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Feature

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(Not) for Sale: Chapter 5 Avoidance Actions

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The Bankruptcy Code vests a *trustee* with the responsibility to manage the debtor's estate and ensures that it is accomplished by charging the trustee with statutory and fiduciary duties essential to the administration of a bankruptcy case. One of the powers that Congress granted trustees is the power to avoid and recover certain transfers of the debtor's property that, if left undisturbed, would prejudice creditors. The statutes providing authority and enabling the exercise of that power are contained in chapter 5 of the Code.

The statutes that describe the Code's avoiding powers repeatedly declare that it is the "trustee" who is authorized to avoid and recover transfers. Yet courts have authorized trustees to sell their avoidance rights to third parties on the basis that the authority that Congress conferred on trustees to pursue them qualified as property of the estate under § 541(a), which a trustee may sell under § 363. An even number of courts have held that such sales are impermissible, thus creating a significant split on this issue.[1]

The U.S. Bankruptcy Court for the Northern District of Iowa in *In re Simply Essentials LLC*[2] recently authorized the trustee's sale of avoidance actions to a creditor. In doing so, the court held that avoidance actions are property of the bankruptcy estate that a trustee is legally authorized to sell.

The court framed the issue by posing the following question: "What are these causes of action if not property of the estate?" The answer lies in the plain language of the statutes enacted by Congress: powers of avoidance and recovery reposed exclusively in the "trustee."

Factual Background

The bankruptcy estate in *In re Simply Essentials LLC* lacked the funds to prosecute avoidance actions to challenge pre-petition transfers of the debtor's interest in the property. The trustee agreed to sell the causes of action to a creditor. The trustee did not receive a single dollar in cash in exchange for relinquishing his statutory authority. The trustee obtained the *opportunity* to receive 15 percent of recoveries, if any, and a reduction of the amount of the buyer's claim against the estate. In accepting the contingent offer, the trustee rejected an unconditional cash offer of $1 million.

The trustee presented the sale to the bankruptcy court for its approval and asserted that avoidance claims qualify as property of the estate under § 541(a), which the trustee is authorized to sell under § 363, and that the transaction was a reasonable compromise under Rule 9019 of the Federal Rules of Bankruptcy Procedure. An insider and target of the avoidance actions objected, asserting that the avoidance claims could not be characterized as property of the estate and could not be legally sold.

Bankruptcy Court's Decision

The bankruptcy court held that avoidance claims are property of the estate, authorized their sale under § 363, and approved the Bankruptcy Rule 9019 compromise. Acknowledging a split of opinion on the issue, the court's analysis rested on the broad language of § 541(a)(1) vesting the estate with all legal or equitable interests of the debtor in property as of the commencement of the case. Alternatively, if the debtor lacks a legal or equitable interest in chapter 5 avoidance actions precluding application of § 541(a)(1), § 541(a)(7) would nevertheless apply because the court ruled that avoidance actions are an interest in property that the "estate acquires" after the commencement of the case.

1 *Compare Cadle Co. v. Mims (In re Moore)*, 608 F.3d 253 (5th Cir. 2010); *Brown v. Barclay (In re Brown)*, 953 F.3d 617 (9th Cir. 2020); *with Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chiner (In re Cybergenics Corp.)*, 226 F.3d 237, 242 (3d Cir. 2000). *See generally In re Redding*, 247 B.R. 474, 477 (B.A.P. 8th Cir. 2000).

2 2022 Bankr. LEXIS 920, Case No. 20-00305 (Bankr. N.D. Iowa April 5, 2022).

The court rejected the argument that avoidance claims are ineligible to be included as property of the estate under § 541(a)(1) because the debtor did not possess any legal or equitable interest in the actions, and because the claims do not arise until a case has been commenced. The court also rejected the argument that § 541(a)(7) solely applies to the recovery from a cause of action and not the cause of action itself. The matter is certified under 28 U.S.C. § 158(d) for direct appeal to the Court of Appeals for the Eighth Circuit.[3]

Avoidance Actions Are Not Property of the Estate

The commencement of a bankruptcy case creates an estate, which is comprised of the property defined by § 541(a). Section 541(a)(1) includes within the estate all legal and equitable interests *of the debtor* in property *as of the commencement of the case*. Therefore, § 541(a)(1) requires a court make two independent inquiries to determine whether the subject property satisfies § 541(a)(1).

