Recent Third Circuit Decision Restores Litigant's Standing to Pursue Causes of Action After the Chapter 7 Trustee Abandoned Them

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Porzio Client Alert

On August 4, 2020, the Third Circuit (the "Court") in *Artesanias Hacienda Real S.A. DE C.V., v. North Mill Capital, LLC v. Leisawitz Heller (In re Wilton Armetale, Inc.)*, 968 F.3d 273 (3d Cir. 2020), held that abandonment by a chapter 7 trustee of a pre-petition cause of action that was property of a bankruptcy estate returned the power to pursue that cause of action to the creditor. This decision is important for creditors because it clarifies that their derivative interest in a bankruptcy estate's claims against non-debtor third parties is not extinguished upon the debtor's filing for bankruptcy, but may instead be revived by the trustee's abandonment of the estate's own interests in the claims.

Background

Before the bankruptcy filing, Artesanias Hacienda Real S. A. de C.V. ("Artesanias") obtained a judgment against Wilton Armetale, Inc. ("Wilton") and gained access to documents it asserts evidenced that North Mill Capital ("North Mill") and certain other parties (the "Defendants") engaged in a scheme to plunder the Wilton's assets. Upon learning of this alleged scheme, Artesanias sued the Defendants in the District Court for an alleged fraudulent transfer and to stop a foreclosure of Wilton's warehouse initiated by North Mill.

Thereafter, Wilton commenced a chapter 7 bankruptcy proceeding, which triggered the appointment of a trustee ("Trustee") to liquidate Wilton's assets. The Trustee resolved the claims of Artesanias and North Mill against Wilton with separate settlements whereby the Trustee agreed to: (1) split the proceeds from the sale of Wilton's remaining assets between Artesanias and North Mill; (2) release North Mill from the bankruptcy estate's claims against it; and (3) not interfere with Artesanias's pending or potential claims against the Defendants. Determining that the risks outweighed any potential benefit, the Trustee also eventually abandoned the vast majority of claims that could have been brought against the Defendants, including Artesanias's claims.

Meanwhile, the Defendants moved to dismiss Artesanias's pending claims in the District Court, which referred the matter to the Bankruptcy Court under 28 U.S.C. § 157(a). The Bankruptcy Court dismissed Artesanias's claims because Artesanias lacked standing upon Wilton filing for bankruptcy and rejected Artesanias's contention that the Trustee's abandonment of the estate's claims re-instated Artesanias's claims against the Defendants. Affirming the decision on appeal, the District Court reasoned that because Artesanias's claims were derivative, only the Trustee had standing to pursue them and that power could not be abandoned to Artesanias. Artesanias then appealed to the Third Circuit.

The Third Circuit's Analysis

The Court explained that upon a bankruptcy filing, most of a debtor's property is transferred to the debtor's bankruptcy estate under 11 U.S.C. § 541, and quoted its own decision from *Bd. Of Trs. Of Teamsters Local 863 Pension Fund v. Foodtown, Inc.* 296 F.3d 164, 169 (3d Cir. 2002) for the proposition that "[a] cause of action [becomes] property of the estate if the claim existed at the commencement of the [bankruptcy] filing and the debtor could have asserted the claim on his own behalf under state law." 968 F.3d at 280. Moreover, the Court clarified that "once a cause of action becomes the estate's property, the Bankruptcy Code gives the trustee, and only the trustee, the statutory authority to pursue it." *Id.*

The Court then followed the Seventh Circuit in finding that standing to pursue a cause of action that is property of a bankruptcy estate is based on statutory authority within the Bankruptcy Code, and not based on constitutional standing to sue in federal court. *Id.* at 280-81. The Court remarked that such view aligns with the United States Supreme Court's decision *Lexmark Int'l, Inc. v. Static Control Components, Inc.*, 572 U.S. 118-125 (2014), which removed statutory additions to constitutional minimums for standing and found that constitutional standing is limited to three elements: (1) "a concrete and particularized injury in fact," (2) "fairly traceable" to the defendant's conduct, and (3) that "a favorable judicial decision" would likely "redress." 968 F.3d at 281.

Applying this law to the facts, the Court held that Artesanias has constitutional standing to bring its claims, because actions by the Defendants allegedly caused it harm by reducing Artesanias's chances of being compensated as a judgment-creditor. *Id.* However, despite Artesanias's constitutional standing, the Court determined that only the Trustee had exclusive statutory authority under the Bankruptcy Code to prosecute Artesanias's claims because (1) the claims pre-existed the bankruptcy filing, and (2) were derivative so they were not personal to Artesanias, but instead derived from a general harm to the debtor's estate and could have been asserted by the debtor on its own behalf. *Id.* at 282-83.

As to the Trustee's abandonment of the claims and its related impact, the court noted that although abandoned claims revert to those that possessed them before the bankruptcy (essentially springing the claims back to life for that party), such abandonment of property of the estate must be done "overtly" and not ambiguously. *Id.* at 284 (quoting 5 Collier on Bankruptcy ¶548.02[5][a]). Here, the Trustee's abandonment of Artesanias's claims against the Defendants was unambiguous and clearly delineated the claims that were and were not being abandoned. The claims abandoned by the Trustee included all claims brought by Artesanias against the Defendants. Furthermore, Artesanias's claims against North Mill were explicitly reserved in the Trustee's settlements with Artesanias and North Mill. Thus, the Court overturned the lower courts' ruling by holding that the Trustee's abandonment of assets back to Artesanias restored Artesanias's ability and statutory authority to pursue its claims against the Defendants. *Id.* at 284-85.

Overall, while claimants should be cautioned that this decision is fact specific to the circumstances before the Court, this decision is a positive development for parties holding so-called derivative claims. All claimants should actively monitor any bankruptcy proceeding that has stayed their claims, try to analyze the impact the bankruptcy case has on their claims, and protect the viability of their claims after the conclusion of the bankruptcy proceeding—including by making sure that any abandonment of estate claims by a trustee is overt and unambiguous. Finally, if the trustee unambiguously abandons the estate's claims, a creditor should consider whether to pursue such claims.