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Preferences for Sale? Analyzing the Fifth Circuit's *South Coast Supply Co*. Opinion

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The Fifth Circuit recently issued an opinion that increases the marketability of estate assets often viewed as untouchable. In *In re S. Coast Supply Co.* ("***South Coast***"), 91 F.4th 376 (5th Cir. 2024), the Fifth Circuit held that a bankruptcy "preference" action may be sold to a third party under section 363 of the Bankruptcy Code even if the buyer is not an estate fiduciary and does not represent the bankruptcy estate. A preference action is an "avoidance" claim arising under section 547 of the Bankruptcy Code. It permits the debtor or trustee to file a lawsuit to recover prepetition transfers made by debtors to non-insiders within ninety days of the petition date, and transfers to insiders within a year of the petition date.[1] Notably, preferences and other avoidance claims have been traditionally viewed as causes of action reserved for prosecution by a bankruptcy fiduciary, like a debtor, trustee, or other court-appointed representative with enhanced duties to the bankruptcy estate. Following *South Coast*, preference claims, and perhaps other avoidance actions, are now more freely marketable, whether as additional collateral to secure a post-petition loan, to provide third parties with adequate protection against diminution in the value of their collateral, or for outright sale to third parties to bring cash into the estate.

I. The Facts

The Debtor issued $320,000 in checks to its former CFO, resulting in prepetition transfers comprising an asserted $316,000 preference claim. The Debtor's prepetition secured lender, Briar Capital, filed a $2.5 million proof of claim secured by a first-priority blanket lien on "all of the Debtor's now owned or hereafter acquired assets, whether tangible or intangible."[2] Briar Capital believed it was oversecured, valuing the collateral at $3.9 million.

During the case, the Debtor obtained "DIP financing" from a third-party lender (the "**DIP Lender**"). DIP financing is a new loan provided to a debtor-in-possession after the case is filed. Under the order approving the DIP financing, Briar Capital retained its senior liens on property acquired by the Debtor prior to the date on which the DIP Lender advanced DIP financing, and the DIP Lender received senior liens on property acquired after that date. The Debtor also commenced a $316,000 preference lawsuit against the CFO and filed a plan of reorganization. The plan proposed to sell certain intangible assets to the DIP Lender for $700,000 cash, earmarking $200,000 to cover administrative expenses arising during the bankruptcy case and the remaining $500,000 to pay general unsecured creditors.

Briar Capital objected to the plan but ultimately withdrew its objection after agreeing with the DIP Lender to the terms of a modified plan. Under the modified plan, Briar Capital abandoned its security interest in the $700,000 proceeds from the sale of intangibles (which typically would include choses in action, but in this case did not include the preference claim against the CFO) to the DIP Lender and waived its administrative expense claim. In exchange, Briar Capital received assets valued at just over $3.4 million in the aggregate, including the $316,000 preference claim against the CFO.[3] The modified plan did not require Briar Capital to return any "surplus" value to the estate, even if it realized value exceeding its allowed $2.5 million claim from the assets.

The Bankruptcy Court confirmed the modified plan. The CFO later filed a Rule 12(b)(1) motion to dismiss the preference action (now owned by Briar Capital) for lack of subject matter jurisdiction. The District Court withdrew the reference over the preference action and granted the CFO's motion to dismiss on grounds that the sale did not confer standing to pursue the preference action to Briar Capital, which appealed the ruling to the Fifth Circuit.

II. Analysis of the Fifth Circuit's Ruling and Reasoning

The Fifth Circuit phrased the issue on appeal as: "whether a preference action, a specific type of avoidance action, may be sold."[4] Reversing the District Court and remanding, the Fifth Circuit held (i) that preference actions are property of the estate under sections 541(a)(1) and (7) of the Bankruptcy Code, (ii) that property of the estate can be sold outside the ordinary course of business under section 363(b)(1) of the Bankruptcy Code, and (iii) that Briar Capital, having purchased the preference claim, had standing to prosecute it against the CFO.[5]

The Fifth Circuit reviewed two key issues in its opinion: (i) how avoidance actions become property of the estate, and (ii) whether third parties must represent the estate (and act in a fiduciary capacity) to prosecute preference actions.

