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Are Chapter 5 Claims Assets of the Estate that a Trustee Can Sell?

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Trustees owe fiduciary duties to the estate, its creditors and other parties-in-interest.[2] Among other things, they have a duty to "collect and reduce to money the property of the estate for which such trustee serves, and close the estate as expeditiously as is compatible with the best interests of parties in interest."[3] Liquidation of real property and tangible personal property is generally compatible with an expeditious closing of the estate.

However, resolving estate claims and causes of action can take years and often delays distributions to creditors. In determining how to most expeditiously close the estate in keeping with the best interests of parties-in-interest, trustees are not stuck with either litigating or abandoning causes of action. Under the right circumstances, selling causes of action, including chapter 5 causes of action, allows for the speediest and most beneficial return to creditors.

While the § 363 sale process is fairly straightforward when dealing with real property, tangible personal property and even certain intangible property, the legal landscape is decidedly thornier when the assets to be sold are causes of action. Although it is clear that trustees are empowered to sell claims that the debtor could have brought pre-petition, courts are deeply divided on the trustee's power to sell claims arising under chapter 5 of the Bankruptcy Code.

This article examines this division and suggests that the Bankruptcy Code, case law, policy and practicality weigh in favor of the salability of estate claims, including chapter 5 causes of action. In addition, the article argues that to fulfill fiduciary duties to the estate, trustees must consider selling claims in determining how to most expeditiously close cases in the best interests of all parties-in-interest.

Trustees' Authority to Sell Property of the Estate

Section 363 authorizes the trustee, after notice and a hearing, to sell "property of the estate," other than in the ordinary course of business.[4] Because the trustee can only sell "property of the estate," a threshold question in any § 363 sale is whether the asset to be sold is property of the estate. Courts permitting the sale of avoidance powers find that such powers are transferrable property of the estate and locate support for this position in various statutory provisions.

Conversely, courts rejecting a trustee's power to sell avoidance actions find that those actions are "non-transferrable statutory powers," that cannot be sold.[5] In short, the split of authority over a trustee's power to sell chapter 5 causes of action boils down to a split over whether chapter 5 causes of action are property of the estate.[6]

1 The authors acknowledge Patrick "Rick" M. Shelby, counsel in the firm's New Orleans office, for his contributions to this article.

2 *See In re Easterday Ranches Inc.*, 647 B.R. 236, 247 n.26-27 (Bankr. E.D. Wash. 2022) (collecting cases).

3 11 U.S.C. § 704(a)(1).

4 11 U.S.C. § 363(b)(1).

5 *In re Murray Metallurgical Coal Holdings LLC*, 623 B.R. 444, 505 (Bankr. S.D. Ohio 2021); *see also Robison v. First Fin. Capital Mgmt. Corp. (In re Sweetwater)*, 55 B.R. 724 (D. Utah 1985), *aff'd in part and rev'd in part*, 884 F.2d 1323 (10th Cir. 1989).

6 *See Briggs v. Kent (In re Prof'l Inv. Props. of Am.)*, 955 F.2d 623, 626 (9th Cir. 1992), *cert. denied*, 506 U.S. 818 (1992) (holding that when creditor is pursuing interests common to all creditors, it may exercise trustee's avoidance powers); *Simantob v. Claims Prosecutor LLC (In re Lahijani)*, 325 B.R. 282, 287 (B.A.P. 9th Cir. 2005) (stating that "[w]hile there is some disagreement among courts about the exercise by others of the trustee's bankruptcy-specific avoiding power causes of action, the Ninth Circuit permits such actions to be sold" (internal citations omitted)); *SVP Fin. Servs. Partners LLLP v. Sky Fin. Servs. LLC*, 588 B.R. 528, 534 (D. Ariz. 2018) ("It is clear to this Court that the Ninth Circuit permits a chapter 7 trustee's avoiding powers to be sold or transferred, even if the sale is made to a party affiliated with a defendant involved in the avoidance actions." (citing *In re Lahijani*, 325 B.R. 282 at 288 (B.A.P. 9th Cir. 2005)); *Cadle Co. v. Mims (In re Moore)*, 608 F.3d 253, 258 (5th Cir. 2010) (finding that trustee may sell causes of action inherited from creditors under § 544(b)); *Pitman Farms v. ARKK Food Co. LLC (In re Simply Essentials LLC)*, 78 F.4th 1006, 1011 (8th Cir. 2023) (holding that chapter 5 avoidance actions are property of estate); *contra*, *Official Comm. of Unsecured Creditors of Cybergenics Corp. ex rel Cybergenics Corp. v. Chinery (In re Cybergenics Corp.)*, 330 F.3d 548 (3d Cir. 2003) (limiting derivative standing to pursue fraudulent-transfer causes of action pursuant to § 544 to unsecured creditors' committees).

