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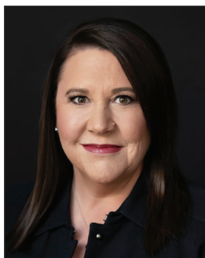
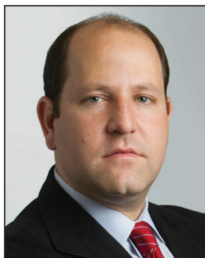
Feature

By Kristina M. Stanger, Ehud Barak and Daniel Desatnik

Estate Avoidance Actions: Stand in the Trustee's Shoes, or Buy Them?



Kristina M. Stanger
Nyemaster Goode, PC
Des Moines, Iowa



Ehud Barak
Proskauer Rose LLP
New York

Daniel Desatnik
Proskauer Rose LLP
New York

Avoidance actions often represent an important source of meaningful recovery for unsecured creditors. Fraudulent transfers and bad actions may have precipitated a debtor's fall into bankruptcy, while preferential transfers may have occurred once a bankruptcy filing was inevitable. Although unsecured creditors may benefit from avoidance of these transfers, the Bankruptcy Code vests the power to bring these actions in the trustee or debtor in possession (DIP), who may not be as incentivized or capitalized to investigate or pursue claims against insiders or important vendors.

Where a trustee is unwilling or unable to bring colorable avoidance actions, courts have permitted creditors to step into the trustee's shoes and pursue these actions on behalf of the estate, which is commonly referred to as "derivative standing."[1] The Eighth Circuit has now definitively ruled that a different — and potentially more lucrative — path is available to unsecured creditors seeking to take matters into their own hands: outright buying the avoidance actions from the estate.

The issue of whether avoidance actions can be sold took center stage in the involuntary chapter 7 case of *In re Simply Essentials*.[2] A creditor, ARKK Food Co.,[3] presented information to the trustee showing that the estate held potentially valuable avoidance actions. The trustee agreed that the "causes of action appear[ed] to have merit and could provide a very large recovery to the estate," but that the estate "lacked sufficient funds" to pursue them.[4]

As a result, ARKK offered to purchase all estate claims against insiders, including avoidance actions, in exchange for the following: (1) assuming all risks, costs and fees of the actions; (2) reducing its own claims against the estate; (3) providing the estate with the first $600,000 in proceeds from the actions; and (4) providing the estate with 15 percent of the proceeds of any additional recovery, after deduction of ARKK's costs and fees.[5] The trustee agreed to the offer, and filed a § 363 motion and notice under Rule 9019 of the Federal Rules of Bankruptcy Procedure to settle ARKK's claim and transfer the estate's causes of action to ARKK (the "sale motion").

The only party to oppose the sale motion was Pitman Farms, the owner of Simply Essentials, which sought a release from the same claims for $1 million. After the trustee rejected this offer, Pitman sought to block the sale to ARKK by arguing that avoidance actions are not property of the estate that can be sold by the trustee. The bankruptcy court held that avoidance actions are property of the estate based on "the [Bankruptcy] Code, case law and common sense" and approved the sale to ARKK as being in the best interests of the estate.[6]

Pitman certified a direct appeal of the sale motion to the Eighth Circuit on the sole issue of whether avoidance actions are property of the estate under § 541 and therefore saleable under § 363. The Eighth Circuit held they were, aligning with all other circuits to confront the issue.[7] This article explores the legal basis for the trustee's ability to sell avoidance actions and discusses the pros and

1 *See, e.g., PW Enters. v. N.D. Racing Comm'n (In re Racing Servs. Inc.)*, 540 F.3d 892 (8th Cir. 2008).
2 *In re Simply Essentials*, Case No. 20-00305 (TJC) (Bankr. N.D. Iowa).
3 The authors are counsel for ARKK in the *Simply Essentials* case, related adversary actions and the Eighth Circuit appeal.
4 *In re Simply Essentials LLC*, 640 B.R. 922, 925-26 (Bankr. N.D. Iowa 2022).
5 *Id.* at 925.
6 *Id.* at 930.
7 *In re Simply Essentials LLC*, --- F.4th --- , No. 22-2011, 2023 WL 5341506 (8th Cir. 2023) (the "Eighth Circuit Opinion"). While other circuits have not addressed the issue as broadly or directly as the Eighth Circuit, opinions from the First, Third, Fifth, Seventh and Ninth Circuits support acquisition of avoidance actions. *See In re Ontos Inc.*, 478 F.3d 427 (1st Cir. 2007); *In re Wilton Armetale Inc.*, 968 F.3d 273, 285 (3d Cir. 2020); *In re Moore*, 608 F.3d 253 (5th Cir. 2010); *Nat'l Tax Credit Partners LP v. Havlik*, 20 F.3d 705 (7th Cir. 1994); *Silverman v. Birdsell*, 796 Fed. App'x 935 (9th Cir. 2020).

cons of this approach, then provides a practical overview of best practices.

