</sup> On remand, the defendants again moved for dismissal of the avoidance proceeding; this time they argued "that under a plain reading of [section] 544(b) and the reasoning of *Hartford Underwriters*,<sup>81</sup> the Committee lacked standing to bring the fraudulent transfer action because only a trustee or debtor-in-possession has such standing."<sup>82</sup> The District Court agreed and dismissed the avoidance proceeding for the second time.<sup>83</sup> The Third Circuit Court of Appeals affirmed *this* dismissal.<sup>84</sup> The court determined that the "rather well established practice" of permitting creditors and creditors' committees to initiate derivative avoidance actions could not survive the Supreme Court's reasoning in *Hartford Underwriters*.<sup>85</sup>

The limited holding of *Hartford Underwriters* foreclosed the independent right of an administrative claimant to seek recovery under the authority of 11 U.S.C. § 506(c).<sup>86</sup> In footnote 5 of the opinion, the Court specifically declined to address

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77. *Id.* at 320.

78. *Id.*

79. *Id.*

80. Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery (*In re Cybergenics Corp.*), 226 F.3d 237, 244 (3d Cir. 2000) [hereinafter *Cybergenics I*]. The court analyzed the fraudulent transfer claims and determined that Cybergenics did not "own" them as assets *per se*. *Id.* at 245. The court opined:

The fact that section 544(b) authorizes a debtor[-]in[-]possession, such as Cybergenics, to avoid a transfer using a creditor's fraudulent transfer action does not mean that the fraudulent transfer action is actually an asset of the debtor[-]in[-]possession, nor should it be confused with the separate authority of a trustee or debtor[-]in[-]possession to pursue the prepetition debtor's causes of action that become property of the estate upon the filing of the bankruptcy petition. Rather, it simply enables a debtor[-]in[-]possession to carry out its trustee-related duties. . . . This attribute is no more an asset of Cybergenics as debtor[-]in[-]possession than it would be a personal asset of a trustee, had one been appointed in this case. Much like a public official has certain powers upon taking office as a means to carry out the functions bestowed by virtue of the office or public trust, the debtor[-]in[-]possession is similarly endowed to bring certain claims on behalf of, and for the benefit of, all creditors.

*Id.* at 243-44 (internal citations omitted).

81. In *Hartford Underwriters*, the United States Supreme Court interpreted the plain meaning of the language "the trustee may" as it appears in section 506(c) of the Bankruptcy Code; the case is discussed *supra* Part II.

82. *Cybergenics II*, 304 F.3d at 321.

83. *Id.*

84. *Id.* at 319.

85. *Id.*

86. *Hartford Underwriters Ins. Co. v. Union Planters Bank*, 530 U.S. at 14.

“the practice of some courts of allowing creditors or creditors’ committees a derivative right to bring avoidance actions when the trustee refuses to do so, even though the applicable Code provisions . . . mention only the trustee.”<sup>87</sup> The Third Circuit was the first circuit to apply the reasoning of *Hartford Underwriters* to the practice of court sanctioned derivative standing and to find, accordingly, that the practice was now untenable.<sup>88</sup> In *Cybergenics II*, the Creditors’ Committee had petitioned the bankruptcy court for the right to utilize 11 U.S.C. § 544, the Code provision that gives the trustee, or debtor-in-possession, the power to avoid fraudulent transfers.<sup>89</sup> Section 544 reads in pertinent part: “the trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim.”<sup>90</sup>

The bankruptcy court, drawing upon pre- and post-*Hartford Underwriter’s* bankruptcy practice, had determined that the Creditors’ Committee may raise a fraudulent transfer claim in the trustee’s name, under section 544, if: “1) it presented colorable fraudulent transfer claims; 2) Cybergenics refused to bring the claims; and 3) Cybergenics’s refusal was unjustified in relation to its duty as a debtor-in-possession to maximize the value of the bankruptcy estate for the creditors.”<sup>91</sup> Finding that these criteria had been satisfied, the bankruptcy court had granted the Committee permission to proceed with the suit.<sup>92</sup>

In contrast, the district court and then the Third Circuit Panel decided that, in light of *Hartford Underwriters*, prior practice and precedent were no longer controlling.<sup>93</sup> Both courts focused intently on the statutory language, specifically the phrase “the trustee may,” as set forth in section 544.<sup>94</sup> Ultimately, they concluded that the Supreme Court’s construction of the identical language in section 506 applied “with equal force” to section 544.<sup>95</sup> The Third Circuit could find no “principled basis” for translating the phrase “the trustee may” differently at different places in the Code.<sup>96</sup> Stressing the need for uniformity in the application of statutory sections that are similar in purpose and content, the court indicated that the presumption of a common meaning could only be overcome with significant evidence that the words were employed in the different sections with different intent.<sup>97</sup> Sections 506 and 544 of the Bankruptcy Code, the court concluded, use the words “the trustee may” in similar purpose and context: as “a description of the powers of the trustee and the avenues for relief available under the Code for the

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87. *Id.* at 13 n.5. See discussion of “footnote five” *infra* Part IV.C.

88. *Cybergenics II*, 304 F.3d at 319, 322-23. Earlier in the year, the Third Circuit acknowledged, in dicta, “that after *Hartford Underwriters*, ‘there is some doubt as to whether a creditor can act derivatively in the debtor’s stead to invoke section 544(b).’” *Id.* at 322 n.8 (quoting *In re PWS Holding Corp.*, 303 F.3d 308 (3d Cir. 2002)). Other courts have questioned the validity of derivative standing under this provision since the *Hartford Underwriters* decision; however, they have reaffirmed the practice. *Id.* at 323 (citing *In re Commodore Int’l Ltd.*, 262 F.3d 96, 100 (2d Cir. 2001)).

89. *Id.* at 322.

90. 11 U.S.C. § 544(b)(1) (1993).

91. *Cybergenics II*, 304 F.3d at 323.

92. *Id.*

93. *Id.* at 330-31.

94. *Id.* at 324.

95. *Id.*

96. *Id.* at 324-25.

97. *Id.* at 325.

benefit of the creditors and the estate.”<sup>98</sup> The court could not find any provision in the Code that expressly extended the authority to utilize section 544 to anyone other than the trustee.<sup>99</sup> In view of the Supreme Court’s “plain meaning” reading of the Bankruptcy Code in *Hartford Underwriters*, the circuit court did not feel it could deem section 544 to be a broad conveyance of power.<sup>100</sup>

#### IV. THE ARGUMENTS RAISED IN *CYBERGENICS II*

##### A. Plain Language Statutory Construction

Since *Hartford Underwriters* came down, several jurisdictions have questioned the continued legitimacy of derivative creditor standing.<sup>101</sup> In 2002, a Louisiana bankruptcy court assessed the potential impact of *Hartford Underwriters*’s “plain meaning” Bankruptcy Code construction.<sup>102</sup> *Cybergenics II* cites to *In re Blount* as support for the proposition that *Hartford Underwriters* has cast doubt upon the validity of derivative creditor standing.<sup>103</sup> The *Blount* court commented:

Although [*Hartford Underwriters*] specifically dealt with only the question of whether a creditor has independent standing to use the collateral surcharge provisions of [section] 506(c), the language and rationale of the opinion seemingly have application to all provisions of the Bankruptcy Code wherein the party authorized to seek recovery (to act) is limited to the trustee. Indeed, the [*Hartford Underwriters*] rationale has been expanded beyond the confines of [section] 506(c).<sup>104</sup>

Further, the *Blount* court inferred from the dicta of *Hartford Underwriters* that the Supreme Court views “‘derivative standing’ as a judicial concoction or equitable gloss upon the Code . . . designed to get around [its] plain language.”<sup>105</sup> In light of this, the *Blount* court surveyed the operation of the language “the trustee may” throughout the Bankruptcy Code, paying particular attention to the avoidance provisions named in footnote five of the *Hartford Underwriters* opinion.<sup>106</sup> The court acknowledged that acceptance of the *Hartford Underwriters* “rationale” would require that “standing to recover property transferred or concealed by the debtor, as established by these Code provisions, is limited solely to ‘the trustee.’”<sup>107</sup>

98. *Id.*

99. *Id.* In specific, the *Cybergenics II* court cited to the Fifth Circuit’s *In re Louisiana World Exposition, Inc.*, 832 F.2d 1391, 1397 (5th Cir. 1988) and the Second Circuit’s *In re STN Enterprises*, 779 F.2d 901, 904 (2d Cir. 1985). *Id.* In both of these cases, the circuit courts acknowledged the lack of clear statutory authority but, nonetheless, validated the practice of derivative standing: holding that a creditor or creditors’ committee may, upon meeting certain conditions and with bankruptcy court approval, initiate adversary proceedings in Chapter 11 cases. *Id.* at 322-23, 325.

100. *Id.* at 325.

101. *Id.* at 328.

102. *In re Blount*, 276 B.R. 753, 759-64 (Bankr. M.D. La. 2002).

103. *Cybergenics II*, 304 F.3d at 328.

104. *Id.* (quoting *In re Blount*, 276 B.R. at 760).

105. *In re Blount*, 276 B.R. at 760.

106. *Id.* See 11 U.S.C. § 545 (2000) (“The trustee may avoid . . . .”); 11 U.S.C. § 547(b) (2000) (“The trustee may avoid . . . .”); 11 U.S.C. § 548(a)(1) (2000) (“The trustee may avoid . . . .”); 11 U.S.C. § 548(b) (2000) (“The trustee of a partnership debtor may avoid . . . .”); 11 U.S.C. § 549(a) (2000) (“The trustee may avoid . . . .”). See also Kirpalani, *supra* note 6, at 1.

107. *In re Blount*, 276 B.R. at 760.

The *Cybergemics II* court's reliance on *Blount*, however, may have been misplaced, because the *Blount* court ultimately concluded that *Hartford Underwriters* did not foreclose derivative creditor standing in bankruptcy proceedings.<sup>108</sup> *Blount* distinguished *Hartford Underwriters* by construing it narrowly, finding that it only controls in the limited scenario where a creditor asserts an *independent right to act for its own benefit, without court authorization*.<sup>109</sup> Because the case at bar did not fit within that express purview, the court chose not to apply the *Hartford Underwriters* "rationale."<sup>110</sup> Instead, the *Blount* court found the authority for derivative standing in Bankruptcy Code section 503(b)(3)(B).<sup>111</sup> This Code provision grants creditors who have, with court approval, recovered property "transferred or concealed by the debtor," the right to recoup administrative expenses associated with that recovery.<sup>112</sup> Although the language seems to imply that creditors have a right to act to recover property, because that is the only way that they would incur administrative expenses associated with recovery, the language is not an express grant of *any* rights or powers other than the recovery of administrative expenses.<sup>113</sup> Its "plain meaning" is that creditors who recover estate property, however that may be, shall be allowed to recover administrative expenses; any other construction requires assumptions regarding Congressional intent and implied powers.<sup>114</sup> Despite this, the *Blount* court interpreted section 503(b)(3)(B) as a substantive textual basis for courts to "confer derivative standing upon creditors to pursue actions that will lead to the recovery of property transferred or concealed by the debtor, for the benefit of the estate."<sup>115</sup>

*Hartford Underwriters*, according to the Louisiana bankruptcy court, mandates that a creditor has no *independent* authority to bring an avoidance action on behalf of the debtor whether the action was for the creditor's own benefit or for the benefit of the estate.<sup>116</sup> The *Blount* court held, however, that under the authority of section 503(b)(3)(B), a creditor may, *with court approval*, recover property trans-

108. See *Cybergemics II*, 304 F.3d at 328-29; cf. *In re Blount*, 276 B.R. at 760-61.

109. See *In re Blount*, 276 B.R. at 760-62.

110. See *id.* *Cybergemics III* premised its holding on the same type of distinction, concluding that the type of right at issue and the manner in which it is asserted control the applicability of *Hartford Underwriters*. See *Cybergemics III*, 330 F.3d 548, 552-53 (3d Cir. 2003).

111. *In re Blount*, 276 B.R. at 760-61. Section 503 provides recovery of 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 . . ." 11 U.S.C. § 503(b)(3)(B) (2000).

112. 11 U.S.C. § 503(b)(3)(B).

113. See *id.*

114. See *id.*; see also *Cybergemics III*, 330 F.3d at 559-67. *Cybergemics III* concluded that sections 1109(b), 1103(c)(5), and 506(b)(3)(B) could be read together to reveal "the role Congress intended creditors' committees to play in the reorganization process." *Id.*

115. *In re Blount*, 276 B.R. at 761. The *Blount* court concluded that section 503(b)(3)(B) was a textual basis for derivative standing and that the language of the provision set forth criteria that must be satisfied before derivative standing may be granted:

[F]irst, that the status of the party seeking administrative expense recovery be a creditor of the debtor. Second, the statute requires that the creditor be one, "that recovers . . . any property transferred or concealed by the debtor." Third, the statute commands that the recovery of property transferred or concealed by the debtor be "for the benefit of the estate." The statute also dictates a fourth requirement, court approval.

*Id.* at 759 (quoting 11 U.S.C. § 503(b)(3)(B)).

116. *Id.* at 760.

ferred or concealed by the debtor *for the benefit of the estate*.<sup>117</sup> This understanding of section 503(b)(4)(B), the court reasoned, was the only understanding that would give it any effect.<sup>118</sup> A creditor who “recovers” is entitled to seek administrative expenses; however, a creditor “who cannot act cannot recover.”<sup>119</sup> The *Blount* court asserts, perhaps erroneously, that derivative creditor standing is a creditor’s only vehicle to “act” under the Code and that without it section 503(b)(3)(B) will be rendered meaningless.<sup>120</sup> In order to give meaning to section 503, the court rejects the “plain meaning” statutory construction approach espoused by the Supreme Court in *Hartford Underwriters* in favor of court-created implicit powers. The court rejects, in other words, the very *Hartford Underwriters* “rationale” it had already acknowledged as “law” in the same opinion.

