Avoiding the Avoidable: The Uncertainty of Selling Avoidance Actions

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An article[1] authored by Harris Winsberg and Michele J. Kim[2] appearing in Volume 22, Number 2 of this journal provided a thorough overview of the complex issue of whether a trustee may sell or assign the bankruptcy estate's avoidance claims under sections 544(b), 547 or 548 of the Bankruptcy Code. The article discussed the differing views of bankruptcy courts and concluded that, given the courts' inconsistent approaches, all parties (the trustee, the defendant, and the purchaser or assignee of the trustee's claims against the defendant) should be aware of the various potential outcomes of a trustee's request to sell or assign avoidance claims. Although courts still have not reached consensus on the appropriate framework to employ in considering whether a trustee may sell or assign such claims, several recent decisions suggest that, for some courts, the framework the court will employ depends on whether the proposed purchaser or assignee of the claims will pursue recovery for its own benefit or for the benefit of the estate.

The Trustee's Avoidance Powers

As a representative of the debtor's bankruptcy estate, the trustee[3] has a duty to maximize the value of the bankruptcy estate for the benefit of the debtor's creditors.[4] Some of the trustee's tools for maximizing the value of the estate are the trustee's so-called "avoidance powers" contained in chapter 5 of the Bankruptcy Code. Three of the most frequently invoked powers are contained in sections 544(b), 547 and 548.[5]

Section 544(b) allows the trustee to assert, for the benefit of the bankruptcy estate, state-law fraudulent transfer claims that could have been asserted by creditors outside of bankruptcy.[6] Upon a debtor's bankruptcy filing, the trustee steps into the creditors' shoes and may pursue such claims. Section 544(b) requires the existence of an actual creditor that could have avoided the potentially fraudulent transfer outside of bankruptcy. Similarly, section 548 empowers the trustee to avoid the debtor's actual and constructive fraudulent transfers that the debtor had made within two years prior to the bankruptcy filing.[7] Unlike section 544(b), section 548 does not require the existence of an actual creditor that could have avoided the potentially fraudulent transfer. Section 547 empowers the trustee to recover certain

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"preferential" transfers that the debtor had made while insolvent within 90 days prior to the bankruptcy filing or, in the case of a transfer to an insider, within one year prior to the bankruptcy filing.[8]

Many cases involving a trustee, especially chapter 7 cases, lack sufficient resources for the trustee to pursue potential avoidance claims. Therefore, a trustee may seek to sell the avoidance claims or have them assigned to a creditor that will pursue them for its own behalf or derivatively for the benefit of the bankruptcy estate.

May a Trustee Sell or Assign Avoidance Claims?

As explored more fully in Winsberg and Kim's article, courts have articulated differing views as to whether a trustee may assign (via a sale or a settlement, or otherwise) avoidance claims.[9] Some courts have taken the strict view that, except for in limited circumstances (such as through a confirmed chapter 11 plan), avoidance claims cannot be assigned.[10] Others have taken a more liberal view that under certain circumstances a trustee may assign avoidance claims if doing so will benefit the bankruptcy estate.[11]

The courts that allow a trustee to assign avoidance claims will analyze the circumstances of a particular case under one or more of several frameworks, such as frameworks used to assess whether to approve a settlement or a sale of assets or frameworks used to determine whether to grant derivative standing to a nontrustee/nondebtor party.[12]

Several recent decisions suggest that, for at least some courts, the appropriate framework depends not on the type of avoidance claim being sold or the identity of the purchaser, but rather who will ultimately benefit from any recoveries on the avoidance claim. In these courts, a trustee's proposed sale of an avoidance claim to a creditor that wants to pursue the claim solely for its own benefit will be analyzed as an outright sale that will likely be denied, while a trustee's proposed sale to a creditor that will pursue recovery for the benefit of the estate will be analyzed under a derivative standing framework that is more likely to be approved.

Recent Decisions

Several recent decisions have held that a trustee was not permitted to assign avoidance claims to a creditor that wanted to pursue the claims for the creditor's own benefit. These decisions suggest that the result may have been different had the trustee or creditor requested derivative standing to pursue the claims on behalf of the estate.