The first inquiry requires a court to resolve whether the debtor possesses any legal or equitable interest in the subject property. The second question is a temporal one and requires a court to determine whether the debtor's legal or equitable interest existed when the bankruptcy case was commenced.[4] Section 541(a)(1) thus creates two categories: property in which the debtor (1) has an interest as of the commencement of the case, and (2) either had no interest at the time or had obtained an interest after the commencement of the case. It is the former category that the law confers to the estate, but the property interests described by the latter category do not become § 541(a)(1) property.[5]

Congress was concerned with another category of property interests. This category relates to property in which the debtor would have had an interest as of the bankruptcy filing *if* the debtor did not convey it to another under circumstances that prejudice parties with an interest in the estate.[6] Congress enacted provisions in chapter 5 to address these issues, and their defining character is the *absence* of the debtor's interest in the transferred property as of the commencement of the case. Put another way, property interests a debtor transfers to a third party prior to the commencement of a bankruptcy case are not estate property under the terms of § 541(a). Courts focus on three subsections of § 541(a) to analyze the issue: whether the avoidance claims are estate property under § 541(a)(1); whether avoidance claims are property that the estate acquires after the commencement of a bankruptcy case; and whether § 541(a)(3) and its treatment of proceeds obtained from avoidance claims imposes any limiting influence on the question of whether avoidance actions are estate property under § 541(a).

Avoidance Actions Fail § 541(a)(1)'s Test for Property of the Estate

A trustee is a representative of the estate who owes fiduciary and statutory duties to the estate and its creditors. Chapter 5 avoidance actions are congressional grants of authority to that fiduciary, and the statutes defining the Bankruptcy Code's avoiding powers repeatedly declare that it is the "trustee" who is authorized to avoid transfers.[7]

A unique feature of the Code is its bifurcation of the authority to avoid the transfer of a property interest from the authority to recover the property or its value.[8] While other statutes describe the prejudicial character of a debtor's transfer of a property interest on the estate and its creditors, it is § 550 that regulates whether that property or value benefits the estate and § 551 that preserves the avoided transfer for the benefit of the estate.

> **The trustee's statutory and fiduciary duties underpin case transparency and public trust by all stakeholders.**

A debtor lacks the authority to either avoid or recover avoidable transfers prior to bankruptcy, and once a case has been commenced, the limiting language of the statutory text makes clear that Congress vested those rights exclusively in estate fiduciaries. The U.S. Supreme Court has found that where the Code authorizes the "trustee" to take action, no independent right of action in any other party exists.[9] While the analysis ends there, the remaining qualification of § 541(a)(1) also is unsatisfied.

Chapter 5 avoidance actions accrue when a debtor commences a bankruptcy case and not before.[10] If it is true that avoidance actions do not arise until the commencement of a bankruptcy case, it is also true that they do not exist as of the commencement of a bankruptcy case.

Authority to Prosecute Avoidance Actions Is Not Property the "Estate Acquires"

Section 541(a)(7) of the Bankruptcy Code includes any interest in property that the "estate acquires" after the bankruptcy filing as property of the estate. However, that subsection "is limited to property interests that are themselves traceable to property of the estate or generated in the normal course of the debtor's business."[11] Thus, "Congress enacted § 541(a)(7) to clarify its intention that § 541 be an all-embracing definition and to ensure that property interests created with or by property of the estate are themselves property of the estate."[12] In referencing property interests "that the

3 *See Pitman Farms v. ARKK Food Co. LLC and Larry Eide, Trustee*, Case No. 22-2011 (formerly Case No. 22-8008) (8th Cir. May 16, 2022).

4 The legislative history of § 541(a)(1) makes it clear that while the statute "will include choses in action and claims by the debtor against others, it is not intended to expand the debtor's rights against others more than they exist as of the commencement of the case." S. Rep. No. 95-989, 95th Cong., 2d Sess. 82 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5868; H.R. Rep. No. 95-595, 95th Cong., 2d Sess. 367 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6323.

5 *See, e.g., Harris v. Viegelahn*, 575 U.S. 510, 513 (2015).

6 *Begier v. Internal Revenue Serv.*, 496 U.S. 53, 58 (1990) (transfer of debtor's property subject to avoidance "is best understood as that property that would have been part of the estate had it not been transferred before the commencement of bankruptcy proceedings").

7 *See* 11 U.S.C. §§ 544, 545, 547, 548, 549, 550, 551 and 553. *See also* 11 U.S.C. §§ 1107, 1203 and 1303 (granting debtor-in-possession rights, powers and duties of trustee in reorganization cases).

8 *See In re Picard*, 917 F.3d 85, 98 (2d Cir. 2019) ("Section 550(a) works in tandem with § 548(a)(1)(A) by enabling a trustee to recover fraudulently transferred property. Recovery is the business end of avoidance.").

9 *See Hartford Underwriters Ins. Co. v. Union Planters Bank NA*, 530 U.S. 1 (2000) (addressing standing under § 506(c)).

