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DIP Financing and Liens On Avoidance Actions

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The Eighth Circuit held that "avoidance actions [*e.g.*, preferences, fraudulent transfers] can be sold as property of the [Chapter 7 debtor's] estate." *In re Simply Essentials, LLC*, 2023 WL 5341506, *1 (8th Cir. Aug. 21, 2023). On a direct appeal from the bankruptcy court, the court affirmed the bankruptcy court's granting of the trustee's motions to compromise and sell property under Bankruptcy Code §363(f). A creditor had objected, arguing unsuccessfully that "avoidance actions… are not part of the bankruptcy estate …." *Id*. As shown below, the Eighth Circuit's holding and reasoning are consistent with the reasoning of other circuits in the asset sale context. More important, the decision has practical significance for Chapter 11 debtor in possession (DIP) lenders. U.S. Trustees and unsecured creditors regularly object to the granting of liens on avoidance actions, but *Simply Essentials* and other appellate rulings should now eliminate the purported legal obstacle.

Relevance

Bankruptcy judges are also often resistant when DIP lenders seek liens on avoidance actions. These estate assets are unencumbered and their proceeds would be otherwise available for unsecured creditors. Thus, local rules for Delaware and the Southern District of New York, for example, require all financing motions to identify and justify liens on estate claims "arising under sections 544, 545, 547 and 548 of the Bankruptcy Code or, in each case, the proceeds thereof." *See*, *e.g.*, Del. Local Bankruptcy Rule 4001-2(a)(i)(U); Southern District of New York Bankruptcy Rule 4001-2(a)(9) (provisions must be "prominently highlighted and easily identified in the motion; failure to do so may result in such provisions being deemed denied by the court"). But mere compliance with these rules does not mean that the court will grant liens on avoidance actions. The debtor in possession and its lender must be prepared to justify the granting of such relief. As shown below, the Eighth Circuit's recent reasoning in *Simply Essentials* and the Seventh Circuit's analysis in *Mellon Bank, N.A. v. Dick Corp.*, 351 F.3d 290 (7th Cir. 2003), *cert. denied*, 124 S. Ct. 2103 (2004) (Dick), provide DIP lenders with the legal support for obtaining liens on avoidance actions when they can show benefit to the debtor's estate.

The Seventh Circuit's Analysis

Post-petition avoidance actions (*e.g.*, fraudulent transfers, preferences) can constitute additional collateral for a new DIP loan despite challenges by the U.S. Trustee or creditors' committee. In Dick, the Seventh Circuit upheld

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the secured creditors' entitlement to pursue preference actions when they had a lien on the claims. The bankruptcy court there had entered an order, affirmed earlier by the Seventh Circuit, *In re Qualitech Steel Corp.*, 276 F.3d 245 (7th Cir. 2001), granting pre-bankruptcy secured creditors the first $30 million of preference recoveries if their collateral position deteriorated. The bankruptcy court granted this relief as a quid pro quo for the secured creditors' consenting to new DIP financing that primed their existing liens.

Creditors who allegedly had received preferential transfers later argued that avoidance actions could not be "for the benefit of the estate" under section 550(a) of the Code if they only benefited secured creditors. Rejecting this argument, the Seventh Circuit found that the secured lenders had benefited the estates and creditors by facilitating the debtor's operating as a going concern pending a sale of its assets. *Dick*, 351 F.3d at 293. The court dismissed the policy arguments frequently advanced to preclude secured creditors from obtaining these recoveries: "A legal rule that… precludes the granting of liens on or sale of [avoidance actions] to lenders who finance a 'quick sale' of a debtor's business would 'derail' beneficial sales because it would reduce the business's value by eliminating the possibility of avoidance recoveries." 351 F.3d at 294. Such a rule would encourage a debtor's preferential or fraudulent transfers to favored vendors and others. "[U]sing the prospect of avoidance actions as additional collateral [in *Dick*] promoted an efficient disposition of [the debtor's] business …." *Id*.

The secured creditor in *Dick* also had standing to pursue avoidance actions: "[The lender] has stepped into the shoes of the dissolved [debtor], acquiring the debtor's claim by means of the order we affirmed [earlier]." 351 F.3d at 292 (citations omitted). No Supreme Court decision ever precluded "the lineal descent of statutory rights." *Id*. (citations omitted). In *Dick*, the Seventh Circuit adopted a flexible rule that would allow "judge and creditors to choose between in–court reorganization and immediate sale" by conducting a fact-based inquiry of what would be in the estates' best interests. *Id*. at 294. It refused to curtail this kind of inquiry with an artificial legal rule against the sale or encumbering of avoidance actions.