The most recent of these decisions is *In re Waterford Funding, LLC*.[13] In that case, Waterford Funding and its affiliate (the "Debtors"), an investment company that allegedly operated a Ponzi scheme, filed Chapter 11 petitions in the Bankruptcy Court for the District of Utah. The court-appointed Chapter 11 trustee (the "Trustee") commenced an adversary proceeding against John Stone ("Stone") seeking to avoid and recover, pursuant to sections 548, 544, 550[14] and 551 and other theories, alleged pre-petition fraudu-

lent transfers the debtor had made to Stone prior to the bankruptcy filing totaling $106,426.27.[15] After Stone failed to answer the Trustee's complaint, the Trustee obtained a default judgment against Stone.[16]

Several years later, the court entered an order granting the Trustee's motion to sell various default judgments, including the default judgment the Trustee obtained against Stone, on an online marketplace.[17] Thereafter, the Trustee sold and assigned the default judgment against Stone (along with several other default judgments against other defendants) to Jamie Baker *dba* Baker Recovery Services ("BRS") for an unspecified sum.[18] The assignment agreement provided as follows:

> For cash consideration to be received from the Buyer upon execution of this Agreement (the "Purchase Price")[,] the Trustee hereby sells, transfers, assigns or otherwise conveys all title, rights, ownership and interests in the aforementioned Judgments to Baker Recovery Services ("Buyer").
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> The Trustee assigns and authorizes Buyer to recover, compromise, settle (in full or in part) and/or enforce the Judgments at its sole discretion. In so doing, the Buyer has all rights of the Trustee and may notify the Judgment Debtors that satisfaction of the Judgments must be made through Buyer.
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> . . .
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> The sale and assignment of the Judgments to the Buyer is "As Is Where Is" with no representations and warranties of any kind, other than that the Trustee is the holder of the Judgments and has the authority to transfer the Judgments as provided for herein.[19]

On February 8, 2016, Stone filed a motion to set aside the default judgment on various grounds, to which BRS objected.[20] Ultimately, the court granted Stone's motion and vacated the default judgment.[21]

On August 8, 2016, BRS filed an amended complaint against Stone, which substituted BRS for the Trustee as plaintiff and alleged many of the same causes of action that the Trustee had asserted in the original complaint. In response, Stone filed a motion to dismiss, which argued, among other things, that BRS did not have standing to bring the action because BRS was merely an assignee of the default judgment.[22]

While Stone's motion to dismiss BRS's amended complaint was pending, the Trustee filed a motion to approve a settlement he had reached with Stone. The settlement provided that Stone would pay $2,500 to the Debtors' estate in exchange for mutual releases between the Trustee and Stone. The Trustee acknowledged that BRS believed it was the owner of the claims in the adversary proceeding, but the Trustee and Stone asserted that after the court vacated the default judgment all such claims reverted to the Debtors' estate. BRS responded that the Trustee had assigned the claims to BRS and that, therefore, the Trustee did not have standing to settle them.[23]

The primary issue in dispute was whether the Trustee or BRS held the claims asserted in the adversary proceeding. If the Trustee held the claims, he could presumably settle them with Stone and effectively prevent BRS from pursuing its amended complaint. If BRS held the claims, the Trustee could not settle them and BRS could continue to litigate against Stone. To

resolve this issue, the court believed the relevant question was whether the Trustee had intended to assign to BRS only the default judgment or to also assign the underlying claims. The court found, however, that it did not have to answer this question because "even if the Trustee intended to assign the underlying claims, he was legally precluded from doing so."[24]

The court explained that a trustee may not, except in limited circumstances, assign its avoidance powers to a third-party. The court provided three reasons for why this is so. First, sections 544, 547 and 548 confer avoidance powers on trustees without mentioning "designees" or "assigns." Second, policy considerations disfavor assigning an avoidance action to a creditor because by allowing the creditor to "pursue that claim on his own behalf, that creditor may be allowed to recover more of the estate's assets than would otherwise rightfully be due to the creditor."[25] Third, permitting parties other than trustees to pursue avoidance actions could "expose the legal system to a multiplicity of lawsuits filed by many different individual plaintiffs[,]" which would burden the courts and run contrary to one of the purposes of appointing a trustee who, by objectively evaluating which actions are viable and cost effective, ensures "the orderly administration of the bankruptcy estate."[26]

For these reasons, the court held that the Trustee could not have transferred the underlying claims to BRS and, at most, could only have transferred the default judgment to BRS. Once that default judgment was set aside, BRS lacked standing to prosecute any of the underlying claims. It followed, therefore, that (1) BRS could not substitute for the Trustee as plaintiff in the adversary proceeding against Stone, and (2) the Trustee still held those claims and could settle them.[27] Having found that the Trustee retained the underlying claims and authority to settle them, the court evaluated and approved the terms of the settlement between the Trustee and Stone.[28]

