

Alert

Ninth Circuit Affirms Sale of Trustee's Litigation Claims to Self-Interested Party

January 22, 2020

A bankruptcy trustee may sell “avoidance powers to a self-interested party that will abandon those claims, so long as the overall value obtained for the transfer is appropriate,” held the U.S. Court of Appeals for the Ninth Circuit on Jan. 15, 2020. *Silverman v. Birdsell*, 2020 WL 236777, *1 (9th Cir. Jan. 15, 2020). Affirming the lower courts, the Ninth Circuit reaffirmed its prior holding that “a bankruptcy trustee may sell an estate’s avoidance claims to a creditor when ‘the creditor is pursuing interests common to all creditors’ and ‘allowing the creditor to exercise those powers will benefit the remaining creditors.’” *Id.*, quoting *In re PRTC, Inc.*, 177 F.3d 774, 782 (9th Cir. 1999) and *Briggs v. Kent*, 955 F.2d 623, 626 (9th Cir. 1992) (“If a creditor is pursuing interests common to all creditors..., he may exercise the trustee’s avoiding powers.”). In *Silverman*, the court-approved sale was “expected to result in abandonment of the claims by transferring them to the would-be defendant.” *Id.*

Relevance

Courts and commentators have questioned the propriety of granting Chapter 11 debtor in possession (“DIP”) financing lenders a lien on avoidance recovery actions (e.g., preferences, fraudulent transfers), another form of “transfer” under Bankruptcy Code (“Code”) §101(54)(A) (“... ‘transfer’ means... the creation of a lien.”). See *In re Qualitech Steel Corp.*, 276 F.3d 245, 248 (7th Cir. 2001) (“courts do not favor using [Code] §364 to give pre-petition lenders security interests in the proceeds of avoidance actions.”); See also U.S. Bankruptcy Court Southern District of New York Rule 4001-2(a), (g)(9) (movant must “prominently highlight ...” any provision in financing order for liens on proceeds of avoidance action and any such provision will be “deemed denied” unless “expressly and separately addressed by the court”; Del. Bankr. L. R. 4001-2(a)(i)(D) (provisions that grant immediately to the prepetition secured creditor liens on “the debtor’s claims and causes of action under [Code] §§ 544, 545, 547, 548 and 549” must be “highlighted” and recite “whether the proposed form of order and/or underlying cash collateral stipulation or loan agreement contains any [such] provision ..., identify the location of any such provision in the proposed form of order, cash collateral stipulation and/or loan agreement, and ... justify the inclusion of such provision”; “[i]n the absence of extraordinary circumstances, the Court shall not approve interim financing orders that include” liens on avoidance action provisions); 3 Collier, *Bankruptcy* ¶1364.06[6] at 364-31, 364-32 (16th ed. 2019) (“... such liens encumber potentially significant assets that would otherwise be available for the benefit of all unsecured creditors” — “can be controversial”).

Facts

The bankruptcy court had granted the motion of the trustee to sell to K certain of his “avoidance claims and related litigation claims held by” the debtor. *Silverman*, 2020 WL 236777, at *1. After the district court affirmed, certain creditors appealed, arguing that the sale was improper because K “is not pursuing

interests common to all stakeholders and its use of those powers will not benefit all stakeholders; ... even if the sale was not improper on this ground, the bankruptcy court abused its discretion because it failed to fully evaluate [a] competing proposal ...” *Id.*

Ninth Circuit Analysis

The Ninth Circuit reaffirmed its prior holding in *PRTC* but, said the court, nothing in that decision “suggests that the analysis is the same when, as here, the sale is expected to result in abandonment of the claims by transferring them to the would-be defendant.” *Id.* Still, reasoned the court, “nothing in ... *PRTC* precludes transferring the trustee’s avoidance powers to a self-interested party that will abandon those claims, so long as the overall value obtained for the transfer is appropriate.” *Id.* As the Bankruptcy Appellate Panel in another case recognized, “*PRTC* stands for the simple proposition that a trustee’s ‘avoiding powers may be transferred for a sum certain.’” *In re Lahijani*, 325B.R.282, 288 (BAP 9th Cir. 2005).