The *Dick* and *Simply Essentials* decisions show that secured lenders may, with factual support, continue to seek liens on avoidance claims in DIP financing orders. Creditors' committees and U.S. Trustees may continue to oppose these requests for liens on preference recoveries in the financing context, but there should be no fixed rule against the granting of such liens. Indeed, with the right facts, granting the DIP lenders a lien can benefit unsecured creditors. *But cf*. E.D. Levin, "Cash Is King, And Those Who Have It Set The Rules?" Comm. L. Bul. 24 (Nov./Dec. 2003) ("… liens on avoidance actions are always requested, but many circuits are lining up and have held that avoidance actions belong only to the debtor or the trustee, and therefore cannot be given as security to a lender …[.]") (no authority cited).

Finally, in *dicta*, the Seventh Circuit in *Dick* agreed that preference claims may be sold by court order: "if the secured creditors had *purchased* for $30 million in cash (paid into [the debtor's] estate before its assets were sold) [they would clearly have] the right to pursue the preference-recovery actions …" *Dick*, 351 F.3d at 293. *See also, 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% of net proceeds if creditor pursued claims).

Also, in an appropriate case with a court order, a secured lender may have standing to pursue a

preference claim on behalf of the estate. Again, there is no hard and fast rule or reason for blocking this kind of litigation. *Glinka v. Murad (In re Housecraft Indus. U.S.A., Inc.)*, 310 F.3d 64 (2d Cir. 2002) (held, secured creditor had standing in Chapter 7 case to join with trustee in bringing fraudulent transfer suit on behalf of estate; relied on "best interests of estate" precedent); *In re Lahijani*, 325 B.R. 282 (9th Cir. BAP 2005) (*held*, clarifying *PRTC*, that Ninth Circuit permits avoidance actions to be sold for sum certain; actions do not have to be pursued on behalf of all creditors); *In re Portland Injury Institute, LLC*, 2022 WL 263490, *4-5 (9th Cir. BAP Jan. 27, 2022) (appropriate for court to analyze sale of claim "under settlement standard" when buyer is potential defendant; but when buyer not potential defendant, "avoiding powers" may be sold "for a sum certain" because "benefit to … estate … is the sale price"; no requirement that all creditors benefit.). The Third Circuit, in *In re Cybergenics Corp*., 226 F.3d 237, 245 (3d Cir. 2000), avoided this issue, finding that the asset sale agreement there never even purported to transfer fraudulent transfer claims (sale of debtor's assets "was not an assignment of avoidance powers … but, rather, it was a sale of [debtor's] 'assets'.")

The Eighth Circuit's Analysis

Benefit to Estate. The Eighth Circuit explained in *Simply Essentials* that regardless of who sues — a trustee or a creditor — the avoidance action "is brought for the benefit of the estate and therefore belongs to the estate." 2023 WL 5341506, at *2. "A paramount duty of a trustee or debtor in possession… is to act on behalf of the bankruptcy estate, that is, for the benefit of the creditors." *Cybergenics*, 226 F.3d at 243.

Property of Estate. Prior to the commencement of the case, the "debtor has an inchoate interest in the avoidance actions …." 2023 WL 5341506, at *2. These actions "qualify as property of the estate" as "inchoate or contingent interests held by the debtor prior to bankruptcy." *Id*., citing *Segal v. Rochelle*, 382 U.S. 375, 379 (1966). Also, under Code §541(a)(7), which includes "[a]ny interest in property that the estate acquires after the commencement of the case," the proceeds of preferences and fraudulent transfers, for example, are "available to the estate after the commencement of the case." *Id*. at *3.

Other appellate courts have reached the same result. *In re Moore*, 608 F.3d 253, 262 (5th Cir. 2010) ("… fraudulent-transfer claims are property of the estate under §541(a)(1) … and … may be sold pursuant to §363(b)"); *In re Ontos, Inc.*, 478 F.3d 427, 431 (1st Cir. 2007) ("… a claim for fraudulent [transfer] is included within [Code] §541(a)(1)); *Nat'l Tax Credit Partners, L.P. v. Havlik*, 20 F.3d 705, 708-09 (7th Cir. 1994) (right to recover fraudulent transfer "is property of the estate that only a trustee or debtor in possession may pursue once a bankruptcy is underway").

Maximize Value of Estate. The Eighth Circuit also justified its ruling by referring to the trustee's fiduciary duty to maximize the estate's value. "When an estate cannot afford to pursue avoidance actions, the best way to maximize the value of the estate is to sell the actions." *Id*. Selling the avoidance actions "is consistent with the congressional intent behind including a fiduciary duty to maximize the value of the estate." *Id*.

Comment

Selling or encumbering avoidance actions in a DIP financing should now be permitted as a matter of law. To quote Dickens, though, "[f]acts alone are wanted in life." Chas. Dickens, "Hard Times" (1854), bk. I, ch. 1. Benefiting the estate and maximizing its value are the relevant factual criteria. In the end, lenders and their borrowers must still prove the necessary facts.

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