It appears, based on the court's reasons for holding that the Trustee was legally precluded from assigning the underlying claims to BRS, that under no circumstances would the court allow a trustee to assign avoidance claims to a creditor that would pursue such claims for its own benefit. The court acknowledged that some courts have granted creditors derivative standing to pursue avoidance actions on behalf of the estate where the trustee or debtor refused to prosecute the claims, but those circumstances were distinguishable from those before the court which involved "an outright sale of avoidance claims."[29]

To support its conclusion, the court cited two recent decisions issued by Judge Thomas J. Tucker of the Bankruptcy Court for the Eastern District of Michigan: *In re Clements Mfg. Liquidation Co., LLC*[30] and *In re Dinoto*.[31] In *Clements Mfg*., the trustee sought approval of a settlement whereby the trustee would assign to a group of creditors various fraudulent transfer claims under sections 544, 548 and 550 of the Bankruptcy Code.[32] The settlement provided that the group could pursue the claims for its own benefit, subject to the requirement to pay to the bankruptcy estate 10% of all sums recovered, up to a maximum of $200,000.[33] The court noted that the proposed arrange-

ment was unlike other cases where courts granted derivative standing to creditors to pursue claims for the sole benefit of the estate.[34] The court recognized that there was a split in the case law on whether a trustee could assign avoidance actions to creditors and briefly summarized the holdings of several decisions on each side of the debate.[35] Ultimately, without any elaboration or analysis, the court held that based on its review of the case law, the trustee was not permitted to assign the claims to the creditor group.[36]

Less than one year after the *Clements Mfg.* decision, Judge Thomas J. Tucker of the Bankruptcy Court for the Eastern District of Michigan, in *Dinoto*, reiterated his holding that a trustee may not—as part of a settlement or a sale, or otherwise—assign avoidance claims to a creditor that would pursue such claims on its own behalf. In *Dinoto*, a trustee sought approval of a settlement whereby the trustee would assign certain state-law fraudulent conveyance claims to two creditors who held 97% of the total amount of unsecured claims in the bankruptcy case. Incorporating by reference the reasons and citations of authority in its *Clements Mfg.* decision, the court ruled that the trustee could not assign the claims. Unlike in its *Clements Mfg.* decision, in *Dinoto* the court specifically indicated its agreement with the Third Circuit's decision in *Cybergenics*,[37] which explained that a creditor's state-law fraudulent conveyance claims, which a trustee has the power to assert under section 544(b), were not assets of the estate that could be sold. Rather, the trustee's power to assert such claims was "[m]uch like a public official [who] has certain powers upon taking office as a means to carry out the functions bestowed by virtue of the office or public trust."[38] The court, as it did in *Clements Mfg.*, distinguished a trustee's outright assignment of avoidance claims from a court's grant of derivative standing to a creditor to pursue recovery for the benefit of the estate. In fact, the court suggested that the circumstances of the case—including the fact that the two creditors held 97% of the amount of unsecured claims against the debtor—presented "a strong reason why such creditors might wish to, and be well suited to, be granted derivative standing to pursue the fraudulent transfer claims on behalf of the entire bankruptcy estate . . ."[39] The court also explicitly stated that its decision was without prejudice to the right of the trustee or the creditors to file a motion seeking derivative standing.

The *Dinoto* and *Clements Mfg.* decisions—while rejecting a trustee's proposed assignment of avoidance claims to creditors seeking to pursue such claims on their own behalf—suggested that the results might have been different had the trustee or creditors sought derivative standing to pursue the avoidance claims for the benefit of the bankruptcy estate. Indeed, prior to the *Dinoto* and *Clements Mfg.* decisions, Judge Thomas J. Tucker of the Bankruptcy Court for the Eastern District of Michigan granted a creditor derivative standing to pursue avoidance claims, including state-law fraudulent conveyance claims under section 544(b). In *In re Dzierzawski*,[40] a creditor sought derivative standing to pursue fraudulent transfer claims solely on behalf of the bankruptcy estate against the debtor's wife. The trustee supported the creditor's request because there were insufficient funds in the

estate for the trustee to pursue the claims, but the debtor and his wife objected.[41]

In her request for derivative standing, the creditor—who held over 99% of the total amount of unsecured claims in the bankruptcy case—proposed to bear the fees and expenses incurred in prosecuting the claims, subject to the creditor's right to seek reimbursement from the estate but only up to the amount that the estate actually recovered from the creditor's prosecution of the claims. After assessing whether the creditor's proposal met the requirements for derivative standing in the Sixth Circuit, the court granted the creditor's motion for derivative standing, finding that granting derivative standing as requested "can possibly result only in a net financial benefit to the bankruptcy estate, or at worst, no net financial effect, positive or negative."[42] Based on its later holdings in *Dinoto* and *Clements Mfg.*, it appears unlikely that the court would have permitted the creditor to purchase the claims to pursue them for her own benefit.

