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Are Bankruptcy Avoidance Actions Becoming a Marketable Asset Class?

By Dan McElhinney and Jorian Rose

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In many bankruptcy cases, courts permit debtors in possession and trustees to "sell" avoidance actions to third parties as part of a Section 363 sale or pursuant to a Chapter 11 plan. However, the purchaser of those actions will not pursue them. Such purchasers are acquiring these actions along with other assets just to avoid suing vendors and other parties in interest, thereby protecting the business they are purchasing.

Courts have limited standing to pursue those actions to parties who can be classified as a "representative of the estate" under Section 1123 of the Bankruptcy Code, a factor that has depressed the development of avoidance action portfolios as an independent asset class available for sale.

The U.S. Court of Appeals for the Fifth Circuit's recent ruling in *Briar Capital Working Fund Capital v. Remmert* (*In re South Coast Supply*) may change all that. Expanding on a developing line of circuit-level cases, the *In re South Coast* decision holds (1) that avoidance actions are "property of the estate" that can be sold pursuant to Section 363(b) and (2) that Section 1123's limitation on standing to pursue such claims is irrelevant.

Should this holding stand and be followed in other circuits, we can expect a shift in how preferences are managed and monetized by trustees and debtors in possession in future bankruptcy cases.

Dan McElhinney, left, of Stretto and Jorian L. Rose, right, of BakerHostetler.

What Is an Avoidance Action?

Generally, the term "avoidance action" (colloquially called a clawback) describes two types of causes of action: (1) direct claims, i.e., those that arise from the Bankruptcy Code and afford the trustee or debtor in possession a claim to avoid and recover transfers made prior to the bankruptcy filing (e.g., Section 547 (preferences) and Section 548 (fraudulent transfers)); and (2) indirect claims, i.e., those that inure to a creditor to the debtor's estate but that the trustee or debtor in possession may pursue for the benefit of the estate under Section 544.

Of note here, the Fifth Circuit previously authorized the transfer of a direct avoidance action claim (together with standing to pursue such claim) to a third party; however, it stopped short of validating a

debtor's right to convey standing to pursue a direct avoidance action claim. *See In re Moore Cadle v. Mims (In re Moore),* 608 F.3d 253 (5th Cir. 2010) (refraining from addressing "the broader question whether a trustee may sell all Chapter 5 avoidance powers, such as the power to avoid preferences under § 547 or to avoid fraudulent transfers under §548").

By its *In re South Coast Supply* ruling, the Fifth Circuit goes one step further by allowing the sale (with standing) of a preference action under Section 547.

'In re South Coast Supply'

In *In re South Coast Supply*, the debtor sued Mr. Remmert, the former company chief financial officer (CFO), under Section 547 in order to recover preferential payments that he received in repayment of a loan. Subsequently, the company's pre-petition secured lender agreed to take ownership of the preference action against the former CFO in settlement of its claim against the debtor's estate. Pursuant to the court-approved Chapter 11 plan, the preference action was assigned to the secured creditor. The former CFO sought to dismiss the preference action following its assignment to the secured lender, arguing the secured creditor lacked standing to prosecute that action.

The district court agreed that the secured creditor lacked standing to pursue the preference claim and dismissed this adversary proceeding, after which the former CFO filed an appeal to the Fifth Circuit.

In addressing the question of whether avoidance actions are property of the estate and therefore subject to disposition via sale under Section 363(b)(3), the Fifth Circuit agreed that avoidance actions are property of the estate under Section 541(a), and therefore could be sold pursuant to Section 363(b)(3) of the Bankruptcy Code.

On the standing question, the Fifth Circuit dismissed arguments centered on the application of Section 1123(b)(3)(B) of the Bankruptcy Code as inapposite. Section 1123(b)(3)(B) limits assignments of avoidance actions by a debtor in possession or trustee to third parties to the extent the third party or assignee is not a "representative of the estate."

However, here, the Fifth Circuit found that because the subject preference action was property of the estate subject to sale under Section 363(b)(3) of the Bankruptcy Code, and because that section "provides different mechanisms by which a debtor-in-possession may liquidate its assets," it need not consider other sections of the Bankruptcy Code on the question of standing.

Said differently, standing was automatically conveyed as part of the transfer. There is no secondary standard that a buyer needs to satisfy in order to pursue an acquired avoidance action.

Predicting the Future

The impact of *In re South Coast Supply* on the market for avoidance actions is unclear. Yet, certainly in the Fifth Circuit—which governs both the Southern and Northern Districts of Texas, very active venues for large bankruptcy cases in recent years—one can envision a new focus on evaluating the potential sale of avoidance actions pursuant to Bankruptcy Code Section 363(b).