Avoidance Powers Are Property of the Estate that Can Be Sold

Many courts, including the Fifth, Seventh and Ninth Circuits, have either implicitly or explicitly found that avoidance actions constitute property of the estate.[7]

Section 541(a)(1)

"Property of the estate" is defined in § 541 and includes "all legal or equitable interests of the debtor in property as of the commencement of the case."[8] "The House and Senate Reports on the Bankruptcy Code indicate that § 541(a)(1)'s scope is broad" and is intended to include "tangible or intangible property, causes of action, and all other forms of property currently specified in section 70a of the Bankruptcy Act."[9] Both courts and the Bankruptcy Code describe avoidance actions as "causes of action."[10] Following this logic, courts have held that § 541(a) brings into the estate avoidance actions, specifically fraudulent transfer causes of action.

In *In re Moore*, the trustee sought approval of a settlement of claims against the debtor's wife, JHM Properties and Brunswick Homes for $37,500.[11] The debtor's largest creditor, Cadle Co., objected to the trustee's proposed settlement and immediately offered to pay the estate $50,000 for the claims, arguing that the trustee's proposal was effectively a sale of estate assets that triggered the trustee's duty to maximize the value of claims.[12]

On appeal, the Fifth Circuit considered the propriety of the trustee selling the claims.[13] First recognizing that, pursuant to §§ 363(b)(1), 541(a)(1) and 363(b), a trustee "may sell litigation claims that belong to the estate, as it can other estate property, pursuant to § 363(b),"[14] the court turned to "whether the trustee may sell the particular claims in this case": claims for reverse veil-piercing and fraudulent conveyance.[15]

The court looked to its previous decision in *S.I. Acquisition*,[16] in which it "held that the alter-ego action brought by the creditor in fact belonged to the debtor and was property of the estate within the meaning of § 541(a)(1)."[17] The fact that in this case Cadle was seeking to pursue reverse veil-piercing claims was of no importance.[18] The court ruled that the reverse veil-piercing claims were property of the estate that could be sold to Cadle by the trustee under § 363(b).[19]

Next, the court recognized that its precedent provides that "Texas fraudulent-conveyance actions are property of the estate under § 541(a)(1) that the trustee may sell to Cadle."[20] However, the court went further in light of § 541(a)(1)'s limitations: Actions only belong to the estate if the debtor could have brought them at the commencement of the case.[21] Noting that § 541(a)(1) "is not the only provision under which property may become property of the estate," the court acknowledged that "the trustee's avoidance powers ... allow the trustee to enlarge the property of the estate after the commencement of the case."[22] Section 544(b) allows the trustee:

> to succeed to the actual, allowable and unsecured claims of the estate's creditors. If an actual, unsecured creditor can, on the date of the bankruptcy, reach property that the debtor has transferred to a third party, the trustee may use § 544(b) to step into the shoes of that creditor and "avoid" the debtor's transfer. Although the cause of action belonged to one creditor, any property the trustee recovers becomes estate property and is divided *pro rata* among all general creditors. The trustee may recover the full extent of the fraudulently transferred property on the basis of one creditor's claim.[23]

Reasoning that "[a] sale of § 544(b) actions is nothing more than a sale of the trustee's right to bring state law claims existing outside of bankruptcy, which is analogous to the trustee's existing power to assign chapter 5 avoidance actions to creditors," the *In re Moore* decision left open "the broader question [of] 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."[24]

Section 541(a)(3) and (a)(4)

Other courts have found that §§ 541(a)(3) and/or (a)(4) provide statutory authority for finding that avoidance actions are property of the estate. Section 541(a)(3) includes in property of the estate "[a]ny interest in property that the trustee recovers" under § 550.[25]

Section 550(a) provides that "to the extent a transfer is avoided ... the trustee may recover for the benefit of the estate, the property transferred, or if the court so orders, the value of such property."[26] The U.S. Supreme Court has found that "the right to recover a post-petition transfer under § 550 is clearly a 'claim' (defined in § 101(4)(A)) and is 'property of the estate' (defined in § 541(a)(3))."[27] While many lower courts have held that § 541(a)(3) and (4) operate to exclude avoidance actions from property of the estate, the Supreme Court's analysis in *Nordic Village* leaves significant room for finding that those very provisions compel a finding that avoidance actions are property of the estate. Some lower courts have also reached that same conclusion.[28]