*Cybergenics II* also considered the Fifth Circuit’s treatment of *Hartford Underwriters*.<sup>121</sup> *In re Stangel*<sup>122</sup> denies a non-trustee the power to avoid a federal tax lien under Bankruptcy Code section 545(2) because that provision conveys that power expressly to the trustee and only the trustee.<sup>123</sup> Section 545 reads in pertinent part: “[t]he trustee may avoid the fixing of a statutory lien on property of the debtor . . . .”<sup>124</sup> The *Stangel* court noted that this section codified the trustee’s ability, and *only* the trustee’s ability, to avoid certain liens and refused to find the provision available to any other parties no matter how viable their interests might be.<sup>125</sup> The *Stangel* court concluded that *Hartford Underwriters* demands strict statutory construction of the Bankruptcy Code: requiring “[reliance] principally on the clear statement in the statute, assisted by the overall context of the Bankruptcy Code.”<sup>126</sup> Because section 545(2) conveys a specific power to a specific party, namely the trustee, the court found that *Hartford Underwriters* forecloses the judicial expansion of that power to other parties in interest.<sup>127</sup> Accordingly,

117. *Id.* at 760-61.

118. *Id.* at 760. This proposition, that the court had authority to “grant derivative standing to pursue recovery of such property (transferred or concealed)[,] . . . seem[ed] self evident . . . .” to the *Blount* court. *Id.* at 761.

119. *Id.* at 760-61 (emphasis added).

120. *Id.* at 761. In his *Cybergenics III* dissent, Judge Fuentes rebuts the argument that section 503(b)(3)(B) is otherwise useless. 330 F.3d 548, 583-84 (arguing that “the most prevalent use of . . . this provision[] is to compensate *individual creditors* who object to discharge and then successfully locate and bring into the estate assets that had been transferred or concealed by the debtor.”).

121. *Cybergenics II*, 304 F.3d 316, 329 (3d Cir. 2002).

122. *In re Stangel*, 219 F.3d 498 (5th Cir. 2000).

123. *Id.* at 500.

124. 11 U.S.C. § 545 (2000).

125. *In re Stangel*, 219 F.3d at 500.

126. *Id.* at 501. The *Stangel* court noted that the Supreme Court had refused to find an implicit conveyance of authority in section 506. *Id.* *Hartford Underwriters* asserts that “[t]his theory—that the expression of one thing indicates the inclusion of others unless exclusion is made explicit—is contrary to common sense and common usage. Many provisions of the Bankruptcy Code that do not contain an express exclusion cannot sensibly be read to extend to all parties in interest.” *Id.* (quoting *Hartford Underwriters Ins. Co. v. Union Planters Bank*, 530 U.S. 1, 8 (2000)).

127. *Id.* The *Stangel* court noted that “[a]lthough § 506(c) is a different provision than the one at issue here, and a Chapter 11 case is different from a Chapter 13 case, the [Supreme] Court’s mode of reasoning is fully applicable” because *Hartford Underwriters* involved a Code provision “that stated that trustees had certain powers, and . . . rejected interpretations that extended those powers to other parties in interest.” *Id.*

the court refused to grant a Chapter 13 debtor permission to pursue an avoidance action.<sup>128</sup>

In the Fifth Circuit, pre-*Hartford Underwriters* case law already favored “plain meaning” construction of the Bankruptcy Code.<sup>129</sup> In 1997, in *In re Hamilton*,<sup>130</sup> the Fifth Circuit had refused “to allow [a] Chapter 13 debtor[] to exercise [the] strong-arm powers reserved for Chapter 13 trustees.”<sup>131</sup> The *Hamilton* court declined to extend the statutory powers of a trustee to a non-trustee when it could find no express textual basis for doing so.<sup>132</sup> *Hamilton* ultimately gave the debtor at issue the authority to avoid a prior foreclosure sale under section 522(h) because this Code provision expressly grants avoidance rights to a Chapter 13 debtor who has satisfied certain criteria.<sup>133</sup>

The reasoning in *Stangel* and *Hamilton* is analogous to the reasoning in *Hartford Underwriters* because in all three cases a non-trustee attempted to assert an independent right to exercise the avoidance powers explicitly available to the trustee under the provisions of the Bankruptcy Code.<sup>134</sup> *Cybergenics II* is also analogous to these cases in the sense that it involves a non-trustee attempting to exercise avoidance powers.<sup>135</sup> However, because the non-trustee party seeking permission to act in *Cybergenics II* was the Creditors’ Committee (and not a Chapter 13 debtor), *Cybergenics II* remains subject to the section 503 arguments raised in *In re Blount* in a way that *Stangel* and *Hamilton* do not.<sup>136</sup> Section 503(b)(3)(B)—as it relates *only* to the potential rights of *creditors*—is not a potential source of implicit rights for Chapter 13 debtors.

*Cybergenics II* also examines *In re McLeroy*,<sup>137</sup> a Texas District Court decision influenced by *Hartford Underwriters*.<sup>138</sup> In *In re McLeroy*, the court refused to allow a Chapter 7 debtor to use section 548 because that section conveys power *exclusively* to the trustee.<sup>139</sup> The purpose of section 548, indicated by the plain language of the Code and also by the Congressional Record, is to limit a bank-

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128. *Id.* Chapter 13 debtors are distinct from debtors-in-possession, as “mere” debtors they do not have the authority to invoke the rights and powers of a trustee. See 11 U.S.C. § 1107 (2000).

129. *In re Stangel*, 219 F.3d at 500-01 (“Two cases . . . lead us to conclude that *Stangel* lacks standing to pursue his avoidance motion.”).

130. 125 F.3d 292 (5th Cir. 1997).

131. *In re Stangel*, 219 F.3d at 500-01 (quoting *In re Hamilton*, 125 F.3d at 296).

132. *Id.* The *Hamilton* court explicitly rejected the suggestion that section 1303, which is frequently referred to a “catch all” provision could serve as a basis of statutory authority for the court to grant derivative power. *In re Hamilton*, 125 F.3d at 296.

133. *In re Stangel*, 219 F.3d at 501. Section 522(h) reads in pertinent part: “*The debtor may avoid a transfer of property of the debtor or recover a setoff to the extent that the debtor could have exempted such property under subsection (g)(1) of this section if the trustee had avoided such transfer, if . . .*” 11 U.S.C. § 522(h) (2000) (emphasis added).

134. See generally *In re Stangel*, 219 F.3d 498 (5th Cir. 2000); *In re Hamilton*, 125 F.3d 292 (5th Cir. 1997).

135. See generally *Cybergenics II*, 304 F.3d 316 (3d Cir. 2002).

136. See *supra* notes 100-119 and accompanying text for discussion of the arguments raised in *In re Blount*.

137. *Educ. Credit Mgmt. Corp. v. McLeroy (In re McLeroy)* 250 B.R. 872 (N.D. Tex. 2000) [hereinafter *In re McLeroy*].

138. *Cybergenics II*, 304 F.3d at 329.

139. *In re McLeroy*, 250 B.R. at 880-81. Section 548 as amended by the Religious Liberty and Charitable Donation Protection Act of 1998 (“RLCDPA”) limits the trustee in attempting to set aside charitable donations as fraudulent conveyances. *Id.* at 881. Section 548(a) reads in pertinent part:

ruptcy trustee's authority to set aside charitable donations under the fraudulent transfer provisions of the Bankruptcy Code.<sup>140</sup> Under section 523(a)(8), a debtor who is attempting to set aside educational loan indebtedness through bankruptcy must establish that paying the debt would amount to "undue hardship."<sup>141</sup> The establishment of undue hardship requires the debtor to account for all his or her "appropriate expenses" and income so that the court may assess the debtor's liquidity.<sup>142</sup> In this case, a debtor who was attempting to set aside educational loan indebtedness was trying to automatically qualify her tithing as an appropriate expense for purposes of the section 523(a)(8) undue hardship test.<sup>143</sup> She argued that the limitation upon the trustee's authority to set aside tithing under section 548 implied a general proposition that tithing was an "appropriate expense" under the Bankruptcy Code.<sup>144</sup> The court found that section 548 "only addresses the avoidance powers of the bankruptcy trustee. [There is] no mention of conferring any additional rights upon any other party . . ." <sup>145</sup> The court refused to expand the intention of section 548 beyond its plain meaning, because under *Hartford Underwriters* "[w]here a statute . . . names the parties granted [the] right to invoke its provisions, . . . such parties only may act."<sup>146</sup>

The *McLeroy* court's refusal to expand the meaning of one section in order to supplement the value of another stands in relative contrast to the section 503 analysis set forth in the *Blount* opinion.<sup>147</sup> The "undue hardship" requirement of section 523(a)(8) is not substantively defined in the Code.<sup>148</sup> Courts have given effect to the requirement through a balancing test: cataloguing the debtor's appropriate expenses and weighing them against income.<sup>149</sup> The *McLeroy* court refused to find that the recognition of tithes as a legitimate expense in one Code provision was a basis for the automatic recognition of it as such in another context.<sup>150</sup> The court found that it was the "better reasoned and more consistent application of the provisions of the Bankruptcy Code," to avoid judicially expanding the consequences of the statute.<sup>151</sup> The decision of the *Blount* court to use the rights defined in one

(1) The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing . . . .

(2) A transfer of a charitable contribution to a qualified religious or charitable entity or organization shall not be considered to be a transfer covered under paragraph (1) . . . .

11 U.S.C. § 548(a) (2000). In this case, the debtor was arguing that RLCDDPA amendments to the Bankruptcy Code conferred a debtor with the automatic right to classify tithing as an "appropriate" expenditure under section 523(a)(8). *In re McLeroy*, 250 B.R. at 879-80.

140. *In re McLeroy*, 250 B.R. at 881-82.

141. 11 U.S.C. § 523(a)(8) (2000) (providing that an individual is not discharged from an education debt unless "excepting such debt from discharge under this paragraph will impose an undue hardship on the debtor and the debtor's dependents.").

142. *In re McLeroy*, 250 B.R. at 877-80.

143. *Id.*

144. *Id.*

145. *Id.* at 880 (emphasis added).

146. *Id.* at 881 (quoting *Hartford Underwriters Ins. Co. v. Union Planters Bank*, 530 U.S. 1, 6-7 (2002)).

147. See *supra* notes 102-120 and accompanying text.

148. See 11 U.S.C. 523(a)(8) (2000); see also *supra* note 140.

149. See, e.g., *In re McLeroy*, 250 B.R. at 878-80.

150. *Id.* at 881.

151. *Id.* at 882.



provision of the Bankruptcy Code in order to define the contours of another right, can only be distinguished from *McLeroy* by positing the argument that section 503(b)(3)(B) would be rendered utterly meaningless without such judicial "expansion,"<sup>152</sup> and section 523(a)(8) would only have *less* meaning.<sup>153</sup> However, *Blount's*, and ultimately *Cybergenics III's*, arguments that 503(b)(3)(B) is rendered "superfluous" or "meaningless" without court sanctioned derivative standing is persuasively refuted by Judge Fuentes's arguments in his *Cybergenics III* dissent.<sup>154</sup> Judge Fuentes catalogs cases where the use of section 503(b)(3)(B) by individual creditors was possible without the judicial expansion of the trustee's avoidance powers.<sup>155</sup>

### *B. Inherent Differences in the Purposes of the Bankruptcy Chapters*

In *Cybergenics II*, the Creditors' Committee argued vigorously to distinguish *Hartford Underwriters*.<sup>156</sup> The first argument expounded upon the inherent differences between Chapter 7 liquidations and Chapter 11 reorganization cases.<sup>157</sup> The court cited Third Circuit precedent acknowledging that "Congress intended a creditors' committee to have more extensive rights in a reorganization than in a liquidation."<sup>158</sup> However, the court then pointed out that in the case at bar there was no reorganization: the debtor had chosen to sell its assets at auction rather than reorganize.<sup>159</sup> Regardless, the court surveyed the reasoning employed by other courts in allowing derivative creditor avoidance suits in Chapter 11 reorganization cases.<sup>160</sup> The court pointed out that other circuits and bankruptcy courts have often found the authority for creditors' committees to stand in the trustee's shoes by combining the implications of sections 1103(c)(5) and 1109(b).<sup>161</sup>

Section 1109, as construed by the Third Circuit, raises in creditors' committees "a broad right to be heard, including, among other powers, an unconditional right to intervene in a Chapter 11 adversary proceeding that has been initiated by a trustee."<sup>162</sup> Section 1109(b) reads: "[a] party in interest, including the debtor, the trustee, a creditors' committee, an equity security holders' committee, or any indenture trustee, may raise and may appear and be heard on any issue in a case under this chapter."<sup>163</sup> In construing this statutory language, the Third Circuit applied the "plain meaning" approach of *Hartford Underwriters*.<sup>164</sup> The court

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152. See *supra* notes 102-120 and accompanying text for discussion of the arguments raised in *In re Blount*. See also *Cybergenics III*, 330 F.3d 548, 563-66 (3d Cir. 2003) (concluding that "if standing to recover is limited exclusively to the trustee—that . . . would render § 503(b)(3)(B) entirely superfluous").

153. See *In re McLeroy*, 250 B.R. at 881.

154. *Cybergenics III*, 330 F.3d at 583-84 (Fuentes, J., dissenting).

155. *Id.*

156. *Cybergenics II*, 304 F.3d 316, 325-27 (3d Cir. 2002).

157. *Id.* at 325.

158. *Id.* (quoting *In re Marin Motor Oil, Inc.*, 689 F.2d 445, 450 (3d Cir. 1982)) (internal quotation marks omitted).