A. Avoidance Actions Become Property of the Estate Under Section 541(a)(1) and (7) of the Bankruptcy Code

Citing Supreme Court precedent[6] and its own jurisprudence[7] to broadly construe section 541 of the Bankruptcy Code, the Fifth Circuit ruled that the preference claim against the CFO constituted property of the Debtor's estate under section 541(a)(1) and (7) and could, therefore, be sold to a non-fiduciary under section 363(b)(1).[8] Section 541(a)(1) includes "all legal or equitable interests of the debtor in property as of the commencement of the case" within the meaning of property of the estate.[9] Section 541(a)(7) includes "any interest in property that the estate acquires after the commencement of the case."[10]

The Fifth Circuit based its ruling on the plain language of section 541(a)(1) and long-standing Supreme Court precedent that held section 541(a)(1) "is intended to include in the estate any property made available to the estate by other provisions of the Bankruptcy Code,"[11] including section 547 (the preference statute). Section 541(a)(1) includes within property of the estate a debtor's property interests "as of" the commencement of a case, no matter how "conditional, future, speculative, or equitable [in] nature" the interests may be.[12] Preference actions arise with the filing of the bankruptcy petition, making them property the debtor has an interest in as of the commencement of the case,[13] and, thus, property of the estate under section 541(a)(1) of the Bankruptcy Code. The Fifth Circuit's inclusion of preference actions within the meaning of section 541(a)(1) fit squarely within the Supreme Court's interpretation of section 541(a)(1) in *Whiting Pools*.[14]

The Fifth Circuit also cited favorably to *Simply Essentials*,[15] in which the Eighth Circuit concluded that "debtor[s] have an inchoate interest in [] avoidance actions *prior to* the commencement of [] bankruptcy proceedings."[16] But section 552(a) of the Bankruptcy Code provides that property the debtor acquires post-petition is not subject to a lien resulting from a prepetition security agreement.[17] Presumably, then, an after-acquired property clause in a prepetition security agreement like Briar Capital's would not attach to (or be perfected as to) a preference action arising *with* the filing of the case, notwithstanding the Eighth Circuit's "inchoate interest" discussion. Further, the Uniform Commercial Code requirements for perfecting a security interest may make perfection of a prepetition security interest in preferences practically impossible, but that discussion exceeds the scope of this client alert.

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B. Debtors May Sell Preference Actions to Non-Fiduciaries and thus Confer Standing to Prosecute the Preference Actions to the Non-Fiduciaries

The second issue that the Fifth Circuit addressed was whether a third party must represent the estate to pursue a validly purchased preference claim. Several courts have held that the bankruptcy avoidance powers are reserved exclusively for representatives of the estate.[18] The Fifth Circuit disagreed, concluding that a third party need not represent the estate to prosecute a preference claim in every case.[19]

A debtor's ability to sell a preference claim to third parties and the appointment of estate representatives to prosecute avoidance actions are "exclusive and independent" issues.[20] The Bankruptcy Code requires enforcement of an estate claim by a representative of the estate only when the claim is *retained* by the estate.[21] But section 1123(b)(3)(B) is not exclusive.[22] What if the estate no longer owns the claim? The Bankruptcy Code provides different mechanisms for a debtor to convert its assets to cash, and section 363(b)(1) of the Bankruptcy Code, for example, does not require third-party purchasers of estate claims to qualify as estate representatives in order to prosecute the claims.[23]Alternatively, a plan may provide for "the sale of all or any part of the property of the estate . . . among those having an interest in such property of the estate."[24] The Bankruptcy Code provides debtors with the flexibility to choose between prosecuting or liquidating claims owned by the estate, and debtors have several methods for realizing value on estate claims, including *but not limited to* the means set forth in section 1123(b)(3)(B). Following the Eighth and Ninth Circuits, the Fifth Circuit concluded that this flexibility enables the debtor to carry out its fiduciary duty to maximize estate value.

In reaching its decision in *South Coast*, the Fifth Circuit rejected the CFO's argument that its ruling would harm the general policy of equity in bankruptcy, concluding instead that allowing the sale of preference actions "will grant bankruptcy courts more flexibility in distributing assets, maximize the value of the bankruptcy estate, and in turn, allow for more equitable distribution of assets."[25] The Fifth Circuit highlighted the fact that Briar Capital waived its administrative expense claim and its security interest in the proceeds from the Debtor's sale of intangibles to the DIP Lender to purchase the preference claim.[26] Thus, the certainty of $700,000 in cash to the bankruptcy estate to cover administrative expenses and distributions to unsecured creditors justified selling the preference claim, which had not yet been prosecuted to judgment.[27]