Are Avoidance Actions Property of the Estate?

The argument against avoidance actions as saleable property of the estate is based on two points: First, avoidance actions are not property, but inalienable rights and powers of the trustee. Second, they do not meet the definition of "property of the estate" under § 541(a) of the Bankruptcy Code because the debtor had no interest in avoidance actions prior to commencement of the case, and § 541(a)(3) provides that the *proceeds* of avoiding powers are property of the estate, thus implying that the actions themselves are not estate property.

Each of these arguments can be readily dispelled, as avoidance actions are not exclusive to the trustee because most courts permit creditors to pursue them for the benefit of the estate through derivative standing. Moreover, although avoidance actions are "rights and powers," they are still a form of property. For example, a "claim" is indisputably a form of property, and the Code defines it as a "*right* to payment" or "*right* to an equitable remedy."[8] Likewise, it is well established that causes of action are a form of property,[9] and the Code expressly refers to the avoiding powers as "causes of action."[10]

Kristina Stanger is a shareholder and restructuring attorney with Nyemaster Goode, PC in Des Moines, Iowa, and a member of ABI's Board of Directors. Ehud Barak is a partner, and Daniel Desatnik is an associate, with Proskauer Rose LLP in New York. Ms. Stanger and Mr. Desatnik are ABI "40 Under 40" honorees, 2018 and 2023, respectively.

Avoidance actions, as a form of property, must have an owner. While some posit that the trustee is the owner, that argument is self-defeating because the trustee could sell its own property without court approval, since § 363 only applies to a sale of estate property. Moreover, the trustee does not own property but merely acts as representative of the estate. As the Eighth Circuit observed, "[w]hether the avoidance action is brought by the trustee or by a creditor, the action is brought for the benefit of the estate and therefore belongs to the estate."[11]

The statutory arguments against avoidance actions being estate property fare no better. While § 541(a)(1) is limited to "all legal or equitable interests of the *debtor* in property *as of the commencement of the case*," § 541(a)(7) includes in the estate "[a]ny interest in property that the *estate* acquires *after* the commencement of the case." The U.S. Supreme Court has broadly interpreted the definition of "property of the estate," finding that § 541(a) can be read "to include in the estate any property made available to the estate by other provisions of the Bankruptcy Code."[12]

Avoidance actions are property made available to the estate after the commencement of the case through chapter 5 and are therefore estate property under § 541(a)(7). Moreover, property of the estate includes inchoate or contingent interests that the debtor held prior to commencement of the case. Where the avoidable transfer occurred pre-petition, the debtor obtained an inchoate interest in an avoidance action, which ripened once the debtor exercised its right to file for bankruptcy. Therefore, avoidance actions are estate property under § 541(a)(1).

Finally, while § 541(a)(3) provides that property that the trustee recovers under certain avoidance actions becomes estate property, this does not negate the action itself from being estate property. The Supreme Court has instructed that § 541(a) acts "as a definition of what is included in the estate, rather than as a limitation."[13] If Congress had wished to exclude avoidance actions from property of the estate, it could have expressly done so by listing them in § 541(b). The inclusion of one type of property should not be read to impliedly exclude another type of property.

From a policy standpoint, opponents of the salability of avoidance actions view their sale as "usurp[ing] the central role [that] the trustee ... plays as the representative of the estate" and disrupting the Bankruptcy Code's equitable treatment of creditors by allowing the purchasing creditor to recover more of the estate's assets than it would through *pro rata* distribution.[14] These concerns may have facial appeal but wither under scrutiny.

The trustee's role is not usurped, because a sale of the actions must be approved by the bankruptcy court as being "in the best interests of the estate," with each party-in-interest given an opportunity to be heard, which is no different from a derivative standing motion. Nor does their sale violate the principle of equitable distribution, because it is not recovery on a claim, but consideration for new value. Enabling the trustee to auction avoidance actions rather than utilize limited estate resources to pursue them can maximize creditor recoveries and result in an efficient liquidation rather than risky and protracted litigation.

Derivative Standing vs. Purchasing Claims

There are numerous advantages to creditors who purchase avoidance actions rather than pursue them derivatively. In *Simply Essentials*, the purchaser was able to, in essence, trade its unsecured claim against a deeply insolvent liquidating debtor for an 85 percent recovery of far larger estate claims against nondebtors. This dramatically improved the creditor's prospects of recovery, since it was no lon-

8 11 U.S.C. § 101(5); *see also United States v. Nordic Vill. Inc.*, 503 U.S. 30, 37 (1992) (stating that "the right to recover a post-petition transfer under § 550 is clearly a 'claim'").

9 *In re Senior Cottages of Am. LLC*, 482 F.3d 997, 1001 (8th Cir. 2007) (stating that "causes of action are interests in property and are therefore included in the estate").