Creating a new market for the sale of avoidance actions could have a positive impact on creditor recoveries in a variety of Chapter 11 cases. For example, in non-sale cases, preferences are often conveyed to the creditors' committee or creditor recovery trusts as part of Chapter 11 plan negotiations.

A committee's interest in pursuing avoidance actions often depends on its willingness to allow suits to be pursued against the constituency it represents (i.e., trade or other unsecured creditors). If, however, avoidance actions can be sold *and* pursued without the need for the acquiring party to share the proceeds with the debtor's estate, avoidance action portfolios suddenly become an interesting new asset class—one that could provide real value to debtors if sold, particularly if done early in the case.

Several factors may slow the development of a robust avoidance action marketplace. The first is whether the Supreme Court grants certiorari on account of the recent petition filed by Remmert. In his petition, Remmert does not challenge the Fifth Circuit's view that avoidance actions are property of the estate under Section 541. Rather, he centers his argument on

whether standing can be conveyed without application of the "representative of the estate" standard under Section 1123(b)(3), a standard, which only applies when dealing with sales under a Chapter 11 plan.

Of note, the petition argues that "[t]he decision [of the Fifth Circuit]…to open the bankruptcy marketplace for statutory avoidance actions will distort the bankruptcy process…[creating] disuniformity in the bankruptcy laws[.]" Should the Supreme Court grant certiorari, one can expect a delay in the opening of this new marketplace.

A second limitation to this marketplace would be scope. While the Fifth Circuit covers the Northern and Southern Districts of Texas—along with other courts in Texas, Mississippi and Louisiana—and has seen a significant increase in important (and sizable) cases in recent decades, it does not include the District of Delaware, which remains the center of the bankruptcy world.

Moreover, it is far from clear that the District of Delaware or the U.S. Court of Appeals for the Third Circuit will align itself with the Fifth Circuit's ruling in *In re South Coast Supply*. Of note, in *In re Cybergenics Corp.* 226 F. 3d 237 (3d Cir.2002), the Third Circuit held that an avoidance action under Section 544 was not an asset of the estate.

Notwithstanding recent clarification on the scope of this holding (see *In re Wilton Armetale,* 968 F. 3d 273, 285 (3d Cir. 2020) ("Cybergenics does not hold that trustees cannot transfer causes of action.")), the current state of Third Circuit case law does not suggest easy alignment with *In re South Coast Supply*.

A third hurdle will be the change in settlement dynamics when a nonfiduciary pursues an avoidance action portfolio. When pursued by a trustee or debtor in possession, many avoidance claims are resolved without the need for mediation or litigation.

One key factor that often influences a preference action settlement is the preference defendant's claim against the debtor. Claim waivers, especially of administrative expense claims, are a popular form of consideration used by preference defendants to avoid paying cash as part of a settlement. Since claims would not be included in an avoidance action portfolio, it is unlikely that claim waivers could be used as currency to fund a preference settlement after the action is transferred to a third party. Also, the trustee or debtor in possession will often assert a count in the complaint pursuant to Section 502(d) to incentivize creditors to engage in settlement discussions.

Section 502(d) disallows distributions on account of an otherwise allowable claim until the creditor returns any avoidable transfers. A nonfiduciary would have no standing or authority to invoke Section 502(d) and therefore could not utilize it as an incentive to entice the preference defendant to settle.

Related to settlement dynamics is the need for the acquiring nonfiduciary to have access to information maintained by the selling debtor in possession or trustee in order to seek to monetize the preference portfolio. This includes (1) address information for preference defendants, (2) bank statement information needed to establish preference period payments, (3) accounting data needed to conduct initial due diligence and evaluate statutory defenses, (4) access to email or other communications between the debtor and preference defendants to identify any non-ordinary course behavior and (5) an understanding of contracts/leases to be assumed.

That said, if these (and other) barriers can be overcome, the future of a marketplace for avoidance actions as an independent asset class would be extremely bright.

In particular, an avoidance action marketplace would be a boon to debtors as it would allow for the early and efficient monetization of avoidance actions, instead of the slow process of liquidating an avoidance action portfolio via contingency fee advisors that exists today. And if the macro trend in Chapter 11 bankruptcies is to improve efficiency in the process, courts may follow the Fifth Circuit's lead in *In re South Coast Supply.*

Dan McElhinney *is senior managing director at Stretto.* **Jorian Rose** *is a partner in the New York office of BakerHostetler.*

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