The Ninth Circuit stressed that it had “never categorically prohibited the type of sale approved by the Bankruptcy Court here.” *Silverman* 2020 WL 236777 at *1. Nevertheless, when a bankruptcy court “authorizes the sale of the estate’s litigation claims to the would be defendant of those claims, ... [it] must analyze the sale under both [Code] §363(b)(1) and Fed. R. Bankr. P. Rule 9019.” *Id.* at *2, citing *Lahijani*, 325B.R. at 288-91. When applying §363, the court must “assure that optimal value is realized by the estate under the circumstances.” *Id.* In comparing K’s cash bid for the claims to the objecting parties’ motion, the bankruptcy court had questioned whether any person “would succeed in litigating the estate’s claims,” reflecting the conclusion that the cash bid was superior. *Id.* According to the court, the bankruptcy court had been familiar “with the extended litigation history between the parties” and had carefully considered “the relevant factors.” *Id.*

The bankruptcy court had also considered all the relevant criteria when applying Bankruptcy Rule 9019 for approval of a settlement. It considered “(a) the probability of success in the litigation; (b) the difficulties, if any, to be encountered in the matter of collection; (c) the complexity of litigation involved, and the expense, inconvenience and delay necessarily attending it; and (d) the paramount interest of the creditors and a proper deference to their reasonable views” *Id.*, quoting and citing *In re Mickey Thompson Entm’t Grp., Inc.*, 292 B.R. 415, 420 (BAP 9th Cir. 2003) and *In re A&C Props.*, 784 F.2d 1377, 1382 (9th Cir. 1986).

Liens on Avoiding Power Actions

Silverman dealt with the outright sale of avoidance power claims. Because granting a DIP lender a lien on these claims is also a transfer under Code §101(54)(A), *Silverman* is most relevant.

As noted, the Seventh Circuit had addressed the propriety of granting a DIP lender lien on avoidance actions in *Qualitech*. In that case, undersecured creditors received a replacement lien on avoidance actions over the opposition of certain creditors. When the debtor had filed its Chapter 11 Petition in March 1999, secured lenders had liens on all the debtor’s assets, securing about \$265 million in claims. 276 F.3d at 246. Management estimated the value of the debtor’s assets at \$225 million as of the bankruptcy filing. *Id.* Although the lenders were undersecured and the debtor was losing \$10 million a month, certain of the lenders agreed to keep the debtor operating with a \$30 million super priority DIP financing, which “required demoting the [preexisting] secured lender’s position and substituting new security under [Code] §364(d)(1). The only other assets in sight were the proceeds of preference

recovery actions [T]he bankruptcy court approved ... financing of \$30 million, with super security and an award of replacement security to the [primed] senior lenders, to the extent that this was necessary to maintain their financial position. No one appealed or sought a stay.” *Id.* at 247.

The debtor’s assets were sold five months after the financing for approximately \$180 million. *Id.* The first \$30 million went to the DIP lenders, “leaving \$150 million for the old secured creditors,” who relied on the provision in the financing order giving them “extra security — first dibs in the preference recovery kitty, which would make up some but far from all the loss.” *Id.*

The creditors’ committee in *Qualitech* argued, of course, that pre-bankruptcy lenders should not receive security interests in the proceeds of avoidance actions and that the secured lenders had improved their position as a result of the DIP financing. *Id.* at 248. “But the bankruptcy judge concluded that good money had been thrown after bad, the secured lenders’ position had been eroded by at least the value of the anticipated preference recoveries, and that they therefore were entitled to a substitute security interest in that collateral.” *Id.* at 247.

The district court and the court of appeals affirmed. The Seventh Circuit held that it was “too late to tell” the primed lenders “that they, rather than the unsecured creditors, must swallow” any loss resulting from the DIP financing. *Id.* at 248. According to the Seventh Circuit, “the secured creditors suffered a loss as a result of the DIP financing,” which “entitled [them] to” the preference recoveries under Code § 364(d)(1). *Id.* at 247. The court’s reasoning is significant:

... [At the beginning of the case] in March 1999 the secured creditors had interests worth \$225 million, yet ... in August 1999 these interests were worth, at most, \$197 million after paying off the DIP lenders.... [T]he secured lenders lost more than the value of the avoidance actions on any calculation.

Id. at 248.

Comment

The Ninth Circuit took a sensible, pragmatic approach in *Silverman*. Following general maxims to bar the transfer of litigation claims – whether by sale or by granting a lien – would cause a debtor’s estate to lose value. So long as the court, after notice and a hearing, is able to evaluate the business justification for the proposed transfer, the “optimal” value of avoiding power actions can be realized.

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