Conclusion

Whether a trustee may sell or assign avoidance claims to a creditor continues to be a complex question with differing views among the courts.[43] Recent decisions, however, suggest that a court's analysis may differ depending on whether the creditor wants to pursue the claims solely for its own or for the benefit of the estate. These decisions, however, leave open several questions. First, would the *Waterford Funding*, *Dinoto*, and *Clements Mfg.* courts have held differently and permitted the trustee's assignment of avoidance actions if the creditor had agreed to share a significant percentage (but not all) of the proceeds with the bankruptcy estate?[44] Second, how should courts—even those courts such as the *Dzierzawski* court that have granted creditors derivative standing to pursue avoidance actions solely for the benefit of the bankruptcy estate—view alternative arrangements, such as litigation funding arrangements, whereby the trustee pursues avoidance actions for the benefit of the estate but effectively sells a percentage of the recovery to a third-party in order to fund the litigation? Are such arrangements merely "wolves in sheep's clothing" that should be treated as proposed sales and evaluated using the existing frameworks? If so, which of the frameworks should apply? Finally, does a sale of avoidance claims to a creditor violate state laws or public policies, such as the champerty doctrine, that prohibit third parties from funding and sharing in the proceeds of litigation?[45] These and other questions are likely to remain unanswered without further analyses from the courts.

NOTES:

[1]Harris Winsberg & Michele J. Kim, Unlocking Value: Can a Trustee Sell Avoidance Claims Grounded in Sections 544(b), 547 or 548 of the Bankruptcy Code?, 22 J. Bankr. L. & Prac. 2 Art. 2 (2013).

[2]In June 2017, Michele J. Kim was appointed as a United States Bankruptcy Judge for

the Southern District of Georgia.

[3]A trustee is appointed in all chapter 7 and chapter 13 bankruptcy cases and, in limited circumstances, in chapter 11 cases. In chapter 11 cases, the debtor remains in possession of its property and has the same rights, powers and duties of a trustee. See 11 U.S.C.A. § 1107 (providing that a debtor in possession has, with a few exceptions, all of the rights, powers, functions and duties of a trustee). For purposes of this article, therefore, references to a trustee also include a debtor in possession in a chapter 11 case.

[4]See In re Rigden, 795 F.2d 727, 730, 14 Bankr. Ct. Dec. (CRR) 1093, 15 Collier Bankr. Cas. 2d (MB) 1206 (9th Cir. 1986) ("The trustee . . . has a fiduciary obligation to conserve the assets of the estate and to maximize distribution to creditors.").

[5]See 11 U.S.C.A. §§ 544(b), 547, 548.

[6]See 11 U.S.C.A. § 544(b).

[7]See 11 U.S.C.A. § 548.

[8]See 11 U.S.C.A. § 547.

[9]See Winsberg & Kim, supra note 1, for a thorough overview.

[10]See Winsberg & Kim, supra note 1.

[11]See Winsberg & Kim, supra note 1.

[12]See Winsberg & Kim, supra note 1.

[13]In re Waterford Funding, LLC, 2017 WL 439308 (Bankr. D. Utah 2017).

[14]Section 550 of the Bankruptcy Code allows the trustee to recover, for the benefit of the estate, the value of any transfers avoided under sections 544, 545, 547, 548, 549, 553(b), or 724(a). See 11 U.S.C.A. § 550.

[15]See In re Waterford Funding, LLC, 2017 WL 439308 (Bankr. D. Utah 2017).

[16]See Waterford Funding, 2017 WL 439308 at *1.

[17]See In re Waterford Funding, Case No. 09-22584 (Bankr. D. Utah) (Nos. 2272, 2279).

[18]See Waterford Funding, 2017 WL 439308 at *1.

[19]See Waterford Funding, 2017 WL 439308 at *1.

[20]See Gil A. Miller, as Chapter 11 Trustee for Waterford Funding, LLC, et al. v. John Stone, Adv. Proc. No. 11-2093 (Bankr. D. Utah) (Nos. 15, 23, 24, 26, 28). Stone's primary argument was that he was not properly served with the Trustee's summons and complaint.

[21]See Gil A. Milller, Adv. Proc. No. 11-2093, at Nos. 33, 34.

[22]See Waterford Funding, 2017 WL 439308 at *2.

[23]See Waterford Funding, 2017 WL 439308 at *2.

[24]See Waterford Funding, 2017 WL 439308 at *2.