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7 *See, e.g., In re Murray Metallurgical Coal Holdings LLC*, 623 B.R. at 505; *see also In re Moore*, 608 F.3d at 258; *Mellon Bank NA v. Dick Corp.*, 351 F.3d 290 (7th Cir. 2003); *In re Prof'l Inv. Props.*, 955 F.2d 623 (9th Cir. 1992).
8 11 U.S.C. § 541(a)(1).
9 *United States v. Whiting Pools Inc.*, 462 U.S. 198, 204-05 and n.9 (1983).
10 *See In re Murray Metallurgical*, 623 B.R. at 505 (collecting cases).
11 *In re Moore*, 608 F.3d at 258.
12 *Id.*
13 *Id.* at 257.
14 *Id.* at 257-58.
15 *Id.* at 258.
16 *In re S.I. Acquisition*, 817 F.2d 1142, 1152-53 (5th Cir. 1987).
17 *In re Moore*, 608 F.3d at 258.
18 *Id.* (discussing Court's earlier analysis in *Schimmelpenninck v. Byrne (In re Schimmelpenninck)*, 183 F.3d 347, 358 (5th Cir. 1999)).
19 *In re Moore*, 608 F.3d at 258-59.
20 *Id.* at 259.
21 *Id.*
22 *Id.* at 260 (citing *Gaudet v. Babin (In re Zedda)*, 103 F.3d 1195, 1201 (5th Cir. 1997)).
23 *Id.* (internal citations omitted).
24 *Id.* at 261, n.13.
25 11 U.S.C. § 541(a)(3).
26 11 U.S.C. § 550(a).
27 *United States v. Nordic Vill. Inc.*, 503 U.S. 30, 37 (1992).
28 *See Gonzales v. United States (In re Silver)*, 302 B.R. 720, 725 (Bankr. D.N.M. 2003), *aff'd in part, rev'd in part*, 303 B.R. 849 (B.A.P. 10th Cir. 2004), *supplemented by* 305 B.R. 381 (B.A.P. 10th Cir. 2004) (finding that avoidance actions under either § 544 or 549 "belong ... to the estate pursuant to § 541(a)(3) (or perhaps § 541(a)(7).").

Section 541(a)(7)

Finally, some courts locate statutory authority for a finding that property of the estate includes avoidance actions in § 541(a)(7), which provides that "[a]ny interest in property that the estate acquires after the commencement of the case" is property of the estate.[29] Thus, even if § 541(a)(1) only brings into the estate claims existing as of the commencement of the case, § 541(a)(7) brings in those claims that could not have been brought before, but can be brought after (*i.e.*, chapter 5 causes of action).[30]

Avoidance Powers Are Nontransferrable Statutory Powers

Courts rejecting a trustee's power to sell avoidance actions find that those actions are nontransferrable statutorily created powers that cannot be sold.[31] The Third Circuit has similarly found that avoidance actions do not constitute "assets" of a debtor.

In *In re Cybergenics Corp.*, Cybergenics entered into an agreement to sell nearly all of its assets to a third party for $2.5 million, and another party bid $2.65 million for its assets at the auction, becoming the successful purchaser.[32] The sale agreement and order approving the asset sale provided that the purchaser "bought 'all of the rights, title, and interest of Cybergenics in and to all of the assets and business as a going concern of Cybergenics.'"[33]

Following the sale, the district court granted motions to dismiss the unsecured creditors' committee's complaint-fraud complaint for lack of subject-matter jurisdiction, "[o]pining that the fraudulent-transfer claims were 'property of the estate'" under § 541 that Cybergenics sold in the asset sale.[34] The court reasoned that § 541(a) "includes causes of action existing at the time a petition for bankruptcy relief is filed" and "fraudulent-transfer claims were in the nature of contract claims, as opposed to tort claims, and therefore were assignable."[35]

On appeal, the Third Circuit considered whether the "fraudulent-transfer claims, which arose from transfers made and obligations incurred by Cybergenics in the 1994 leveraged buyout, [were] assets of Cybergenics."[36] The court noted that "at least outside of the context of bankruptcy, it is clear that a fraudulent-transfer claim arising from Cybergenics' transfers and obligations belongs to Cybergenics' creditors, not to Cybergenics."[37]

