

Alert

Third Circuit Sidesteps Ruling on Validity of Avoidance Claim Sale

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The U.S. Court of Appeals for the Third Circuit recently dismissed an appeal from “the sale of legal claims” as “statutorily moot” under Bankruptcy Code (“Code”) § 363(m) because the appellants “had not obtained a stay” of the effectiveness of the sale order pending appeal. *In re Pursuit Capital Mgmt., LLC*, 2017 U.S. App. Lexis 20889 (3d Cir. Oct. 24, 2017). According to the court, “we cannot give [the appellants] the remedy they seek without affecting the validity of the sale.” *Id.*, at *37.

Relevance

The issue dodged by the Third Circuit in *Pursuit* was whether the trustee could sell the estate’s avoidance power claims to a third party. Other circuits have addressed the issue directly or indirectly. *Mellon Bank v. Dick Corp.*, 351 F.3d 290, 292-93 (7th Cir. 2003) (avoidance actions constituted additional collateral for debtor-in-possession loan; secured lenders entitled to preference actions; lenders had benefited estate and had standing to sue; in *dicta*, court said that preference claims could be sold by court order); *In re P.R.T.C., Inc.*, 177 F.3d 774, 782 (9th Cir. 1999) (trustee assigned to largest creditor avoidance power claims because estate lacked funds to pursue, but creditor required to remit to estate 50 percent of net proceeds); *In re Housecraft Indus. USA, Inc.*, 310 F.3d 64 (2d Cir.2002) (secured creditor had standing to join with trustee in bringing fraudulent transfer suit on behalf of estate); *In re Lahijani*, 325 B.R. 282 (9th Cir. BAP 2005) (avoidance actions may be sold for sum certain; do not have to be pursued on behalf of all creditors). The Third Circuit had previously evaded the issue when it found that an asset sale agreement never purported to sell fraudulent transfer claims. *In re Cybergenics Corp.*, 226 F.3d 239 (3d Cir.2000). As noted below, the issue may eventually return to the Third Circuit in the *Pursuit* case.

Code § 363(m) essentially provides that the reversal on appeal of an asset sale order will not affect the validity of the sale to a good faith purchaser “unless [the] sale [was] stayed pending appeal.” This provision is meant to “overcome people’s natural reluctance to deal with a bankrupt firm . . . as purchaser . . . by assuring them that so long as they are relying in good faith on [the court’s] approval of the transaction they need not worry about their [position] merely because some creditor is objecting to the transaction and [an appellate court may] reverse the bankruptcy judge. The proper recourse for the object[or] . . . is to get the transaction stayed pending appeal.” *In re EDC Holding Co.*, 676 F.2d 945, 947 (7th Cir. 1982).

Courts also recognize the need for finality in consummated transactions. *In re UNR Inds., Inc.*, 20 F.3d 766, 769 (7th Cir. 1994); *Pittsburgh Food & Bev. Inc. v. Ranallo*, 112 F.3d 645, 647-48 (3d Cir. 1999). The requirement of a stay pending appeal is no mere “formality;” it “serves to maintain the status quo . . . , thereby preserving the ability of the reviewing court to offer a remedy and holding at bay the reliance interests in the judgment that otherwise militate against reversal of the sale.” *In re CGI Inds., Inc.*, 27 F.3d 296, 299 (7th Cir. 1994).

Facts

The trustee for the Chapter 7 debtor in *Pursuit* held “avoidance” claims (i.e., fraudulent transfer, preference) against the debtor’s insiders totaling about \$645,000. He decided to sell these claims “because the bankruptcy estate had no funds available” to litigate. 2017 U.S. App. Lexis 20889, at *4. After the defendant insiders objected to the sale of the claims to certain creditors (“Creditor Group”) and even offered more money for the claims, the trustee “decided that an auction was the best means to maximize value for the estate” and obtained court “permission to conduct one.” *Id.*, at *5.

The auction was adjourned after procedural skirmishing, causing the trustee to solicit sealed bids from the parties. He received a bid for \$180,001 from the Creditor Group but “nothing” from the defendant insiders. In their sale agreement, the Creditor Group agreed to pursue the claims “at their cost and expense [and] . . . [a]ny net recovery [would] be paid into the estate for distribution to all creditors.” *Id.*, at *8. The trustee sold the claims “as is, where is — i.e., no representations or warranties.” *Id.*

The insiders offered the trustee \$205,150 to settle the claims, which he declined. Rejecting the insiders’ request to reopen the auction with a further increased settlement offer at \$250,000, the bankruptcy court approved the trustee’s sale agreement with the Creditor Group, finding “the sale price [to be] fair” and noting the “potential additional recovery” for creditors from this offer. Because “there was no evidence of collusion,” the court found that the parties “had acted in good faith.” *Id.*, at *12. Still, the bankruptcy court preserved the insiders’ ability to raise defenses to any claims by the Creditor Group but took no position as to whether a third party could prosecute avoidance claims. *Id.*, at *13. The Creditor Group, in the meantime, prosecuted the purchased claims, but the bankruptcy court “deferred ruling” on the insiders’ dismissal motion “pending” the Third Circuit’s decision on the sale order appeal. *Id.*, at *16. Thus, the substantive issue (sale of avoidance claims) may ultimately reach the Court of Appeals.

