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Fifth Circuit Avoidance Actions

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On Monday, January 22, 2024, the United States Court of Appeals for the Fifth Circuit entered a ruling in the South Coast Supply Company case[1] allowing a bankrupt debtor to sell preference claims arising under section 547 of the Bankruptcy Code.[2] In doing so, the Fifth Circuit overruled the district court, which followed a long body of case law holding that debtors in possession could not sell avoidance actions.[3] The Fifth Circuit's ruling in *South Coast Supply* will have meaningful effects on players in bankruptcy cases. Debtors have an immediately saleable asset that they can use to generate funds. DIP lenders[4] may subject avoidance actions to liens to secure post-petition loans. Official committees of unsecured creditors may now lack the leverage of judicial ambiguity within the Fifth Circuit once used to preserve avoidance actions for the exclusive (or sometimes shared) benefit of general unsecured creditors.

The Fifth Circuit's decision follows a logical analysis. First, the court recognizes that congressional authority supports a broad reading of what should be considered "property of the estate" under section 541(a)(1) of the Bankruptcy Code. Next, the Court acknowledged that under section 541 of the Bankruptcy Code, property of the debtor's estate includes "all kinds of property" including "causes of action." [5]

[1] *Briar Capital Working Fund Capital, L.L.C. v. Remmert (In re South Coast Supply Co.)*, Case No. 22-20536, Doc. No. 00517039869 (5th Cir. Jan. 22, 2024) ("South Coast Supply").

[2] Title 11 of the United States Code, sections 101 et seq., is generally referred to as the Bankruptcy Code.

[3] *South Coast Supply*, p. 5 ("the district court followed cases from bankruptcy courts ruling that outright sales of preference actions under 11 U.S.C. § 547 are impermissible.").

[4] Parties that lend money to debtors after the commencement of a bankruptcy case are generally referred to as "DIP Lenders" (DIP meaning debtor-in-possession).

[5] *Id.* at 8 (citing *In re Equinox Oil Co.*, 300 F.3d 614, 618 (5th Cir. 2002)).

Citing a prior decision, the court then noted that reading 541(a)(1) broadly, as the court must, a preference action must be considered property of the estate because it is "a right of action created by federal bankruptcy law to avoid a transfer of property." [6] Moreover, the court recognized that avoidance actions also fall under the definition of estate property under section 541(a)(7) of the Bankruptcy Code because they are arguably assets that arise under the Bankruptcy Code after the commencement of a bankruptcy case. [7] Again citing one of its earlier decisions, the court reasoned that "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." [8] Finally, the court made clear that a bankrupt debtor may administer property of its estate, including through a sale following notice and hearing. It stands to reason, the Court ruled, that as a result, once an avoidance action is sold the purchaser may bring suit even if not a "representative of the estate." [9]

South Coast Supply has had an immediate effect. On January 26, 2024, Judge Everett, of the Bankruptcy Court for the Northern District of Texas, Dallas Division, adjudicated a contested DIP financing motion in the Ebix, Inc. bankruptcy case in which the United States Trustee objected to a proposed DIP financing facility that would grant the DIP Lender liens on the debtors' avoidance actions.[10] In its objection, which was filed almost two weeks before *South Coast Supply*, the United States Trustee argued, among other things, that under In re *Cybergenics Corp*., 226 F.3d 237, 243-45 (3d Cir. 2000), an avoidance action is not property of a debtor's estate under section 541 of the Bankruptcy Code, and so cannot serve as collateral securing a loan to a debtor. [11] At the final DIP financing hearing, Judge Everett responded to the United States Trustee's objection. Addressing the case participants, Judge Everett reasoned that based on South Coast Supply, a debtor's avoidance actions must be treated like any other asset, or, for example "a bag of oranges." The debtor can sell its bag of oranges or use its bag of oranges as collateral to secure a loan. In essence, an avoidance action must be treated like any other tangible or intangible asset. A debtor can sell it, use it as collateral, assign it, or abandon it, so long as the debtor's actions comply with the Bankruptcy Code.

[6] *Id.* (citing *In re Moore*, 608 F.3d 253, 257-58 (5th Cir. 2020)).

[7] *Id.* at 9.

[8] *Id.* (quoting I*n re TMT Procurement Corp*., 764 F.3d 512, 525 (5th Cir. 2014)).

[9] *Id.* at 14, resolving the potential conflict with statutory language found in 1123(b)(3) of the Bankruptcy Code.

[10] *In re Ebix Inc*., 23-80004-swe11, Notice of Hearing Held [Dkt. No. 266] (Bankr. N.D. Tex. Jan. 26, 2024).

[11] *Ebix*, Case No. 23-80004-swe, *United States Trustee's Objection to Debtors' Emergency Motion for Entry of Interim and Final Orders (I) Authorizing (A) Postpetition Financing and (B) the Use of Cash Collateral; (II) Granting Liens and Providing Superpriority Administrative Expense Claims; (III) Granting Adequate Protection to Prepetition Lenders; (IV) Modifying the Automatic Stay; (V) Scheduling a Final Hearing; and (VI) Granting Related Relief* [Dkt. No. 142] (Bankr. N.D. Tex. Jan. 10, 2024).

South Coast Supply has the potential to bring optionality to a debtor in bankruptcy. If the debtor is cash poor and needs money immediately, it can sell its avoidance actions. If a debtor has time and capital, it may prosecute its avoidance actions to generate maximum returns. If a DIP lender is concerned that insiders may have fraudulently transferred its pre-petition collateral away prior to bankruptcy, it may insist that avoidance actions serve as collateral securing a DIP loan. Committees of unsecured creditors may negotiate the assignment or waiver of avoidance actions, depending on the circumstances, to protect their constituency from potentially wasteful litigation. One thing is certain: *South Coast Supply* will have a material effect on bankruptcy cases filed within Fifth Circuit. Though less certain, it should also make the Fifth Circuit a more debtor-friendly venue moving forward.

While the Fifth Circuit's decision put to bed a longstanding question of law, it also gives rise to many others. For example, in which court must the purchaser of an avoidance action under section 547 of the Bankruptcy Code file suit? How should avoidance action purchasers resolve logistical issues pertaining to 547(b) diligence obligations? When, during a debtor's reorganization, should an avoidance action purchase file suit given section 547's "chapter 7" defense? What happens if a debtor and an avoidance action purchaser have competing interests regarding proof of a debtor's insolvency prior to or during a bankruptcy case? While debtors may now sell avoidance actions, the Fifth Circuit has done little to clarify what comes after the sale.

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About the Author

Experienced strategist and courtroom advocate **John Kane** represents clients in all facets of bankruptcy and distressed assets cases, including secured and unsecured creditors, bankruptcy trustees, creditors' committees, corporate debtors, and parties interested in purchasing claims and distressed assets.

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