159. *Id.* at 325 n.12.

160. *Id.* at 325-27.

161. *Id.* (collecting cases).

162. *Id.* at 326.

163. 11 U.S.C. § 1109(b) (2000).

164. *Cybergenics II*, 304 F.3d at 326. *Hartford Underwriters* is often referred to in legal commentary as a "return to plain meaning" in reference to the style of statutory interpretation employed by the Court. See, e.g., Bloom & Solomon, *supra* note 14, at 420-25.

was unwilling to allow a broad “right to be heard” provision to serve as an implicit expansion of section 544, which confers a specific right to a specific party, the trustee.<sup>165</sup> To do so, the court held, would “expand the intent evidenced by the plain, specific language used by Congress in [section] 544(b).”<sup>166</sup> The decision to reject such an expansion was bolstered further by dicta in *Hartford Underwriters*, where the Supreme Court indicated that it would not construe section 1109 as a statutory basis for a non-trustee to bring suit under a provision granting exclusive authority to a trustee.<sup>167</sup> Although section 1109 applies to reorganization and *Hartford Underwriters* involved a liquidation, the Court asserted “in any event, we do not read [section] 1109(b)’s general provision of a right to be heard as broadly allowing a creditor to pursue substantive remedies that other Code provisions make available only to other specific parties.”<sup>168</sup>

The *Cybergenics II* court disposed of the section 1103(c) argument in similar fashion.<sup>169</sup> Section 1103(c) of the Bankruptcy Code reads in pertinent part: “A committee appointed under section 1102 of this title may . . . perform such other services as are in the interest of those represented.”<sup>170</sup> The court rejected the argument that “other services” included commencing suit.<sup>171</sup> Although subsection (c)(5) could be characterized as a “catch all,” they refused to read this catch all as a “roving grant of power.”<sup>172</sup> Instead, the court, invoked *ejusdem generis*,<sup>173</sup> “a familiar canon of statutory construction,’ [that] catch-all provisions ‘are to be read as bringing within a statute categories similar in type to those specifically enumerated.’”<sup>174</sup> The court looked at subsections (c)(1)-(4) and found that a right to initiate suit was not akin to the specifically enumerated rights of participation, consultation or investigation.<sup>175</sup> It characterized section 1103 as authorizing “only limited, discrete rights of participation for a committee.”<sup>176</sup>

The court noted that Congress had explicitly granted the trustee the capacity to sue and be sued and asserted that there was no analogous conveyance of function or duty to the creditor’s committee in section 1103 or anywhere else in the Code.<sup>177</sup> Although agreeing that sections 1103 and 1109 conferred significant authority to creditors’ committees in Chapter 11 proceedings, the court declined to find that they provided the authority for court sanctioned derivate standing.<sup>178</sup> Interestingly, the *Cybergenics II* court did not analyze section 503 and its refer-

165. *Cybergenics II*, 304 F.3d at 326 (quoting *Hartford Underwriters Ins. Co. v. Union Planters Bank*, 530 U.S. 1, 8 (2000)).

166. *Id.*

167. *Hartford Underwriters Ins. Co. v. Union Planters Bank*, 530 U.S. at 7.

168. *Id.* at 8.

169. *Cybergenics II*, 304 F.3d at 326-27.

170. 11 U.S.C. § 1103(c)(5) (2000).

171. *Cybergenics II*, 304 F.3d at 327.

172. *Id.* at 326 (internal quotations omitted).

173. This is a “canon of construction that when a general word or phrase follows a list of specific persons or things, the general word or phrase will be interpreted to include only persons or things of the same type as those listed.” BLACK’S LAW DICTIONARY 535 (7th ed. 1999).

174. *Cybergenics II*, 304 F.3d at 326-27 (quoting *Fed. Maritime Comm’n v. Seatrain Line, Inc.*, 411 U.S. 726, 734 (1973)).

175. *Id.* at 327; see also 11 U.S.C. § 1103(c).

176. *Cybergenics II*, 304 F.3d at 327.

177. *Id.* at 326.

178. *Id.* at 327.

ence to “creditors who recover” for any possible implicit conveyance of authority to creditors.<sup>179</sup> The court determined that the Code does not permit creditors’ committees to pursue avoidance actions derivatively irrespective of “whether the trustee fails to act and/or the committee secures court approval,” and the court asserted that any judicially created criterion for expanding section 544 is textually unjustified.<sup>180</sup>

### C. Footnote Five of Hartford Underwriters

*Hartford Underwriters* holds that individual creditors may not assert an independent right to pursue the recovery of administrative expenses pursuant to Code section 506(c).<sup>181</sup> *Hartford Underwriters* does not indicate whether a creditor may ask the bankruptcy court for permission to pursue recovery under section 506(c) in the trustee’s stead, i.e., *derivatively*.<sup>182</sup> In footnote five of *Hartford Underwriters*, the Supreme Court expressly declined to pass upon the validity of derivative standing in regard to administrative recovery under section 506(c) or in regard to avoidance actions under sections 544, 545, 547(b), 548(a), and 549(a).<sup>183</sup> Many courts have relied on footnote five in order to limit the impact of *Hartford Underwriters* to issues arising under section 506.<sup>184</sup> In 2001, a Massachusetts bankruptcy court declared that *Hartford Underwriters* was a mere “red herring” with no substantive impact upon the validity of court sanctioned derivative standing in bankruptcy proceedings.<sup>185</sup> The Third Circuit Panel explored the “red her-

179. *See id.* *See also supra* notes 100-119 and accompanying text for discussion of the arguments raised in *In re Blount*. This failure may be explained by Judge Fuentes’ dissent in *Cybergenics III*. In his dissent, Judge Fuentes posits that, were creditors’ committees to pursue avoidance actions in the trustee’s stead, section 503 would not be the appropriate provision for the recovery of their administrative expenses. *Cybergenics III*, 330 F.3d 548, 583-84 (3d Cir. 2003). If this argument is accepted, it breaks the majority’s “chain of inference.”

180. *Cybergenics II*, 304 F.3d at 327.

181. *Hartford Underwriters Ins. Co. v. Union Planters Bank*, 530 U.S. 1, 14 (2000).

182. *Id.* at 13 n.5.

183. *Id.* “Footnote five” is a controversial and frequently cited note in *Hartford Underwriters*; the Court referenced the section 544 practice at issue in *Cybergenics II* and declined to decide its validity at that time. *Id.* The text of the note reads as follows:

We do not address whether a bankruptcy court can allow other interested parties to act in the trustee’s stead in pursuing recovery under § 506(c). *Amici . . .* draw our attention to the practice of some courts of allowing creditors or creditors’ committees a derivative right to bring avoidance actions when the trustee refuses to do so, even though the applicable Code provisions, see 11 U.S.C. §§ 544, 545, 547(b), 548(a), 549(a), mention only the trustee. *See, e.g. In re Gibson Group, Inc.*, 66 F.3d 1436, 1438 (6th Cir. 1995). Whatever the validity of that practice, it has no analogous application here, since petitioner did not ask the trustee to pursue payment under § 506(c) and did not seek permission from the Bankruptcy Court to take such action in the trustee’s stead. Petitioner asserted an independent right to use § 506(c), which is what we reject today. *Cf. In re Xonics Photochemical, Inc.*, 841 F.2d 198, 202-03 (6th Cir. 1988) (holding that a creditor had no right to bring avoidance action independently, but noting that it might have been able to seek to bring derivative suit).

*Id.*

184. *See, e.g., Jackson v. Russell (In re Dur Jac Ltd.)*, 254 B.R. 279, 286 n.7 (Bankr. M.D. Ala. 2000); *see also Cybergenics II*, 304 F.3d at 327 (discussing the treatment of footnote five by other courts).

185. *Cybergenics II*, 304 F.3d at 327-28 (quoting *Together Dev. Corp. v. Pappas (In re Together Dev. Corp.)*, 262 B.R. 586, 589 (Bankr. D. Mass., 2001) [hereinafter *Together Dev. Corp.*]).

ring" theory and dismissed it as misguided.<sup>186</sup> Such courts, the panel concluded, had focused too discretely upon the factual setting of *Hartford Underwriters*.<sup>187</sup>

According to *Cybergenics II*, the real mandate—the real holding—of *Hartford Underwriters* cannot be distinguished away: courts should construe the Bankruptcy Code according to its plain meaning.<sup>188</sup> Courts that have disregarded the impact of *Hartford Underwriters* upon derivative standing have overlooked the substance of the decision.<sup>189</sup> The Supreme Court's edict regarding "plain meaning" Code construction is relevant to all Code provisions containing an express grant of power to the trustee.<sup>190</sup> Courts confronted with the words "the trustee may" from anywhere in the Bankruptcy Code should defer to *Hartford Underwriters* strict constructionist style rather than conjure up implicit grants of authority.<sup>191</sup>

Some courts have posited that footnote five is the Supreme Court's "recognition of the policy considerations that are the genesis of [a] long standing bankruptcy practice."<sup>192</sup> In *Together Development Corporation v. Pappas*, for example, the Second Circuit found that court-sanctioned derivative standing under sections 544, 545, 547(b), 548(a), and 549(a) is grounded in policy, history, efficiency and the status quo and that, pursuant to footnote five, it is undisturbed by *Hartford Underwriters*.<sup>193</sup> In contrast, the *Cybergenics II* court read footnote five "plainly."<sup>194</sup> The Third Circuit Panel concluded that the Supreme Court had simply declined to decide an issue that was not squarely before it.<sup>195</sup> This interpretation is supported by the *Hartford Underwriters* opinion, where the Court announced that contemplating the merits of various bankruptcy policies was the province of Congress and not the Court.<sup>196</sup> The Supreme Court was ultimately unwilling to go beyond a natural reading of the Bankruptcy Code in order to shape a policy-based outcome.<sup>197</sup> Therefore, it would be ironic to conclude that they included footnote five as an implicit endorsement of a particular bankruptcy "policy." The *Cybergenics II* court acknowledged this irony and concluded that no such argument could be reconciled with any language in the *Hartford Underwriters* decision.<sup>198</sup>

186. *Id.* The *Cybergenics II* court examined *Together Dev. Corp.* in detail because it is one of the few opinions that sets forth a substantive analysis of *Hartford Underwriters* before reaching the decision to disregard it. *Id.*

187. *Id.*

188. *Id.*

189. *Id.*

190. *See id.* at 328-29.

191. *See id.* *See, e.g.,* *Together Dev. Corp.*, 262 B.R. 586, 591-92 (Bankr. D. Mass. 2001). The *Together Dev. Corp.* court could find "no provision of the Code that prohibits the Committee's action herein." *Id.* at 591. In addition, the court derived implicit authority for court sanctioned derivative standing from sections 1103 and 1109. *Id.* at 591-92.

192. *See, e.g.,* *Together Dev. Corp.*, 262 B.R. at 591.

193. *Id.* at 591-92 (referring to the practice at issue as "longstanding," "not simply pre-Code practice, but rather current practice," "well entrenched," and "cost and time efficient.").

194. *See* *Cybergenics II*, 304 F.3d at 328.

195. *Id.* at 329 n.13 ("The Court did not reach the derivative suit issue with regard to [s]ection 506(c) or other provisions because it simply was not presented . . .").

196. *Hartford Underwriters Ins. Co. v. Union Planters Bank*, 530 U.S. 1, 13-14 (2000) ("In any event, we do not sit to assess the relative merits of different approaches to various bankruptcy problems. It suffices that the natural reading of the text produces the result we announce. Achieving a better policy outcome . . . is a task for Congress, not the courts.").

197. *Id.*

198. *Cybergenics II*, 304 F.3d at 328-29.

*D. Policy, Prior Practice and Pragmatism**1. Policy and Prior Practice*

Many commentators and courts argue that prior bankruptcy practice, pragmatism and policy distinguish derivative rights under sections 544, 545, 547(b), 548(a), and 549(a) from an independent right under section 506(c) and, therefore, distinguish *Hartford Underwriters*.<sup>199</sup> Before resting *Cybergenics II* squarely on "plain meaning" statutory construction, the court explored these arguments.<sup>200</sup> The Supreme Court has held that, "in expounding a statute, we must not be guided by a single sentence or member of a sentence, but look to the provisions of the whole law, and to its *object and policy*."<sup>201</sup> However, the Supreme Court has *also* held that any party arguing to expand the text of the Bankruptcy Code beyond its natural reading must meet an exceptionally heavy burden of persuasion.<sup>202</sup> In light of both statements, the Third Circuit determined that *policy considerations can only be used to expand the plain meaning, or natural reading, of the Bankruptcy Code in exceptional circumstances*.<sup>203</sup> The court concluded that there were no such exceptional circumstances militating in favor of expanding the use of the sections 544, 545, 547(b), 548(a), and 549(a).<sup>204</sup> The court acknowledged that the history of derivative avoidance actions at common law and under the earliest versions of the Code was more compelling than the history of independent rights under 506(c) and its forerunners.<sup>205</sup> However, the court did not believe that this history could overcome the natural meaning of the language "the trustee may."<sup>206</sup> The Third Circuit adopted the *Hartford Underwriters* conclusion that the language "the trustee may" left no room for clarification by prior practice.<sup>207</sup>

*2. Pragmatism (addressing the realities of Chapter 11 reorganization)*

The *Cybergenics* Creditors' Committee argued that conflicts of interest are inherent to the reorganization process and that debtors-in-possession are inappropriately influenced by these conflicts.<sup>208</sup> The Committee argued that derivative standing was a necessary vehicle to police the reorganization process and to ensure that the value of estate is maximized.<sup>209</sup> A debtor-in-possession, often existing management in a financially distressed business, may use the trustee provisions to favor certain creditors; may be unwilling to avoid transactions with a supplier or lender with whom it hopes to continue a business relationship after a successful

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199. See, e.g., *Together Dev. Corp.*, 262 B.R. 586, 591-92 (Bankr. D. Mass. 2001); Bloom & Solomon, *supra* note 14, at 424-25.