Next, the court considered whether a chapter 11 debtor in possession (DIP) acquires its creditors' fraudulent-transfer claims against third parties as a result of filing for bankruptcy.[38] The court determined that "[t]he fact that section 544(b) authorizes a [DIP], such as Cybergenics, to avoid a transfer using a creditor's fraudulent-transfer action does not mean that the fraudulent-transfer action is actually an asset of the [DIP], nor should it be confused with the separate authority of a trustee or [DIP] to pursue the pre-petition debtor's causes of action that become property of the estate upon the filing of the bankruptcy petition."[39] Instead, § 544(b) "simply enables a [DIP] to carry out its trustee-related duties."[40]

Ultimately, the court concluded that "the fraudulent-transfer claims, which state law provided to Cybergenics' creditors, were never assets of Cybergenics."[41] Neither was "[t]he avoidance power itself."[42] The Third Circuit later clarified this holding, stating that *Cybergenics* "does not hold that trustees cannot transfer causes of action but [it] leaves that question open because the asset transfer at issue did not reach the creditors' claims."[43]

The Case for Allowing the Sale and Assignment of Chapter 5 Causes of Action

A common problem faced by trustees is the lack of estate recourses necessary to pursue meritorious causes of action. In cases when the estate cannot bear the costs of prosecuting colorable claims, a sale of claims may be the only realistic chance for creditor recoveries.[44] Fortunately, even if there is not controlling case law in your jurisdiction permitting such sales, there is abundant support in the Bankruptcy Code and case law for such sales.

In addition, courts permitting sales of chapter 5 causes of action have commented that Congress was aware that many estates lack the resources to prosecute chapter 5 causes of action and would not have enacted robust avoidance provisions in the Code if they could not be used in most cases.[45]

Even when an estate has the resources to pursue litigation, selling claims early can provide the best return for creditors. Monetizing chapter 5 causes of action through litigation can take years, further delaying and likely dissipating any recovery for the general unsecured creditors. In contrast, the § 363 sale process is quick. If our recent inflation woes have taught us anything, it is that a dollar today really is worth more than a dollar tomorrow.

In evaluating whether to liquidate claims now at a discount or litigate the claims, trustees should consider, among other things, the anticipated cost of litigation, the delay to creditor distributions resulting from litigation, the resources available to the trustee to litigate the claims, and the anticipated pool of creditor claims. In smaller cases with more limited creditor bodies, consulting key creditors and other stakeholders is advisable. After all, parties-in-interest may be interested in purchasing and pursuing claims. In furtherance of the trustee's duty to

29 11 U.S.C. § 541(a)(7).
30 *See Smith v. Morris R. Greenhaw Oil & Gas Inc. (In re Greenhaw Energy Inc.)*, 359 B.R. 636, 642 (Bankr. S.D. Tex. 2007).
31 *See generally In re Murray Metallurgical Coal Holdings LLC*, 623 B.R. at 505 (lengthy discussion of case law); *see also In re Sweetwater*, 55 B.R. 724, *aff'd in part and rev'd in part*, 884 F.2d 1323 (10th Cir. 1989).
32 *In re Cybergenics Corp.*, 226 F.3d at 239.
33 *Id.*
34 *Id.*
35 *Id.*
36 *Id.* at 241.
37 *Id.* at 242.
38 *Id.* at 242-43.
39 *Id.* at 243.
40 *Id.*
41 *Id.* at 245.
42 *Id.*
43 *Artesanias Hacienda Real S.A. de C.V. v. N. Mill Capital LLC (In re Wilton Armetale Inc.)*, 968 F.3d 273, 285 (3d Cir. 2020) (citing *In re Cybergenics Corp.*, 226 F.3d at 244-45).
44 *See generally In re Simply Essentials LLC*, 78 F.4th at 1010 ("When an estate cannot afford to pursue avoidance actions, the best way to maximize the value of the estate is to sell the actions.").
45 *Id.* at 1010 ("Our interpretation of the Bankruptcy Code — in a way that allows the Trustee to sell avoidance actions — is consistent with the congressional intent behind including a fiduciary to maximize the value of the estate.").

the estate, careful consideration should also be given to whether the potential increased return in litigating the claim is consumed by the fees, costs and commissions to be paid as administrative expenses.[46]

Conclusion

The proceeds of chapter 5 causes of action and other litigation claims are often the estate's only unencumbered assets — the only potential pool for a distribution to general unsecured creditors. To fulfill their fiduciary duties to the estate and, particularly, its unsecured creditor body, before spending years litigating claims, trustees should consider selling litigation claims to expedite distributions to creditors. abi

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46 *See generally* David R. Hague, "Milking the Estate," 121 *W. Va. L. Rev.* 83 (2018) (exploring potential impropriety and increased costs to estate associated with trustees retaining their own firms to pursue claims on behalf of estate).