10 *Myers v. Raynor (In re Raynor)*, 406 B.R. 375, 381 (B.A.P. 8th Cir. 2009). "The avoidance actions therefore accrue on the same day as the order for relief is issued." *Id.*

11 *TMT Procurement Corp. v. Vantage Drilling Co. (In re TMT Procurement Corp.)*, 764 F.3d 512, 524 (5th Cir. 2014); *accord*, *In re Trinity Gas Corp. (Reorganized)*, 242 B.R. 344, 350 (Bankr. N.D. Tex. 1999); *In re Doemling*, 116 B.R. 48, 50 (Bankr. W.D. Pa. 1990).

12 *In re TMT Procurement Corp.*, 764 F.3d at 524-25.

estate acquires," the statute also makes it clear that there is a distinction between the debtor and the estate.

Congress Addressed Both Trustee Recovery and Estate Ownership of Avoided Transfers

Congress did not leave questions regarding the authority to avoid and recover transferred property interests or whether the recovered property or its value is property of the estate open to judicial interpretation. The Bankruptcy Code supplies unambiguous answers to these questions.

Congress identified the trustee as the sole party authorized to recover an avoided transfer. Section 550(a) directs that the trustee's recovery is "for the benefit of the estate." Similarly, § 551 mandates that any transfer avoided is preserved "for the benefit of the estate," but the phrase "for the benefit of the estate" in these statutes exists to provide clarity as to where the value of any avoided and recovered transfers is reposed: to the estate generally and not to any particular class of creditors.[13] The mechanism by which Congress vests the recovered property or its value in the estate is specifically provided by § 541(a)(3), which directs that any interest in property that the trustee recovers under § 550 is included in the bankruptcy estate.

Congress could have easily included avoidance claims as property of the estate under § 541(a) as it did the products and proceeds of their successful prosecution. Instead, it enacted a more nuanced approach by divorcing the authority to prosecute and recover avoided transfers from the ownership of the products and proceeds of the claims. Congress conferred the power and authority to recover avoided transfers on the trustee, and if they are successfully recovered, the interest is deemed property of the estate by § 541(a)(3).

On its face, § 541(a)(7) could at first blush be construed to describe avoidance actions as property of the estate despite its conspicuous silence on the issue, but avoidance claims are remedies solely available to creditors under state law. Absent the authority granted by Congress, trustees would be barred from asserting avoidance claims in their entirety.[14] The exclusive authority conferred on the trustee by Congress significantly disturbs the legal status quo by divesting creditors of their individual legal rights and vesting that authority in a trustee to serve an important public policy goal: the creation of an estate for the fair and equitable distribution of a debtor's property. Judicial approval of a sale of the authority to recover avoided transfers to a third party impermissibly expands the express, limited grant of authority of § 550(a). In addition, it rests more weight on § 541(a)(7)'s silence on the issue than it can reasonably bear.

Conclusion

Bankruptcy is a collective remedy designed to maximize value for those creditors entitled to participate in the pool of assets comprising the bankruptcy estate. Judicial concern for the practical issues confronting trustees in cases like *In re Simply Essentials LLC* that may impair the ability to pursue potentially meritorious avoidance actions is understandable. However, this concern cannot form the basis for diluting the fidelity that courts owe to the text of the governing statutes and the entire framework enacted by Congress.

Section 541(a)(1) is inapposite. Section 541(a)(7) should not be construed so as to suspend or supersede the plain text of § 550, in which Congress carefully vested the authority to commence avoidance actions in a fiduciary while expressly limiting property of the estate under § 541(a)(3) to the property or value actually recovered by a trustee under § 550. A court construing § 541(a)(7) and its silence regarding avoidance actions to facilitate their sale unlawfully confers authority on a private party that Congress expressly reserved to trustees charged with fiduciary responsibilities. The buyer's professionals similarly are not governed by important statutory regulations and oversight.

The Bankruptcy Code requires trustees to provide notice, an opportunity to be heard, and a judicial officer to rule on trustee actions as part of a collective proceeding. The sale of avoidance claims eliminates much of that disclosure, oversight and procedure. In addition, the procedural mechanisms provided to trustees by Bankruptcy Rule 9019 and § 363, deferential to a trustee's judgment, are not a sufficient substitute for the moderating influence of the persistent fiduciary duties that Congress imposed on trustees.

The trustee's statutory and fiduciary duties underpin case transparency and public trust by all stakeholders. Alienating the authority to recover avoided transfers from the Bankruptcy Code's duties and oversight imposed on trustees diminishes transparency and trust and frustrates the intent of Congress expressed in the plain language of the statutory text. abi

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13 *See Mellon Bank NA v. Dick Corp.*, 351 F.3d 290, 293 (7th Cir. 2003).
14 *See Rake v. Wade*, 508 U.S. 464, 471 (1993).