200. *Cybergenics II*, 304 F.3d at 331-32.

201. *Id.* at 331 (quoting *Kelly v. Robinson*, 479 U.S. 36, 43 (1986)) (emphasis added).

202. *Id.* (citing *Hartford Underwriters Ins. Co. v. Union Planters Bank*, 530 U.S. at 9).

203. See *id.*

204. See *id.*

205. *Id.*

206. *Id.*

207. *Id.* The court found that "[section] 544(b), using the same operative language as [section] 506(c), is just as clear and unambiguous, and the provision's meaning may not be altered by prior practice." *Id.* See also discussion of *Hartford Underwriters*, *supra* Part II.

208. *Cybergenics II*, 304 F.3d at 332.

209. See *id.*

reorganization; or may have developed friendships that make it difficult to choose to pursue actions with severe economic impacts.<sup>210</sup> The Third Circuit acknowledged that other courts had been persuaded by this dilemma.<sup>211</sup> Such courts have relied on policy considerations and found that “judicially created creditor derivative suit[s]” were integral in side stepping conflicts of interest and concomitantly furthering the goals of reorganization to the benefit of all creditors.<sup>212</sup> *Together Development*, for example, explored potential conflicts of interest for the debtor-in-possession in a Chapter 11 bankruptcy proceeding where the potential defendants of the avoidance action were themselves insiders of the debtor.<sup>213</sup> The Creditors’ Committee had discovered the potentially fraudulent transfers by debtor insiders; however, the debtor-in-possession refused to pursue the allegations.<sup>214</sup>

The *Together Development* court analyzed the validity of the potential avoidance action by applying a four factor balancing test that had been set forth by a California bankruptcy court in *In re Catwil Corporation*.<sup>215</sup> The test contemplated criteria that, if satisfied, warranted the authorization of a derivative action.<sup>216</sup> The *Together Development* court found that the *Catwil* balancing test was legitimately premised on a combination of sections 1103(c)(5) and 1109(b)<sup>217</sup> and asserted, “[t]hus, it is evident to this Court that the Bankruptcy Code anticipates and provides for the approach pragmatically adopted by various other bankruptcy courts to deal with the conflicts arising with insiders of corporate bankruptcy debtors.”<sup>218</sup> *Together Development* authorized the creditors in that case to prosecute avoidance actions because, the court concluded, the Committee’s actions were “overwhelmingly beneficial to all members of the Debtor’s estate” and in furtherance of prin-

210. *Id.* at 332 n.15; See also RICHARD I. AARON, *BANKRUPTCY LAW FUNDAMENTALS* § 10:1 (2003); Kirpalani, *supra* note 6, at 1. In response to *Cybergenics II*, many commentators have argued the importance of judicial consideration of these conflicts of interest in bankruptcy proceedings:

In a quest to maximize value, the parties who are best positioned to rehabilitate a company’s operating performance may not be the parties to investigate the pre-bankruptcy malfeasance of their colleagues or the board. Instead of forcing the estate to choose a team best suited for one, but not both, mission, bankruptcy courts (until *Cybergenics II*) had the flexibility to accommodate both objectives by authorizing committees to investigate and prosecute such causes of action on behalf of the estate.

*Id.*

211. *Cybergenics II*, 304 F.3d at 331-32.

212. *Id.*

213. 262 B.R. 586, 591 (Bankr. D. Mass. 2001). See *supra* notes 185-193 and accompanying text for the discussion of other aspects of this case.

214. *Together Dev. Corp.*, 262 B.R. at 589.

215. 175 B.R. 362 (Bankr. E.D. Cal. 1994). “[T]he *Catwil* court weighed four factors: (1) whether the defendants were insiders of the debtor; (2) whether the debtor was fully aware of the committee’s intent to file the actions; (3) whether time was of the essence in filing the complaints; and, (4) whether there was any likelihood of confusion as to which party would pursue the claims.” *Together Dev. Corp.*, 262 B.R. at 589-90.

216. *Id.* at 590.

217. *Id.* at 589. Cf. *Cybergenics III*, 330 F.3d 548, 559-67 (3d Cir. 2003).

218. *Together Dev. Corp.*, 262 B.R. at 590.

cipals of the Code.<sup>219</sup> According to *Together Development*, if derivative standing was invalidated, it would give rise to a "serious abuse of the bankruptcy system" that could not be "countenanced by the Bankruptcy Code or [the courts]."<sup>220</sup>

The Sixth Circuit has also voiced concerns that conflicts of interest may wield inappropriate influence upon a debtor-in-possession.<sup>221</sup> In 1995, the court held that a bankruptcy court may grant an individual creditor the authority to initiate an avoidance action derivatively, if the creditor:

- (1) has alleged a colorable claim that would benefit the estate, if successful, based on a cost-benefit analysis performed by the court; (2) has made a demand on the debtor-in-possession to file the avoidance action; (3) the demand has been refused; and, (4) the refusal is unjustified in light of the statutory obligations and fiduciary duties of the debtor-in-possession in a Chapter 11 reorganization.<sup>222</sup>

In this pre-*Hartford Underwriters* decision, the court found that, while the Bankruptcy Code does not expressly authorize a creditors' committee to act in the trustee's stead, it does not expressly prohibit such action either.<sup>223</sup> The court decided that, under the circumstances of the case at bar, court authorized derivative standing would further the broader goals and purposes of the Bankruptcy Code.<sup>224</sup> The court opined:

A debtor-in-possession often acts under the influence of conflicts of interest and may be tempted to use its discretion under [s]ections 547 and 548 as a sword to favor certain creditors over others, rather than as a tool to further its reorganization for the benefit of all creditors as Congress intended. Given this reality, we do not believe Congress intended to exclude creditors from seeking to avoid preferential or fraudulent transfers where the debtor-in-possession abuses its discretion.<sup>225</sup>

In accordance with this perception of Congressional intent, the *Gibson* court found that the judiciary had the authority to analyze the action or inaction of debtors-in-possession and to confer standing upon creditors when equitable.<sup>226</sup> Look-

219. *Id.* at 591. The court opined that derivative creditor standing was: premised on the parties expectations of the utilitarian, time tested process which has evolved in bankruptcy law and under the Bankruptcy Code in order to ensure that appropriate lawsuits proceed in cases where debtor's counsel has some reason not to pursue all potential assets of the estate due to a conflict of interest, *be that conflict real or perceived.*

*Id.* at 591-92 (emphasis added).

220. *Id.* at 592. The court viewed the creditors' committee as a vehicle to ensure the furtherance of the purposes and policies of bankruptcy, and as a safeguard "against certain potential gaps in the handling of a bankrupt estate." *Id.* Derivative creditor avoidance actions were described as a "practical solution of permissive delegation in order to avoid an insider's circumvention of either the letter or the spirit of the Bankruptcy Code." *Id.*

221. *Cybergeneics II*, 304 F.3d 316, 331-32 (3d Cir. 2002).

222. *Canadian Pac. Forest Products Ltd. v. J.D. Irving Ltd. (In re Gibson)*, 66 F.3d 1436, 1438 (6th Cir. 1995) [hereinafter *Gibson*].

223. *Id.* at 1440-41. The *Gibson* court surveyed the Code for possible sources of authority for creditors to initiate avoidance actions. *Id.* at 1145 n.1. The court acknowledged that the authority "might" be derived from the section 1109, "Right to be Heard" provision, but declined to follow that theory. *Id.*

224. *See id.*

225. *Id.* at 1441.

226. *See id.* at 1438-42.

ing to the purposes of Chapter 11 reorganization, the court concluded that although reorganization did not mandate estate "maximization," it did require that the trustee or debtor-in-possession act to conserve and protect assets.<sup>227</sup> Given these duties, the Sixth Circuit concluded that the failure of a debtor-in-possession to pursue an avoidance action might be characterized as an abuse of discretion if the inaction was "unjustified."<sup>228</sup> The court discussed the debtor-in-possession's fiduciary duties and offered some guidance as to how a bankruptcy court might assess whether a debtor-in-possession's actions, or lack thereof, were unjustified.<sup>229</sup> Ultimately, *Gibson* concluded that the judiciary is responsible for policing Chapter 11 reorganizations in order to ensure that the broad purposes and policies of bankruptcy are carried out.

The Seventh Circuit has also concluded that judicially conferred derivative standing is a means to police a debtor-in-possession's potential conflicts of interest.<sup>230</sup> In this case, Xonics, the debtor-in-possession, was acting, as opposed to failing to act, to set aside a payment to one of its suppliers (as a voidable preference pursuant to section 547(b)).<sup>231</sup> The supplier, Mitsui, contended that Xonics was not insolvent at the time of the disputed payment, and, therefore, the payment could not be avoided.<sup>232</sup> Mitsui argued that the validity of Xonics's insolvency at the time of the payment was dependant upon the validity of several inter-affiliate transactions between itself and its parent corporation: these transactions were responsible for the creation of Xonics's liabilities.<sup>233</sup> If the transactions with Xonics's parent corporation were avoided *first*, then there would be no insolvency basis for Xonics to avoid its payment to Mitsui.<sup>234</sup> In analyzing this argument, the Seventh Circuit found that Mitsui was "entitled to wonder whether the refusal by the debtor-[in]-possession to try to void the [allegedly fraudulent transactions with its parent corporation] was really made in good faith."<sup>235</sup> To this end, the court instructed that Mitsui could have done one of two things: first, it could have sought the appointment of a trustee under section 1104; or second, it could have sought the permission of the bankruptcy court "to bring a form of derivative suit in the name of the debtor."<sup>236</sup> The latter option, the court opined, required the party seeking the suit to convince the court that "the debtor was [somehow] shirking its statutory responsibilities."<sup>237</sup>

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227. *Id.* at 1442. The court found that the purpose of Chapter 11:

is to provide a debtor with legal protection in order to give it the opportunity to reorganize, and thereby to provide creditors with going-concern value rather than the possibility of a more meager satisfaction through liquidation. Therefore, maximization of the value of the estate is not necessarily the primary goal of a . . . reorganization.

*Id.* (internal citations omitted).

228. *Id.*

229. *Id.* at 1442-46.

230. *In re Xonics Photochemical, Inc.*, 841 F.2d 198, 203 (7th Cir. 1988).

231. *Id.* at 199.

232. *Id.*

233. *Id.* at 201. Mitsui argued "that Xonics Photochemical was not insolvent when they were made because the transactions between it and its affiliates were (1) void under state law . . . or (2) voidable as fraudulent conveyances." *Id.*

234. *See id.* at 201-02.

235. *Id.* at 202.

236. *Id.* at 202-03.

237. *Id.* at 203.



In 2001, the Second Circuit held that court-sanctioned derivative standing during a Chapter 11 reorganization helped realize the broader policies and purposes of bankruptcy law: alleviating debtor-in-possession conflicts of interest, as well as conserving estate resources.<sup>238</sup> The court noted that a debtor-in-possession might want to request a creditors' committee to prosecute insiders, former insiders, customers, or vendors in order to avoid conflicts of interest.<sup>239</sup> Further, allowing a creditors' committee to pursue the litigation might better serve the bankruptcy estate by effecting a "reasoned and practicable division of labor."<sup>240</sup> *In re Commodore International Limited* evolved out of a complex web of multi-national litigation.<sup>241</sup> In this case, the debtor-in-possession had agreed to let the Creditors' Committee initiate an adversary proceeding that it did not have the resources to pursue independently.<sup>242</sup> The district court reviewed Second Circuit precedent and determined that "creditors' committees have an implied . . . right . . . to initiate adversary proceedings . . . only when the trustee or debtor[-]in[-]possession unjustifiably fail[s] to bring suit or abuse[s] its discretion in not suing to avoid a preferential transfer."<sup>243</sup> Ultimately, the circuit court reversed this decision, finding that a creditors' committee "[may] also obtain standing with [a debtor-in-possession's] consent and bankruptcy court approval."<sup>244</sup> The circuit court acknowledged that the debtor-in-possession is the usual party to initiate an adversary proceeding, but held that creditors' committees maintain a qualified right to initiate such proceedings, in the debtor-in-possession's name, and on behalf of the estate, if the bankruptcy court consents.<sup>245</sup>

In defining the scope of a committee's "qualified" right to initiate adversary proceedings the Second Circuit relied on *In re Spaulding Composites*,<sup>246</sup> which was decided by the Bankruptcy Appellate Panel of the Ninth Circuit.<sup>247</sup> The *Spaulding Composites* court had held that "a debtor[-]in[-]possession may stipulate to representation by an unsecured creditors' committee" so long as it obtains bankruptcy court approval.<sup>248</sup> The Second Circuit summarized and adopted the Ninth Circuit B.A.P.'s approach:

- (1) A creditors' committee may acquire standing to pursue the debtor's claims if: (1) the committee has the consent of the debtor-in-possession or trustee, and (2) the court finds that suit by the committee is (a) in the best interest of the bankruptcy estate, and (b) is "necessary and beneficial" to the fair and efficient resolution of the bankruptcy proceedings.<sup>249</sup>

238. *Commodore Int'l Ltd. v. Gould (In re Commodore Int'l Ltd.)*, 262 F.3d 96, 99-100 (2d Cir. 2001) [hereinafter *Commodore*].

239. *Id.* at 99 (citing 3 COLLIER ON BANKRUPTCY § 1103.05 (3d Ed. 2001)).

240. *Id.* at 100.

241. *Id.* at 97-98.

242. *Id.* at 98.