[25]See Waterford Funding, 2017 WL 439308 at *3 (citing In re Harrold, 296 B.R. 868, 872–73, Bankr. L. Rep. (CCH) P 78901 (Bankr. M.D. Fla. 2003). The court's analysis seemed to ignore the fact that the consideration BRS paid for the default judgment against Stone became an asset of the bankruptcy estate to be shared with all creditors and presumably represented the trustee's risk assessment of the costs and likelihood of achieving a recovery on the default judgment.

[26]See Waterford Funding, 2017 WL 439308 at *3.

[27]See Waterford Funding, 2017 WL 439308 at *3.

[28]See Waterford Funding, 2017 WL 439308 at *3. It is unknown whether BRS was able to obtain a refund of the amount it paid for the default judgment against Stone. If BRS did not receive a refund, the bankruptcy estate obtained a double recovery on account of the same

causes of action: first, by selling to BRS the default judgment against Stone and, second, by settling with Stone the underlying causes of action against him.

[29]See Waterford Funding, 2017 WL 439308 at *3.

[30]In re Clements Manufacturing Liquidation Company, LLC, 558 B.R. 187 (Bankr. E.D. Mich. 2016).

[31]In re Dinoto, 562 B.R. 679 (Bankr. E.D. Mich. 2016).

[32]See Clements Mfg., 558 B.R. at 188.

[33]See Clements Mfg., 558 B.R. at 188.

[34]See Clements Mfg., 558 B.R. at 188 n.4.

[35]See Clements Mfg., 558 B.R. at 188–89.

[36]See Clements Mfg., 558 B.R. at 189.

[37]In re Cybergenics Corp., 226 F.3d 237, 36 Bankr. Ct. Dec. (CRR) 190, 44 Collier Bankr. Cas. 2d (MB) 1418, Bankr. L. Rep. (CCH) P 78263 (3d Cir. 2000).

[38]See Dinoto, 562 B.R. at 682 (citing Cybergenics at 243–44); see also Mem. Order Re Sale of Avoidance Actions, In re Parirokh, DG 11-05409 (Bankr. W.D. Mich., May 2, 2013) (agreeing with Cybergenics and stating that "Just as we do not permit public officials to sell the powers of their office or delegate their authority to private actors, so should we pause when a trustee proposes what amounts to the same thing.").

[39]See Dinoto, 562 B.R. at 682.

[40]In re Dzierzawski, 518 B.R. 415 (Bankr. E.D. Mich. 2014).

[41]See Dzierzawski, 518 B.R at 417, 423–24.

[42]Dzierzawski, 518 B.R at 423.

[43]The Court of Appeals for the Third Circuit was recently asked to decide whether a trustee had the ability to transfer certain avoidance claims to a group of creditors. The court did not consider the issue — but acknowledged that the issue "does not have an obvious answer" — and dismissed the appeal as moot under section 363(m) of the Bankruptcy Code because the appellants never sought or obtained a stay of the order approving the sale of the claims. See In re Pursuit Capital Management, LLC, 874 F.3d 124, 64 Bankr. Ct. Dec. (CRR) 226 (3d Cir. 2017).

[44]Other courts have approved sales with sharing arrangements. See, e.g., In re P.R.T.C., Inc., 177 F.3d 774, 34 Bankr. Ct. Dec. (CRR) 480, 42 Collier Bankr. Cas. 2d (MB) 269 (9th Cir. 1999) (court approved trustee's sale of avoidance claims to creditor in return for 50% of any recovery after attorney's fees and costs because no other option had the potential to provide any recovery to the remaining creditors).

[45]Litigation funding arrangements are becoming increasingly common in the United States and some courts reviewing such arrangements have held that champerty and similar doctrines did not prohibit them in those cases. See, e.g., Charge Injection Technologies, Inc. v. E.I. Dupont De Nemours & Company, 2016 WL 937400 (Del. Super. Ct. 2016) (denying motion to dismiss action and rejecting defendant's arguments that litigation funding arrangement constituted champerty and maintenance). Although champerty and similar doctrines are often regarded as outdated concepts, they are still relevant in certain jurisdictions. See, e.g., Justinian Capital SPC v. WestLB AG, 28 N.Y.3d 160, 43 N.Y.S.3d 218, 65 N.E.3d 1253 (2016) (affirming dismissal of action on the ground that the plaintiff's acquisition of notes from original noteholder for the sole purpose of commencing suit was champertous); WFIC, LLC v. LaBarre, 2016 PA Super 209, 148 A.3d 812 (2016) (invalidating as champertous an agreement to pay a portion of litigation proceeds to funders who were unrelated to the litigation).