On appeal, the insiders argued in the district court that (a) only the trustee could prosecute avoidance claims; (b) the trustee lacked authority to sell the claims; and (c) the bankruptcy court’s good faith finding was erroneous. But, of “utmost importance,” the insiders never sought a stay of the sale order pending appeal. The district court found the appeal “statutorily moot” because “no stay had been obtained and any reversal . . . of the sale would naturally affect the validity of the sale.” It also rejected the insiders’ attack on “the good faith and the integrity of the auction process . . .” *Id.*, at ** 14-15.

The Third Circuit

The Third Circuit stressed the “purpose of [Code] § 363(m) [:] . . . to promote the finality of sales.” *Id.*, at *18. But the court declined to rule on whether the avoidance claims were transferable, for that was “the very merits issue that the [insiders] should have preserved by seeking a stay but did not.” *Id.*, at *18-19. Also, the insiders failed to “argue that the avoidance claim[s] are exempt from § 363(m) because [they] did not fall within the meaning of ‘estate property’ under that mootness statute.” *Id.*, at *19 n.16.

1. *Good Faith.* The court first rejected the insiders’ challenge to the good faith of the trustee and the Creditor Group. It found “no clear error in the Bankruptcy Court’s good faith finding nor any error in the legal standard applied.” *Id.*, at *23. First, “the Trustee acted in accordance with his fiduciary obligations, rather than in collusion with the Creditor Group or through attempts to take advantage of the [insiders].” *Id.* The trustee not only entertained a bid from the insiders and requested an auction, which was competitive, but he continued to negotiate “privately and publicly with” the parties. *Id.*, at *24. The trustee also consulted with the bankruptcy court about the best way to proceed. According to the Third

Circuit, the insiders “failed to win at the auction not because of the Trustee’s conduct, but because of their own decisions during the bidding process.” *Id.*, at *25. Finally, “the Creditor Group acted in good faith” by following the rules of the auction, submitting timely bids and increasing its bids when required by the competition. *Id.*

2. *Value.* The Third Circuit found that the trustee received “appropriate value . . . for the claims.” *Id.*, at *25. In contrast to the insiders’ bid, the Creditor Group’s bid “offers the opportunity for a recovery to the estate . . . if litigation of the claims against the [insiders] is successful.” *Id.*, at *26. The insiders’ bid for the claims, though, was predicated on their acquiring the claims “precisely so that the claims will not be litigated.” *Id.*

3. *Discrimination.* The court rejected the insiders’ complaint that the trustee had discriminated against them by refusing to negotiate after the final sealed bidding deadline. First, the trustee had to change the auction procedures because of the insiders’ “contentious and at times obstreperous behavior The [insiders] had ample opportunity to participate, and elected not to. The trustee also entertained multiple bids from the [insiders] and engaged in negotiations with them.” *Id.*, at *28.

4. *Stay Pending Appeal Requirement.* The Third Circuit further rejected the insiders’ argument that they “did not need to incur the expense associated with seeking a stay” pending appeal because the assets were being sold “as-is, where-is.” *Id.*, at *29. Applying the terms of Code § 363(m), the insiders had “failed in obtaining a stay of the Sale Order,” stressed the court. *Id.*, at *30. Looking at the remedies sought by the insiders, the insiders wanted a finding that the trustee lacked authority to sell his avoidance powers because, among other things, they may not be transferred. *Id.*, at *35. If the court had accepted that argument, however, its “ruling would surely affect the validity of the sale in the sense that the ability to pursue a claim [was] essential to any meaningful transfer of such an asset.” — a central element of the sale. *Id.*, at *36. As the district court noted, “a finding that the Trustee lacked authority to transfer the causes of action . . . ‘would affect its validity’ and demonstrate that the sale was flawed.” *Id.*, at *37. Because the Third Circuit refused to give the insiders “the remedy they [sought] without affecting the validity of the sale,” it held the appeal to be statutorily moot.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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