243. *Id.* at 99 (quoting *Commodore Int'l Ltd. v. Gould (In re Commodore Int'l Ltd.)*, 253 B.R. 336, 339 (S.D.N.Y. 2000) (internal quotation marks omitted) (emphasis added). See also *Unsecured Creditors Comm. of Debtor STN Enters. Inc. v. Noyes (In re STN Enters.)*, 779 F.2d 901 (2d Cir. 1985).

244. *Commodore*, 262 F.3d at 98 (emphasis added).

245. *Id.*

246. 207 B.R. 899 (B.A.P. 9th Cir. 1997).

247. *Commodore*, 262 F.3d at 99.

248. *Id.* at 99-100.

249. *Id.* at 100 (quoting *Spaulding Composites*, 207 B.R. at 94).

In this respect, the *Commodore International* court, like the *Gibson* court, examined the broad goals of bankruptcy law and asserted that bankruptcy courts should have the latitude to ensure that these goals are realized.<sup>250</sup> In *Commodore International*, the Second Circuit adopted rules that provide bankruptcy courts with significant latitude to “manage . . . litigation and to check [for] any potential . . . abuse by the parties.”<sup>251</sup> Under *Commodore International*, bankruptcy courts define what is “necessary and beneficial” in a bankruptcy case and can authorize or reject adversary proceedings accordingly.<sup>252</sup>

The *Cybergenics II* court contemplated the policy considerations underlying *Gibson* and *Together Development* but concluded that they were not a sufficient justification for overlooking the plain meaning of the text.<sup>253</sup> The Third Circuit echoed *Hartford Underwriters*, finding that the task of “fashion[ing] a new procedure” to address these issues was a task for Congress and not the courts.<sup>254</sup> The court indicated that “[i]t might well be sound policy” to address the conflicts of interest that confront a debtor-in-possession.<sup>255</sup> However, sound policy or not, the court declined to find that the judiciary had the authority to sanction “such an arrangement.”<sup>256</sup> Instead, the Third Circuit proffered several alternatives available to creditors inclined to pursue avoidance claims should a debtor-in-possession, justifiably or unjustifiably, decline to do so: alternatives which would not require going outside a plain reading of the Bankruptcy Code.<sup>257</sup> A discussion of these alternatives follows.

## V. THE PRACTICAL EFFECTS OF CYBERGENICS II

### A. Cybergenics II: *Discussion of Alternatives*

The Third Circuit conceded that the practice of judicially authorizing creditor derivative suits under section 544, the practice that it was rejecting, had continued in several jurisdictions, including its own, beyond the issuance of *Hartford Underwriters*.<sup>258</sup> These cases were decided without any reference to *Hartford Underwriters* and, in some cases, without any comment on a committee’s capacity to

250. *See id.* at 99-100.

251. *Id.* at 100.

252. *See id.*

253. *Cybergenics II*, 304 F.3d 316, 332 (3d Cir. 2002). The court discussed the purposes of Chapter 11 and acknowledged that the practical realities of reorganization generate conflicts of interest. *Id.* at 332 n.15.

[M]anagement may be unwilling to set aside an avoidable transfer with a supplier or lender with whom it intends to do future business after the business is successfully reorganized. Friendships develop in business which may make the debtor[-]in[-]possession hesitant to sue. Therefore, a major problem in chapter 11 cases is assuring that the debtor[-]in[-]possession performs the duties with the same faithful concern for the interests of creditors as would be expected of an independent trustee.

*Id.* (quoting *City Corp. Acceptance v. Robison (In re Sweetwater)*, 884 F.2d 1323, 1329 n.7 (10th Cir. 1989)).

254. *Id.* at 332 (internal citation and quotation omitted).

255. *Id.*

256. *Id.*

257. *Id.* at 333.

258. *Id.* at 330 (collecting cases).

bring the claim.<sup>259</sup> The operative theme among them, according to *Cybergenics II*, was that none of the parties had raised the issue of derivative creditor standing.<sup>260</sup> For example, within the Third Circuit, in *Official Committee of Unsecured Creditors v. R.F. Lafferty*,<sup>261</sup> the parties had stipulated to the Committee's authority to assert the claim in the trustee's stead.<sup>262</sup> The debtor-in-possession apparently conceded to the capacity of the Committee to bring a derivative proceeding.<sup>263</sup> The *Cybergenics II* court, now squarely confronted with the question of the practice's validity, opined that "[a] panel of this court is bound to follow the holdings of published opinions of prior panels of this court unless overruled by the court en banc or the holding is undermined by a subsequent Supreme Court case."<sup>264</sup> In light of *Hartford Underwriters*, the Third Circuit panel decided all prior holdings authorizing creditor derivative suits under the Code's avoidance provisions could "no longer stand."<sup>265</sup>

The court then contemplated the remedies available to a creditors' committee when a debtor-in-possession will not—or cannot—commence an adversarial proceeding. First, under section 1103(c)(4), a creditors' committee may seek to have a trustee or examiner appointed under section 1104.<sup>266</sup> Second, the court suggested that a creditor could move to dismiss the bankruptcy proceeding under section 1112 in order to pursue claims in state court under applicable state law.<sup>267</sup> The court noted that when *Cybergenics*, as debtor-in-possession, had declined to pursue the avoidance claims pressed by the Committee, *Cybergenics* had moved to dismiss its bankruptcy case.<sup>268</sup> If the Creditors' Committee had not objected to this dismissal, then the individual creditors would have been able to pursue fraudulent transfer claims under New Jersey state law.<sup>269</sup> However, the court conceded that "federal bankruptcy avoidance action[s] [have] a significant advantage over avoidance claims brought under state law."<sup>270</sup> The federal provision is often re-

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259. *Id.*

260. *Id.*

261. 267 F.3d 340 (3d Cir. 2001).

262. *Cybergenics II*, 304 F.3d at 330.

263. *Id.*

264. *Id.* at 330-31 (quoting *United States v. Continental Airlines (In re Continental Airlines)*, 134 F.3d 536, 542 (3d Cir. 1998)) (internal quotation marks and citations omitted).

265. *Id.* at 330.

266. *Id.* at 333. Section 1103 "Powers and duties of committees" reads in pertinent part: "[a] committee appointed under section 1102 of this title may . . . request the appointment of a trustee or examiner under § 1104 of this title . . ." 11 U.S.C. § 1103(c) (2000). Section 1104 "Appointment of trustee or examiner" provides that "[a]t any time after the commencement of the case but before confirmation of a plan, on request of a party in interest or the United States trustee, and after notice and a hearing, the court shall order the appointment of a trustee . . . for cause . . ." 11 U.S.C. § 1104(a) (2000).

267. *Cybergenics II*, 304 F.3d at 333. Section 1112 "Conversion or Dismissal" provides that "the court may convert . . . or . . . dismiss a case under this chapter, whichever is in the best interest of creditors and the estate, for cause, including . . . [the] continuing loss to or diminution of the estate and absence of a reasonable likelihood of rehabilitation . . ." 11 U.S.C. § 1112(b) (2000) (emphasis added). The court also noted that any claim avoidable under section 544 is, necessarily, a nonbankruptcy cause of action. *Cybergenics II*, 304 F.3d at 333 n.17. "The avoidance power under [section] 544(b) may be used to avoid transfers that are 'voidable under applicable state law . . .'" *Id.* (quoting 11 U.S.C. § 544(b)) (internal citation omitted).

268. *Cybergenics II*, 304 F.3d at 333, n.17.

269. *Id.*

270. *Id.*

ferred to as a “strong-arm provision” because it avoids a transfer in its entirety, for the benefit of the bankruptcy estate as a whole, and is not limited in effect, like state law provisions, to voiding the transfer only to the extent necessary to satisfy the claim of an individual creditor.<sup>271</sup>

In light of the alternatives, the Creditors’ Committee proposed that the Third Circuit remand so that it could have the opportunity to move for the appointment of a trustee as the proper party in interest to raise the contested fraudulent conveyance claims.<sup>272</sup> The Committee relied on Rule 17(a) of the Federal Rules of Civil Procedure, which is “intended to prevent the forfeiture [of colorable claims] when determination of the proper party to sue is difficult or when an *understandable mistake* has been made.”<sup>273</sup> The court, however, was unwilling to remand for a belated opportunity to substitute the proper party in interest.<sup>274</sup> The court viewed the Committee’s litigation choices as understandable *choices* based upon prevailing law and not understandable *mistakes*.<sup>275</sup> The court noted that even after the defendants’ second motion to dismiss, which argued the applicability of *Hartford Underwriters*, the Committee still did not choose to move for a trustee to be appointed and “did not even argue for such an appointment in the alternative.”<sup>276</sup> Because the issue had not been raised below, the court declined to address it now.<sup>277</sup> The Third Circuit Panel held that a creditor or creditors’ committee may not initiate an avoidance action, affirmed the district court’s decision to dismiss, and declined to order a remand to explore the alternatives.<sup>278</sup>

### B. The Effect of Cybergencics II within the Third Circuit

At the time that *Cybergencics II* came down, there were over 250 cases pending in the Third Circuit that would then require a substitution of the proper party in interest to prosecute the claims or would need to be dismissed for the plaintiff’s lack of capacity to sue.<sup>279</sup> The decision to vacate *Cybergencics II* pending a rehear-

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271. *Id.* “Section 544(b) . . . allows an entire conveyance to be set aside no matter how small the claim of the ‘individual creditor actually holding the avoidance claim.’” *Id.* (quoting *Cybergencics I*, 226 F.3d 237, 245 (3d Cir. 2000)).

272. *Id.* at 333-35.

273. *Id.* at 333 (quoting FED. R. CIV. P. 17(a) advisory committee’s note) (internal quotation marks omitted) (emphasis added). The text of the rule reads in pertinent part that “[n]o action shall be dismissed on the ground that it is not prosecuted in the name of the real party in interest until a reasonable time has been allowed.” FED. R. CIV. P. 17(a).

274. *Cybergencics II*, 304 F.3d at 334. The Committee was arguing for a characterization of the issue at bar as “proper party in interest” as opposed to “standing *per se*” in an attempt to bring itself within the meaning of Federal Rule of Civil Procedure 17(a). *Id.* The Third Circuit agreed with the Committee’s characterization: “The Committee satisfies constitutional and prudential requirements for standing in the case. However, it is not the real party in interest because it is not entitled to enforce the avoidance claims under [section] 544(b).” *Id.* The court concluded that it was not appropriate to remand for substitution of the proper party in interest. *Id.*

275. *Id.* at 334-35.

276. *Id.*

277. *Id.*

278. *Id.*

279. Official Comm. of Asbestos Pers. Injury Claimants *ex. rel.* W.R. Grace Co. v. Sealed Air Corp. (*In re* W.R. Grace Co.), 285 B.R. 148, 155 (Bankr. D. Del. 2002) [hereinafter *Grace*].

ing en banc did not come down until November 20, 2002.<sup>280</sup> During the month that *Cybergenics II* was controlling law, a multi-billion dollar litigation was scheduled for trial in Delaware District Court; *Cybergenics II* left the parties involved, and the court, scrambling to figure out the proper course of action.<sup>281</sup>

Earlier that year, in March 2002, the Delaware court had granted permission for two creditors' committees, the Personal Injury Committee and the Property Damage Committee, to prosecute fraudulent conveyance claims in W.R. Grace's bankruptcy case.<sup>282</sup> The court premised its decision on prior practice and precedent within the Third Circuit and found that "[t]he necessity of [the] order was three-fold."<sup>283</sup> First, the potential recovery of the suit represented immense material value to the estate; the court listed the current book value of the debtor's assets as 2.7 billion dollars while the potential recovery of the fraudulent conveyance prosecution was over 3.8 billion dollars.<sup>284</sup> Second, "on the face of the papers" the claims appeared to be at least colorable.<sup>285</sup> And, third, the debtor-in-possession's prosecution of the claims seemed improbable if not impossible.<sup>286</sup> The debtor in this case, W.R. Grace, was also the subject of asbestos litigation.<sup>287</sup> The success of the disputed avoidance actions would depend, in part, on establishing W.R. Grace's asbestos liability as of the date of the contested transfer.<sup>288</sup> As such, W.R. Grace could not prosecute the avoidance claims, because "regardless [of the value] of the potential recovery for the estate, [such a] position would require it to concede the merits of the asbestos claims against it."<sup>289</sup>

The Committees's fraudulent conveyance claims were set to be litigated on September 30, 2002; however, *Cybergenics II* interceded by ten days.<sup>290</sup> The Delaware court convened a conference to determine how "best to salvage the case

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280. *Cybergenics II*, 310 F.3d at 785-86. A majority of active Third Circuit judges voted to vacate the *Cybergenics II* pending a rehearing en banc, however Judges Alito and Fuentes, who had both voted in favor of the panel opinion, would have allowed it to stand pending en banc review. *Id.*

281. *Grace*, 285 B.R. at 151-54.

282. *Id.* at 153. The W.R. Grace bankruptcy litigation is incredibly complex, including issues of asbestos liability, Chapter 11 reorganization conflicts, and fraudulent conveyance claims all intermingled and relatively interdependent. *See generally id.*

283. *Id.* at 152.

284. *Id.*

285. *Id.* The court cited to the *Gibson* decision for the rule that a creditor could be granted derivative standing to bring an avoidance action if: the claim was *colorable*; the debtor-in-possession refused to prosecute the claim; and, pursuit of the claim would be beneficial to the bankruptcy estate. *Id.* The court apparently premised its belief that the claims were colorable, at least in part, on the fact that the disputed transfers had been contested in litigation in multiple jurisdictions before the debtor had even filed a bankruptcy petition. *See id.* *See also Gibson*, 66 F.3d 1436 (6th Cir. 1995).