10 Section 926, titled "Avoiding Powers," provides that if the debtor in a municipal bankruptcy "refuses to pursue a cause of action under section 544, 545, 547, 548, [or] 549(a)," a court "may appoint a trustee to pursue such cause of action."

11 Eighth Circuit Opinion at *2.

12 *See United States v. Whiting Pools Inc.*, 462 U.S. 198, 205 (1983).

13 *Id.*

14 *In re Baltimore Energy Servs. II, Corp.*, 432 F.3d 557, 562 (4th Cir. 2005).

ger limited to its *pro rata* share of estate proceeds, whereas creditors typically have to watch from the sidelines and hope the trustee investigates and prosecutes avoidance actions, as ownership of the claims provides the acquirer with control over their prosecution, recovery and settlement. In addition, the acquirer is able to use the trustee's power of turnover to obtain estate documents and use the estate's attorney/client privilege to investigate and support actions.

Another key benefit from this approach is removing the claims from an estate that may have large administrative or priority claims against it. In such a scenario, when standing in the trustee's shoes, unsecured creditors would have minimal incentive to derivatively pursue the avoidance actions, because a substantial portion of the proceeds would go to administrative and priority claimants.

However, seeking to purchase claims has drawbacks. First and foremost, acquiring claims will only work if the trustee or DIP is willing to sell them. A chapter 11 DIP might not entertain an offer to buy claims if it would result in insiders and important vendors being sued by a creditor. A derivative standing motion can be brought in circumstances where the estate representative unjustifiably refuses to bring such actions.

Second, because the sale needs to be approved by the bankruptcy court, the targets of the claims can attempt to outbid the prospective purchaser. Where the purchase is structured so the primary consideration for the estate is a percentage of the recovery on the claims (*e.g.*, 15 percent of the net proceeds in *Simply Essentials*), the target of the claims can acquire them at a "discount" by offering cash in an amount higher than the estate's share of the claims (*e.g.*, the cash equivalent value of 16 percent).

Another drawback is that while the acquirer steps into the trustee's shoes, they put themselves in the cross-hairs of their targets, who may retaliate by purchasing and litigating claims against the acquirer or propounding costly discovery against them. Because the acquirer is not a trustee or an estate fiduciary, the bankruptcy court might be skeptical of its motives and not afford the same deference as the trustee. Lastly, the acquirer takes on the financial burden of funding the pursuit of the claims and the risks attendant with litigation and collection, and might not be entitled to an administrative claim for its professional fees.

Structuring a Deal and Best Practices

Creditors interested in acquiring avoidance actions can employ certain best practices to maximize this approach's success. First, the creditor should assess whether the strategy is viable. Factors include whether it is a trustee case, whether the estate lacks funds to pursue the claims and whether there would be significant opposition in a sale or auction context.

Next, the creditor should conduct its own investigation into the number and strength of claims that exist to determine the amount it is willing to expend purchasing the claims and funding litigation. If substantial value exists, the creditor should structure the deal with the estate to offer both a fixed value (*i.e.*, cash payments, reduction of the creditor's claim, etc.) and a share of the upside of the claims. The latter consideration ensures that the creditor's pursuit of the claims remains for the benefit of the estate, and incentivizes the trustee and estate creditors to support the actions.

The agreement with the estate should also perform the following: (1) provide that the creditor has derivative standing; (2) ensure the trustee's continued cooperation; (3) provide the creditor with full settlement authority without a fiduciary duty to the estate; (4) provide copies of the debtor's relevant documents; and (5) assign the attorney/client privilege with respect to the purchased actions. The creditor should also demand a break-up fee in anticipation of a potential auction.

Once a deal has been reached, the creditor should be prepared for a contested hearing and auction. Targets of these actions are often accused of significant wrongdoing and might be motivated to shield themselves, and/or bury or resolve those actions. Preparing a comprehensive valuation of the claims supported by evidence is vital in demonstrating that the deal is higher and better in an auction context if the targets seek releases for cash. Such valuation will also be crucial at an evidentiary hearing in demonstrating the value of the offer to the estate where the consideration includes a share in the claims' proceeds.

Building support with estate creditors around accountability by the targeted actors could also help establish that the deal is in the best interests of the estate. An affidavit or court testimony from the trustee as to the analysis and conclusion of the benefit to the estate also provides an important evidentiary basis for court approval.

Conclusion

The Eighth Circuit decision in *Simply Essentials* provides definitive, circuit-level authority enabling a bankruptcy estate to sell or collateralize avoidance actions as property of the estate. Following this ruling, creditors should strongly consider whether they should stand in the trustee's shoes, or buy them.

In the proper context, creditors may be able to acquire these claims to enhance their prospects of recovery, but not without bearing the cost and risks. Meanwhile, those with exposure to avoidance actions should be aware of the salability of avoidance actions, the consequences of a creditor acquiring them, and the proactive measures they can take to shield themselves from exposure. abi

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