286. *Id.* In a complex web of motions the debtor had previously moved to intervene and then tried to withdraw from the proceedings. *Id.* However, in pre-petition litigation and at the early stages of the action at bar, the debtor had continuously resisted the accusation that the challenged transfers were fraudulent. *Id.* at 152-53.

287. *Id.*

288. *Id.* at 152.

289. *Id.* The factual disposition of this case presents a conflict of interest scenario not contemplated by the analogous cases addressed thus far in this Comment. In the instant case, the need for a derivative action may have resulted from a *justified* refusal of the debtor-in-possession to pursue the claim, which would stand in contrast to the *unjustified refusal or consent* scenarios discussed earlier. *See, e.g., Commodore*, 262 F.3d 96 (2d Cir. 2001).

290. *Grace*, 285 B.R. at 153.

and bring the substantive issues to trial.”<sup>291</sup> The court issued an Order to Show Cause and the parties were instructed to bring motions on the issue.<sup>292</sup> On October 24, before *Cybergenics II* was vacated and set for en banc rehearing, the *Grace* court handed down a decision reviewing its options, ordering that the fraudulent conveyance claims would proceed to trial and issuing a sua sponte interlocutory appeal to the Third Circuit.<sup>293</sup> The *Grace* opinion addressed the best of a “win-narrowed” field of options and expounded on their relative values to the situation at bar: motion to dismiss, motion to appoint an examiner, motion to appoint a limited purpose trustee, motion to appoint a plenary trustee, and, the motion ultimately granted, motion to reset trial.<sup>294</sup>

The defendants moved to dismiss the fraudulent conveyance action.<sup>295</sup> They argued that remanding for the appointment of a trustee was the only tenable solution to the problem at hand and asserted that pursuant to Federal Rule of Civil Procedure 17(a) it was no longer reasonable to remand the case for the appointment of a trustee.<sup>296</sup> Aligning themselves with *Cybergenics II*, the defendants contended that their adversaries had had notice that their derivative capacity to sue might be in jeopardy after the lower court had ruled on the issue.<sup>297</sup> The Delaware court, however, disagreed and held that no litigant could have been expected to anticipate the changes wrought by *Cybergenics II*.<sup>298</sup> The court was not willing to accept the argument that “the only [tenable] solution to the . . . problem [was] barred as untimely raised.”<sup>299</sup> In fact, the court was not willing to accept that there was only one tenable solution; it rejected the motion to dismiss and moved on to consider the other motions *seriatim*.<sup>300</sup>

The court examined the possibility of appointing an examiner, a limited purpose trustee, or a plenary trustee as the proper party in interest to prosecute the

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291. *Id.* at 154. The court noted that it had set an expedited pace to bring the matter to trial because efforts toward an effective reorganization would likely be hampered, if not precluded, by the uncertainty represented by an unresolved fraudulent conveyance claim. *Id.* at 153. The court summarized the immense “case management challenge” that the parties undertook in preparing an unduly complex litigation for trial in only five months and found fees and expenses thus far totaled in excess of 16.7 million dollars. *Id.* at 153-54.

292. *Id.* at 154.

293. *Id.* at 162-63. The court anticipated that application for interlocutory appeal would be forthcoming, so it moved to issue the order on its own. *Id.* at 162. Finding itself in “uncharted waters,” the court acknowledged that there was “substantial ground for a difference of opinion” with regard to the order it had issued. *Id.* Unequivocally wishing to avoid an “unconscionable” waste of assets or “deprive all the parties of the benefits of the expedited resolution they [had] worked hard to achieve” the court sent the case to the circuit court for resolution of the “plainly” controlling issue of law. *Id.* at 162-63.

294. *Id.* at 154-62. The motion to reset trial also included a motion to prohibit participation by the debtor, which the court denied. *Id.* at 162. Participation by the debtor in these proceedings was in and of itself a heavily litigated issue which the court chose not to revisit in depth in this particular opinion. *Id.*

295. *Id.* at 154.

296. *Id.* at 154-55.

297. *Id.* See also *supra* Part V.A. (discussing *Cybergenics II*’s analysis of Rule 17(a)).

298. *Grace*, 285 B.R. at 154-55. The court noted that even *Cybergenics I* had “treated derivative capacity to sue . . . as a settled issue” and had not questioned the validity of the practice. *Id.* at 155.

299. *Id.*

300. *Id.*

fraudulent conveyance claims.<sup>301</sup> The debtor, W.R. Grace, and two other parties to this case moved to appoint an “examiner with expanded powers.”<sup>302</sup> The parties argued that section 1106 authorizes an examiner not only to investigate but also to prosecute a fraudulent conveyance claim when the debtor refuses to do so.<sup>303</sup> Section 1106(b) reads, in pertinent part, “[a]n examiner . . . shall perform [certain specified duties of a trustee] and . . . any other duties of the trustee that the court orders the debtor[-]in[-]possession not to perform.”<sup>304</sup> The *Grace* court surveyed several lower court opinions authorizing an examiner to prosecute fraudulent conveyance actions, but then rejected the reasoning employed in those decisions.<sup>305</sup> The court found that when a debtor-in-possession exercises its right not to prosecute an action, it is exercising a statutorily based prerogative.<sup>306</sup> The court refused to equate this choice not to act with a court order not to act, the latter of which is a necessary element of section 1106.<sup>307</sup> To make such a “leap,” the court reasoned, would be to reject two fundamental principles implicated by *Cybergenics II*: first, a section 544 action is the sole statutory prerogative of the trustee or debtor-in-possession; and second, the Bankruptcy Code should be read literally.<sup>308</sup>

The court rejected a limited purpose trustee in the same fashion, reasoning: “[t]here is no such entity . . . under the Code.”<sup>309</sup> The court also found that the co-existence of a limited purpose trustee and a debtor-in-possession would be inherently problematic should disagreement as to the best interests of the estate arise.<sup>310</sup> Splitting the role of “representative of the estate” between two parties—particularly two parties with antagonistic goals regarding a fraudulent conveyance claim—is not a workable solution.<sup>311</sup> On the other hand, the court found that a plenary, “typical, non-limited purpose Chapter 11 trustee,” would, at least, allow the case to go forward on unquestioned legal footing.<sup>312</sup> However, the court denied the motion to appoint a trustee, because “where the impetus for a trustee [in this case] stems from the single issue of the fraudulent conveyance action, . . . a trustee should be a last resort.”<sup>313</sup> In light of all the confusion, however, the court set

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301. *Id.* at 155-60.

302. *Id.* at 155 (internal quotation omitted). The debtor, as well as the Property Committee and the Equity Committee all moved for this option under section 1104(c). *Id.*

303. *Id.* at 155-56.

304. *Id.* at 156 (quoting 11 U.S.C. § 1106(b)) (ellipses and textual changes in original) (emphasis added).

305. *Id.* at 157.

306. *Id.* at 156.

307. *Id.*

308. *Id.* The court also doubted whether the concept of an examiner as a prosecutor of fraudulent conveyance claims would be consistent with Code conceptually. *Id.* Noting that an examiner is not authorized by the Code to retain counsel or hire other professionals, the court found it “difficult to see how an examiner could function as a true plaintiff in a complex fraudulent conveyance action.” *Id.*

309. *Id.* at 157.

310. *Id.*

311. *Id.*

312. *Id.* The court noted that “the Court of Appeals has expressly approved the appointment of a trustee where appropriate to prosecute a fraudulent conveyance action when the debtor refuses to act.” *Id.* at 156.

313. *Id.* at 160. Section 1104 gives the court the authority to appoint a trustee “for cause, including fraud, dishonesty, incompetence or gross mismanagement of the affairs of the debtor by current management . . . if such appointment is in the interest of the creditors, any equity security holders, and other interests of the estate . . .” 11 U.S.C. § 1104(a) (2000). Court findings under this section mandate the appointment of a trustee. *Grace*, 285 B.R. at 158.

forth some preliminary findings on the issue so that the option would not be foreclosed.<sup>314</sup> The circumstances of the case, according to the court, suggested that the debtor's refusal to prosecute the fraudulent conveyance claims might well rise to the level of cause required under section 1104(a)(1) or (2) of the Bankruptcy Code for the appointment of a trustee, despite the inherent disruption of displacing a debtor-in-possession and despite the late stage in the proceeding.<sup>315</sup>

The court ultimately granted the motion to reset trial and based its decision on two grounds.<sup>316</sup> First, the court held that it was compelled to protect the investments of the estate and of the defendant in preparation for litigation.<sup>317</sup> Emphasizing that "this matter was on the eve of a very complex trial," the court invoked its authority under section 105 of the Bankruptcy Code to issue any order "necessary or appropriate," in order to relax the rule of *Cybergenics II*.<sup>318</sup> Second, the court indicated that the procedural posture of *Cybergenics II* "militates in favor of relief from its holding here."<sup>319</sup> With the petition for rehearing en banc still pending at that time, the court found that the *Cybergenics II* "mandate" had not yet firmly issued.<sup>320</sup> Extensive delay while the *Cybergenics* appellate process unraveled was not acceptable to the court.<sup>321</sup> The court found that resetting the W.R. Grace matter for trial would do little to erode the precedential value of *Cybergenics II* because no other case was "likely to find itself in the peculiar circumstances of . . . a multi-billion dollar litigation, days from trial."<sup>322</sup> After resetting the trial, the court issued a certificate for interlocutory appeal, and put the case in queue for the Third Circuit Court of Appeals to resolve without further waste of resources.<sup>323</sup>

*In re TEU Holdings*<sup>324</sup> was also before a Delaware bankruptcy court in November 2002, before *Cybergenics II* was vacated pending rehearing en banc.<sup>325</sup> The Official Committee of Unsecured Creditors in this case had filed an adversary proceeding in February 2002 pursuant to a court order authorizing them to pursue avoidance actions against various former officers and/or directors of the debtor-in-possession.<sup>326</sup> One of the claims for relief stated in the Committee's complaint was for the avoidance of certain payments to these insiders as fraudulent transfers.<sup>327</sup> The bankruptcy court raised the *Cybergenics II* issue sua sponte, and decided, accordingly, that an appropriate basis for dismissal was apparent from the

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314. Grace, 285 B.R. at 157-60.

315. *Id.* at 159.

316. *Id.* at 160.

317. *Id.* at 160-61.

318. *Id.* at 161. Section 105 reads in pertinent part: "The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." 11 U.S.C. § 105(a) (2000).

319. Grace, 285 B.R. at 161.

320. *Id.*

321. *Id.* The court opined that "[t]he likelihood increases with each passing week that witness preparations will become stale, experts will become unavailable, and team members will move on, to name but a few of the vicissitudes of litigation delayed." *Id.*

322. *Id.* at 161-62.

323. *Id.* at 162-63.

324. 287 B.R. 26 (Bankr. D. Del. 2002).

325. *Id.* at 26.

326. *Id.* at 29.

327. *Id.* at 41.



face of the complaint.<sup>328</sup> The fraudulent transfer claim was dismissed and the prior order that it had authorized was vacated.<sup>329</sup> The court gave no further comment to the consequences of *Cybergenics II*—its ambiguous appellate status or its potentially inequitable effect—other than to conclude that it was controlling and to apply it to the case at bar.<sup>330</sup>

In *In re Parcel Consultants*,<sup>331</sup> the Creditors' Committee had initiated an adversary proceeding seeking to set aside five payments as avoidable preferences.<sup>332</sup> When *Cybergenics II* was issued, the change in controlling law was applied to the ongoing proceeding, apparently, swiftly and without issue.<sup>333</sup> In this Chapter 11 proceeding, however, a reorganization plan had already been confirmed, a trust had been formed from the four entities comprising the debtor, and, most significantly, a trustee had been appointed.<sup>334</sup> This procedural posture softened the impact of *Cybergenics II*: the *Parcel Consultants* Creditors' Committee was able to duly submit an application to substitute the trustee as the plaintiff and proper party in interest.<sup>335</sup> *Parcel Consultants* was issued in December 2002, and the bankruptcy court noted, at that time, that *Cybergenics II* had been vacated pending a rehearing en banc.<sup>336</sup> The court decided that it would, therefore, not assess the validity of derivative creditor standing.<sup>337</sup> The decision never explicitly discusses reinstating the Creditors' Committee as plaintiff, but they are the named plaintiff in the opinion's caption and the court refers to the motions and arguments as "the Committee's" motions and arguments.<sup>338</sup>

Four months after the Third Circuit vacated *Cybergenics II*, bankruptcy courts, waiting for the en banc decision to be handed down, were still confronting the opinion's lingering impacts.<sup>339</sup> In *In re Combustion Engineering*, an "unofficial" committee of "potential" tort creditors and an individual tort creditor came before the court in an effort to get a temporary restraining order to prohibit the debtor from making preferential payments.<sup>340</sup> The court denied the request for a temporary restraining order because the moving parties failed to prove a likelihood of success on the merits as is necessary for the court to grant such extraordinary

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328. *Id.* "A court 'may on its own initiative enter an order dismissing the action provided that the complaint affords a sufficient basis for the court's action.'" *Id.* (quoting *Bryson v. Brand Insulations, Inc.*, 621 F.2d 556, 559 (3d Cir. 1980)).

329. *Id.*

330. *See id.*

331. 287 B.R. 41 (Bankr. D. Del. 2002).

332. *Id.* at 42-43.

333. *Id.* at 42-43, 43 n.1.

334. *Id.* at 43.

335. *Id.* at 43 n.1.

336. *Id.*

337. *Id.*

338. *Id.* at 41. *See also id.* at 43 ("the Committee's cross-motion is denied"); *id.* at 47 n.9 ("the Committee requested further"); *id.* at 47 ("Even if the Committee were to establish").

339. *See, e.g.*, Pre-Petition Comm. of Select Asbestos Claimants v. Combustion Eng'g, Inc. (*In re Combustion Eng'g, Inc.*), 292 B.R. 515 (Bankr. D. Del. 2003).

340. *Id.* at 517. The official creditors committee had not yet been formed in this case. *Id.* at 520. The "potential" tort creditors were actually a group of law firms with a largely unidentified group of theoretical clients holding theoretical claims. *Id.* at 517-20.

preemptive relief.<sup>341</sup> Furthermore, in light of *Cybergenics II*, the court questioned whether tort creditors had the authority to challenge a debtor's pre- or post-petition transfers.<sup>342</sup> The court found that the validity of derivative creditor standing was uncertain and refused to speculate as to whether either of the claimants would be permitted to initiate a derivative action in the future.<sup>343</sup>

#### VI. THE CIRCUIT SPLIT: FEDERAL COURT DECISIONS IN CONFLICT WITH *CYBERGENICS II*

In *Cybergenics II*, the Third Circuit, by its own acknowledgement, handed down a decision that abandoned precedent and long-standing prior bankruptcy practice.<sup>344</sup> The holding wielded significant immediate impact upon the jurisdiction, as evidenced by *Grace*, and, despite being vacated, continued to cast uncertainty and confusion in Third Circuit bankruptcy courts, as evidenced by *In re Combustion Engineering*. Decisions issued in other jurisdictions have remarked upon the issues raised by *Cybergenics II*, but none evidence an inclination to follow the controversial Third Circuit decision.<sup>345</sup> Other courts have, instead, reaffirmed the practice of authorizing creditors and creditors' committees to bring avoidance actions on behalf of the debtor in appropriate circumstances.<sup>346</sup> The resulting cross-jurisdictional conflict in substantive bankruptcy law raises a variety of considerations. First, interested parties, particularly creditors, who are able to influence where a debtor files a bankruptcy petition may try to urge filing in jurisdictions where precedent clearly protects their interests in maximizing the estate through avenues that have been tested and shaped by the practical realities of bankruptcy practice.<sup>347</sup> And, second, although many of the courts choosing to preserve the practice of derivative creditor avoidance actions have put forth well-reasoned opinions, it remains unavoidable that the Bankruptcy Code still "does not expressly authorize the practice in a way that leaves no room for doubt."<sup>348</sup>

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341. *Id.* at 520. The court dismissed the unofficial creditors' committee's request for a TRO, because the Committee did not represent a real party in interest. *Id.* at 517-19. The unofficial "committee" did not, as of the time it appeared before the court, represent any actual creditors with actual claims/interests against the debtor. *Id.* at 517-18. Analysis of the individual tort creditor's request for a TRO was carried further because the court found him to be a real party in interest. *Id.* at 518-19.

342. *Id.* at 520.

343. *Id.* The court opined:

The bankruptcy community in this Circuit awaits the decision of the Court of Appeals on the reargument *en banc* in *Cybergenics* with great anticipation. Whether the court can authorize a committee to use the estate's avoidance powers is a matter of great significance to bankruptcy lawyers and judges. Regardless of the outcome, however, this court is asked to go one step beyond *Cybergenics* and is asked to predict that either [of the creditors before the court] will be permitted to exercise avoidance powers in lieu of the Debtor . . . . [T]his court cannot go so far . . . .

*Id.*

344. *Cybergenics II*, 304 F.3d 316, 322 (3d Cir. 2002) ("Therefore, we must decide in this case whether the plain language of § 544 and the holding of Hartford Underwriters invalidates the rather well-established practice of allowing creditors and creditors' committees to bring avoidance actions derivatively.")

345. See, e.g., Housecraft, 310 F.3d 64 (2d Cir. 2002).

346. See *id.* at 70, 71.

347. See Hale and Dorr, *supra* note 16, at 2.

348. John J. Rapisardi, *Part 2: Circuits on Who Can Prosecute Estate Avoidance Claims*, 288 N.Y.L.J., \*1, 5 November 21, 2002.

*A. The Eighth Circuit*

In early 2002, before *Cybergenics II*, a Missouri bankruptcy court was confronted with a case raising very similar issues. In *In re Newcorn Enterprises, Ltd.*,<sup>349</sup> the Official Unsecured Creditors' Committee sought leave from the bankruptcy court to file an adversary proceeding to marshal the debtor's assets.<sup>350</sup> The debtor's sole secured creditor, Commercial Bank, objected to the Committee's motion, arguing that *Hartford Underwriters* precluded the court from granting derivative standing to a non-trustee.<sup>351</sup> Commercial Bank held a lien on proceeds from the sale of debtor's assets, as well as a Deed of Trust to real property, which had been pledged as collateral by the debtor's shareholders.<sup>352</sup> The Committee was seeking to marshal the debtor's assets in an effort to get Commercial Bank's secured interest in the shareholders' real property included in the bankruptcy estate.<sup>353</sup> If the Committee succeeded, Commercial Bank would be compelled "to satisfy its claim against the estate, in part, from collateral pledged by . . . shareholders rather than solely from [asset liquidation] proceeds."<sup>354</sup> This would leave more of the proceeds available to satisfy the claims of the unsecured creditors.<sup>355</sup>

The power to seek a marshalling of a debtor's assets arises under the rights and powers conveyed to the trustee or debtor-in-possession in section 544(a) of the Bankruptcy Code.<sup>356</sup> In this Chapter 11 case, the principal actor on behalf of the debtor corporation, who was making estate decisions in the bankruptcy proceedings, was also one of the principal shareholders of the debtor and holder of the real property at issue.<sup>357</sup> He would clearly benefit if Commercial Bank satisfied its claims out of the liquidation proceeds and he retained title to his real property.<sup>358</sup> In light of this conflict of interest, the court was not surprised that the debtor refused to file an action to marshal the assets of the estate.<sup>359</sup> The Committee argued that section 1109 gave it the authority to bring a marshalling complaint under section 544(a) when a trustee or debtor-in-possession unreasonably refuses to do so.<sup>360</sup> The *Newcorn* court noted that the Supreme Court, albeit in dicta, had rejected the argument that section 1109's "general provision of a right to be heard is . . . broad enough to allow a creditor standing 'to pursue substantive remedies that other Code provisions make available only to other specific parties.'"<sup>361</sup> However, the *Newcorn* court also noted that the Supreme Court had not addressed the

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349. 287 B.R. 744 (Bankr. E.D. Mo. 2002).

350. *Id.* at 745.

351. *Id.* at 746.

352. *Id.*

353. *Id.*

354. *Id.* at 745. The court noted that the Committee was seeking to act for the benefit of the estate, "attempting to make the Debtor's asset pie larger in hopes of increasing the pay-out to unsecured creditors after the lien of Commercial Bank is satisfied." *Id.* at 746.

355. *Id.*

356. *Id.* at 746-47.

357. *Id.*

358. *See id.*

359. *Id.* at 747.

360. *Id.* at 746. Section 1109 conveys a right to raise and be heard on any issue in any case to any party in interest, including a creditors' committee. 11 U.S.C. § 1109 (2000).

361. *In re Newcorn Enters., Ltd.*, 287 B.R. at 748 (quoting *Hartford Underwriters Ins. Co. v. Union Planters Bank*, 530 U.S. 1, 8 (2000)).

merits of “whether a creditor or other interested party may obtain derivative standing to bring an action when a trustee has refused to act” and acknowledged that the federal courts were split on the issue.<sup>362</sup>

Surveying the various circuits, the *Newcorn* court found that courts granting derivative standing to nontrustees generally require the interested party to establish the existence of a colorable claim, which if successful would benefit the estate, making “the trustee/debtor-in-possession’s refusal to act . . . unjustified.”<sup>363</sup> The equitable authority to confer standing to nontrustees, the *Newcorn* court noted, is generally derived from section 105 of the Bankruptcy Code.<sup>364</sup> However, the *Newcorn* court also examined the reasoning of courts that had refused “to grant standing, derivative or otherwise, to interested parties when the plain language of the statute grants a right of action to only the trustee,” and, interestingly, the court cited a pre-*Hartford Underwriters* bankruptcy decision as an example thereof.<sup>365</sup> The case cited, *Surf N Sun Apts., Inc. v. Dempsey*,<sup>366</sup> relies on a 1988 Supreme Court decision, which indicates that the equitable powers of the bankruptcy court “*must and can only be exercised within the confines of the Bankruptcy Code.*”<sup>367</sup> Using language that presaged *Hartford Underwriters*, the *Sun N Surf* court concluded “that when Congress clearly and plainly grants the power to act to the trustee under a section of the Code, the limitation of equity power expressed in *Norwest Bank* precludes a bankruptcy court from granting derivative standing to any other party.”<sup>368</sup>

The *Newcorn* court found that, when read together, *Hartford Underwriters* and *Norwest Bank* “suggest” that a plain language interpretation of the Bankruptcy Code should control: that when Congress clearly conveys a grant of authority to the trustee, only the trustee may exercise that authority and that it is beyond the scope of the equitable powers of the bankruptcy court, in these circumstances, to grant derivative standing to a nontrustee.<sup>369</sup> However, two considerations compelled the Missouri bankruptcy court to reject the suggestion: first, the Eighth Circuit had already endorsed derivative creditor standing in *Nangle v. Lauer*<sup>370</sup> and second, the Supreme Court had “side-stepped” the issue in footnote five of *Hartford Underwriters*.<sup>371</sup> The *Newcorn* court argued that the *Nangle* court must have “concluded that *Norwest Bank* did not curtail a bankruptcy courts’ equitable power to grant derivative standing when a trustee unreasonably fails to act” even though no such analysis was set forth in the *Nangle* opinion.<sup>372</sup> Accordingly,

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362. *Id.*

363. *Id.* The court cited to *Gibson* as support for the validity of this rule. *Id.*

364. *Id.* See also 11 U.S.C. § 105 (2000); *supra* note 318.

365. *In re Newcorn Enters., Ltd.*, 287 B.R. at 748.

366. 253 B.R. 490 (M.D. Fla. 1999).

367. *In re Newcorn Enters., Ltd.*, 287 B.R. at 748 (quoting *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206 (1988)) (emphasis added). *Surf N Sun Apts., Inc.* arose under section 503(b)(3)(B). *Id.*

368. *Id.* at 749.

369. *Id.*

370. 98 F.3d 378, 388 (8th Cir. 1996). In *Nangle*, the court refused to allow creditors to bring a preferential transfer action because they offered no evidence that the trustee was “unable or unwilling” to pursue the claims himself. *Id.* The reverse implication of this decision is that if the creditors had presented such evidence they would have been allowed to proceed. See *id.*

371. *In re Newcorn Enters., Ltd.*, 287 B.R. at 749.

372. *Id.*

despite “find[ing] that the two Supreme Court cases . . . create a reasonable argument to deny derivative standing,” the court followed *Nangle*.<sup>373</sup> The court granted the Committee the authority to pursue the claims because they were colorable and would, if successful, benefit the estate as a whole.<sup>374</sup>

### B. The Second Circuit

One month after the Third Circuit issued *Cybergenics II*, the Second Circuit handed down *Housecraft*.<sup>375</sup> *Housecraft* was a Chapter 7 bankruptcy proceeding in which the trustee and the primary secured creditor of the debtor were jointly prosecuting fraudulent transfer claims to recover property transferred by the debtor both before and after filing bankruptcy.<sup>376</sup> The defendant, Federal Plastics Manufacturing, moved to dismiss the creditor, Banque Nationale de Paris (“BNP”), from the proceeding for lack of standing.<sup>377</sup> Federal Plastics raised the argument that sections 548 and 549 of the Bankruptcy Code contain express authorizations for the trustee or debtor-in-possession, and only that party, to bring avoidance actions and, therefore, BNP had no statutory authority to be a party to the suit.<sup>378</sup> Although this argument appears to rely on *Hartford Underwriters*, the Second Circuit opinion makes no reference to either that Supreme Court case or to *Cybergenics II*.<sup>379</sup>

The bankruptcy court recognized that the Housecraft estate did not have the funds to pursue this claim on its own.<sup>380</sup> Because the potential recovery of the fraudulent transfer claims was sizable, the bankruptcy court found that it was in the best interests of the estate to ratify an agreement between BNP and the trustee to prosecute the claims jointly.<sup>381</sup> The district court agreed, relying on Second Circuit precedent in order to find that BNP had standing because it was in the estate’s best interests: “because the suit presents colorable claims for relief; because [the trustee] would have failed to pursue the suit without the assistance of BNP; and because there is no net financial burden on the bankruptcy estate, BNP is entitled to standing.”<sup>382</sup>

The Second Circuit affirmed the district court’s reasoning, expressly stating that “[a]lthough not explicitly authorized by the Code, we have extended standing . . . under [sections] 548 and 549 to additional parties such as creditors when to do so is in the best interest of the estate.”<sup>383</sup> The court restated its position that credi-

373. *Id.* at 749-50.

374. *Id.* at 750.

375. 310 F.3d 64 (2d Cir. 2002).

376. *Id.* at 65-66.

377. *Id.* at 66.

378. *Id.* at 67.

379. See generally *Housecraft*, 310 F.3d 64 (2d Cir. 2002).

380. *Id.* at 68 n.4.

381. *Id.* at 68. The agreement between BNP and the trustee provided that BNP would put up the funds necessary to prosecute that claim. *Id.* It stipulated that if there was any recovery from the litigation, funds would be as follows: “(1) litigation costs and attorney’s fees to BNP, (2) \$15,000 to Housecraft’s estate, and (3) the balance to be split, 80% for BNP and 20% for the estate.” *Id.* at 67.

382. *Id.* at 68 (quoting *Glinka v. Abraham & Rose Co.*, 199 B.R. 484, 494) (Bankr. D. Vt. 1996)).

383. *Id.* at 70.

tors may bring adversary proceedings when a trustee or debtor-in-possession unjustifiably refuses to bring suit, or when the creditor(s) have: (1) consent from the trustee or debtor-in-possession; (2) the suit is in the estate's best interest; and (3) the suit is "necessary and beneficial" to the efficient resolution of the bankruptcy case.<sup>384</sup> The *Housecraft* court found that these criteria were satisfied: the trustee had given consent; without BNP's help the trustee could not have pursued the claim or any part thereof; and, it substantially reduced the likelihood of any future litigation between BNP and the estate regarding BNP's security interest in the transferred property.<sup>385</sup>

Federal Plastics also argued that the court's holding in *Commodore* regarding creditor derivative standing should not be extended to secured creditors, like BNP.<sup>386</sup> Secured creditors, it asserted, could be distinguished from unsecured creditors by the fact that unsecured creditors and the trustee or debtor-in-possession have a common interest in the value of the estate.<sup>387</sup> In contrast, the secured creditor's interest is virtually certain to conflict because a valid security interest will devalue the estate.<sup>388</sup> The court rejected this argument, finding that the interests of the estate were still protected.<sup>389</sup> First, the trustee could withhold consent to the creditor, secured or unsecured, to pursue claims when he or she determines that the "creditor's interests are adverse to those of the estate."<sup>390</sup> Second, the bankruptcy court must make an independent determination that the creditor's interests are not adverse to the estate.<sup>391</sup> Further, the court noted, if BNP had not been allowed standing to jointly prosecute the claim, Federal Plastics would have "succeeded in evading the bankruptcy laws and benefiting financially at the expense of Housecraft's estate."<sup>392</sup>

A few months later, a Connecticut bankruptcy court cited *Housecraft* in support of its holding that an unsecured creditors' committee had derivative standing to pursue an avoidance action on behalf of a Chapter 11 debtor-in-possession in *In re Stanwich Financial Services*.<sup>393</sup> In this case, the Official Committee of Unsecured Creditors was, pursuant to a court approved stipulation with the debtor, prosecuting avoidance claims in order to set aside prepetition transfers of stock.<sup>394</sup> The defendants, Jonathon Pardee and Ogden Sutro, argued that the plain language of the Bankruptcy Code in section 544(b) authorized only a trustee or debtor-in-possession to commence or prosecute avoidance actions.<sup>395</sup> However, the court refused to "blindly" extend the textual interpretation of one section of the Bank-

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384. *Id.* (internal quotation omitted).

385. *Id.* at 72. BNP had a security interest in the property that had been transferred. *Id.* at 67. The property, Nutribar containers, had been sold so the sole recovery available to BNP pursuant to its security interest was the possible recovery of a money judgment. *Id.* at 68.

386. *Id.* at 72.

387. *Id.*

388. *See id.*

389. *Id.*

390. *Id.*

391. *Id.*

392. *Id.* at 71.

393. 288 B.R. 24, 27 (Bankr. D. Conn. 2002).

394. *Id.* at 25.

395. *Id.* at 25-26.

ruptcy Code to another.<sup>396</sup> Looking at the express language in footnote five of the *Hartford Underwriters* opinion, which declined to address the validity of the practice at issue, the Connecticut bankruptcy court refused to find the Supreme Court's analysis of the language "the trustee may" in section 506 controlling in a case arising under section 544(b).<sup>397</sup> Instead, the *Stanwich* court found that Second Circuit precedent, which respected "the equitable balance struck by a holistic reading of the Bankruptcy Code," was controlling.<sup>398</sup> The court found that "the core objectives of bankruptcy" would not be realized if recipients of pre- or post-petition estate property could be insulated from avoidance actions and, accordingly, it granted the Creditors' Committee "standing to commence and prosecute the instant adversary proceeding on behalf of the bankruptcy estate."<sup>399</sup>

### C. The Ninth Circuit

In 2002, a California bankruptcy court examined the Second Circuit's "rule," as it tried to discern whether, and under what circumstances, a court may, notwithstanding *Hartford Underwriters*, "authorize a party other than the trustee to act on the trustee's behalf."<sup>400</sup> In *In re Smith*, the plaintiff, Bank One, a secured creditor of the debtor, asked the bankruptcy court to grant it the authority to commence a derivative surcharge action under section 506(c), the same provision of the Code at issue in *Hartford Underwriters*.<sup>401</sup> Bank One tried to distinguish its case by arguing that the Supreme Court had "expressly left open the question whether a bankruptcy court could 'allow other interested parties to act in the trustee's stead in pursuing recovery under [section] 506(c).'"<sup>402</sup> Ultimately, the California court

396. *Id.* The *Stanwich* court cited to principles of statutory construction as set forth in Supreme Court cases other than *Hartford Underwriters*: "[s]tatutory construction is a holistic endeavor . . . the meaning of one provision is clarified by the remainder of the statutory scheme when only one of the permissible meanings produces a substantive effect that is compatible with the rest of the law." *Id.* at 26 (alteration in original) (quoting *United States v. Cleveland Indian Baseball Co.*, 532 U.S. 200, 217 (2001) (quoting *United States Savings Assn. v. Timbers of Inwood*, 484 U.S. 365 (1998))).

397. *Id.* at 26.

398. Official Comm. of Unsecured Creditors v. Pardee (*In re Stanwich Fin. Servs.*), 288 B.R. at 26.

399. *Id.* at 27. The *Stanwich* court also relied on a Ninth Circuit case, which in turn had relied on Second Circuit precedent, to support its holding:

a flat prohibition against any surrogate representation . . . not only conflicts with accepted practice, it also fails to recognize the potential benefits of allowing an unsecured creditors' committee to conduct estate litigation. The [debtor-in-possession] has an obligation to pursue all actions that are in the best interests of creditors and the estate . . . . An unsecured creditors' committee has a close identity of interests with the [debtor-in-possession] in this regard . . . . Rather than a flat prohibition, impartial judicial balancing of the benefits of a committee's representation better serves the bankruptcy estate. So long as the bankruptcy court exercises its judicial oversight and verifies that the litigation is indeed necessary and beneficial, allowing a creditors' committee to represent the estate produces no undue concerns.

*Id.* (quoting *Liberty Mut. Ins. Co. v. Official Unsecured Creditors' Comm. of Spaulding Composites Co.*, 207 B.R. 899, 904 (B.A.P. 9th Cir. 1997) (alterations in original) (internal quotations and citations omitted)).

400. *In re Smith Bros. Motors, Inc.*, 286 B.R. 905, 908 (Bankr. N.D. Cal. 2002).

401. *Id.* at 906.

402. *Id.* at 908 (quoting *Hartford Underwriters Ins. Co. v. Union Planters Bank*, 530 U.S. 1, 13 n.5 (2000)).

chose not to reach the issue, finding that even if it did have the authority to “confer derivative standing on a party to assert the trustee’s rights under [section] 506(c) . . . this is not an appropriate case for the court to do so.”<sup>403</sup> The court reasoned that, if the trustee reasonably—and not in violation of his fiduciary duties to the estate—refused to allow a creditor to act in his stead, then a court should defer to that decision.<sup>404</sup> In this case, the court found that the trustee was acting reasonably because the section 506(c) surcharge claim was not colorable.<sup>405</sup>

The court never concluded whether derivative creditor standing is valid.<sup>406</sup> However, interestingly, the court endeavored to establish a Code “hierarchy” as to when derivative standing was “more likely” to be valid.<sup>407</sup> The more likely a provision was to benefit the estate as a whole rather than a particular claimant, the more likely a court had the authority to authorize derivative standing.<sup>408</sup> Since avoidance actions were more likely to benefit the estate than administrative surcharge claims, the court speculated that derivative standing might be valid under the former but not under the latter.<sup>409</sup>

The *Smith* court’s speculation calls attention to the irregular and unsettled form of judicially conferred derivative standing. The concept of derivative standing rests upon the notion that the judiciary may extend express, and otherwise exclusive, powers to “non-grantees” whenever it deems that act to be necessary or beneficial to a bankruptcy estate. It may be appropriate in one circumstance but not another; it may be appropriate for use under one provision but not another; it may be appropriate for use under one provision under peculiar circumstances but only in limited effect. The decisions that adopt derivative standing purport to set forth rules defining and limiting the concept. However, these rules are, in effect, policy judgments about the role non-trustees should play in bankruptcy proceedings. Until *Cybergenics II*, courts generally issued these “best interests of the estate” policy judgments as a matter of course.

## VII. CONCLUSION

Shortly before *Cybergenics II* was issued the American Bankruptcy Journal noted:

Although the Bankruptcy Code is silent with respect to the right of a creditors’ committee to file an adversary proceeding, almost all of the courts that have considered this issue have been unanimous in recognizing that such a right exists. However, most courts have required that the committee obtain prior court approval as a condition precedent to the initiation of suit. A debtor may have a number of valid reasons why it believes that a suit should not be instituted, particularly within the context of a reorganization. These reasons, however, must be balanced against the creditors’ interests in recovering property of the estate, which implies that the committee must establish some “benefit to the estate” in pursuing the claims. Assuming bankruptcy court approval, there have been few challenges to the committee’s institution of suit.<sup>410</sup>

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403. *Id.*

404. *Id.*

405. *Id.* at 909-10.

406. *See generally id.*

407. *See generally id.*

408. *See id.* at 908.

409. *Id.*

410. Lawrence K. Snider, *Recent Decisions Regarding Creditors’ Committees*, AM. BANKR. INST. J., 22 at 22 (March 2002).



However, such a challenge has now clearly been raised to the forefront of bankruptcy law discussion. The threatened abrogation of the practice has already started to have a profound effect on bankruptcy proceedings in the Third Circuit and could, ultimately, alter a bankruptcy practice that has roots over one hundred years old. Those who insist that the practice is vital and necessary in order for the overarching policies of bankruptcy to be achieved try to substantiate their position with a range of theories regarding the appropriateness of "equitable" Bankruptcy Code construction.

As the *Newcorn* court speculated, equitable Code construction and derivative creditor standing are no longer tenable under the present Court without Congressional action. *Hartford Underwriters* and *Norwest Bank* suggest that a bankruptcy court must construe the Bankruptcy Code literally and that it may not use its equitable powers to confer authority upon parties to act when such action is outside the express constraints of the Code. The "best interests of the estate" logic employed by decisions such as *Housecraft* cannot survive *Hartford Underwriters* because courts may not pursue the best interests of the estate by side-stepping the plain meaning of express Code provisions.

There are no Bankruptcy Code provisions that clearly and literally convey the power to initiate suit, in the name of the trustee, to nontrustees. Section 503 might imply that such a right exists, but the right itself is nowhere to be found in the text.<sup>411</sup> It is unlikely that a court espousing "plain meaning" Bankruptcy Code construction, such as the current Supreme Court, will substantiate the validity of an "implied" right through a patchwork of Code provisions, when it can find no express language to support it. Furthermore, the section 503 argument is only persuasive if the Court finds that it raises enough of an ambiguity regarding derivative creditor standing that statutory interpretation requires the Court to supplement its understanding of the language with established pre-Code practice. In *Hartford Underwriters*, the Supreme Court indicated there would be an exceptionally heavy burden of persuasion in convincing the Court that "clarification" of Code language by pre-Code practice is warranted.<sup>412</sup> It is unlikely that the ambiguity regarding section 503, especially as it is undercut by Judge Fuentes' dissent in *Cybergenics III*, will meet this heavy burden.<sup>413</sup>

Under current Supreme Court precedent and extant Bankruptcy Code language, *Cybergenics II* was rightly decided. The Third Circuit panel had the option of "side-stepping" the issue, like many other courts, and maintaining the status quo. Nonetheless, the *Cybergenics II* court chose to reach the issue and to assess the validity of derivative avoidance actions pursuant to a "plain meaning" analysis of the Bankruptcy Code. The court correctly concluded that, absent plain and unambiguous legislative reform, this type of derivative standing is no longer tenable. Given the intricacies of bankruptcy practice and the widely disparate circumstances of each bankruptcy estate, lawmakers should amend the Bankruptcy Code and memorialize the authority of bankruptcy courts to extend the trustee's express pow-

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411. See 11 U.S.C. § 503 (2000).

412. *Hartford Underwriters Ins. Co. v. Union Planters Bank*, 530 U.S. 1, 9 (2000).

413. See *supra* note 120, at 586. Judge Fuentes further argued that, even if the court were to look at pre-Code practice, they would "find only four or five [cases] that recognize derivative action by creditors' committees." *Cybergenics III*, 330 F.3d 548, 586 n.4 (3d Cir. 2003) (Fuentes, J., dissenting).

ers to a non-trustee when it is in the best interests of the estate to do so. In light of *Norwest* and *Hartford Underwriters*, Congress's broad grant of equitable authority in section 105 is insufficient. Bankruptcy practice may have reached "a point at which the most orthodox legal proposition, if not tied to a specific Code section, may actually be challenged as spurious."<sup>414</sup>

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414. *Textualism*, *supra* note 2, at 8 (quoting Andrew Kull, *Restitution in Bankruptcy: Reclamation and Constructive Trust*, 72 AM. BANKR. L. J. 265, 266-67 (1998)). Professor Kull noted that codification of general background common law can lead to a phenomenon of its ultimate obscuring:

Unlike the comprehensive framework of a continental legal code, the Uniform Commercial Code and the Bankruptcy Code were drafted as common-law statutes. In theory, at least, they displace the preexisting common law only to the extent they alter it, and they presume the continued existence of this background law to govern every question not otherwise resolved. In practice it does not work quite like that. Lawyers and judges who deal regularly with commercial materials come to expect that any problem worth arguing about has been made the subject of an express statutory provision, their usual task being to locate and explicate the relevant statutory language. In consequence, the neglected background law recedes still further . . . .

*Id.*