III. Closing Thoughts

Bankruptcy courts have historically balked at debtors' attempts to pledge avoidance claims as collateral to secure post-petition financing or cash-collateral usage due to uncertainty and uneasiness regarding a third party's standing to prosecute the trustee's avoidance powers. Courts have expressed similar reservations when non-fiduciaries sought to prosecute avoidance actions for their own benefit absent proof of standing. The Fifth Circuit previously reserved ruling on the issue, focusing instead on the importance of the debtor's disclosure statement describing reserved causes of action with specificity.[28] In this context, defendants in post-confirmation litigation have challenged both whether debtors properly disclosed and reserved avoidance claims and whether creditors that do not represent the estate have standing to prosecute avoidance claims. In *South Coast*, the Fifth Circuit has preempted the latter argument (at least with respect to preferences) by confirming that debtors may sell preference actions to third-party non-fiduciaries under section 363(b)(1) of the Bankruptcy Code if the sale maximizes estate value.[29] While the Fifth Circuit limited the scope of its holding to preference actions, its reasoning may apply to other avoidance actions, including fraudulent transfers, which can include both state and federal claims under sections 544, 548 and 550, and wrongful post-petition transfers under section 549.

South Coast has opened the door for debtors to sell or pledge preference actions, and perhaps other avoidance actions, to non-fiduciary third parties in the Fifth Circuit. Time will tell the full extent of *South Coast's* impact on

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bankruptcy practice in the Fifth Circuit, but the opinion indicates that trustees can sell any estate property, including chapter-five claims, to third-party non-fiduciaries so long as the transaction maximizes estate value. As a result, lenders, investors in third-party litigation, and others wanting to purchase and prosecute bankruptcy claims have cause to rejoice.

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[1] "Transfers" and "insiders" have specific meanings under the Bankruptcy Code. *See* 11 U.S.C. § 101(31) (insiders comprise essentially all officers, directors, and others in control of the debtor) and (54) (broadly defining transfers to include all payments and anything of value).
[2] *Briar Capital Working Fund Capital, LLC v. Remmert* ("***Briar Capital v. Remmert***"), No. 4:18-CV-2867, 2022 WL 4137840, at *1 (S.D. Tex. Sept. 12, 2022), *rev'd and remanded sub nom. In re S. Coast Supply Co.*, 91 F.4th 376, 378 (5th Cir. 2024).
[3] Briar Capital received the following assets under the modified plan: (i) $896,000 in cash; (ii) $1,795,000 in inventory; (iii) $600,000 in accounts receivable, of which $400,000 was likely collectible; and (iv) the $316,000 preference claim against the CFO. *Id.* at *3.
[4] *South Coast*, 91 F.4th at 381.
[5] *Id.* at 385–86.
[6] *Id.* at 381 (citing *U.S. v. Whiting Pools, Inc.*, 462 U.S. 198, 205 (1983) ("[Property of the estate] is intended to include in the estate any property made available to the estate by other provisions of the Bankruptcy Code.")).
[7] *South Coast*, 91 F.4th at 382 (citing *In re Equinox Oil Co.*, 300 F.3d 614, 618 (5th Cir. 2002)).
[8] *South Coast*, 91 F.4th at 381.
[9] 11 U.S.C. § 541(a)(1).
[10] *Id.* § 541(a)(7).
[11] *Whiting Pools*, 462 U.S. at 205.
[12] *See South Coast*, 91 F.4th at 382 (citing *In re Kemp*, 52 F.3d 546, 550 (5th Cir. 1995)).
[13] *South Coast*, 91 F.4th at 382.
[14] *Id.* ("Preferences are a mechanism in the Bankruptcy Code by which additional property is made available to the estate, fitting squarely within the *Whiting Pools* definition.").
[15] *Id.* at 382–83 (citing *In re Simply Essentials, LLC*, 78 F.4th 1006, 1011 (8th Cir. 2023) ("Chapter 5 avoidance actions are property of the estate")).
[16] *Simply Essentials*, 78 F.4th at 1009 (emphasis added). The Fifth Circuit also endorsed the Ninth Circuit's reasoning that preferences are property of the estate which can be sold to maximize the value of the estate. *South Coast*, 91 F.4th at 383 (citing *In re Lahijani*, 325 B.R. 282, 288 (9th Cir. BAP 2005) ("While 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 or transferred.")). It is worth noting, however, that unlike the Fifth and Eighth Circuits, the Ninth Circuit did not expressly rule that avoidance actions are property of the estate under section 541(a)(1). Instead, the Ninth Circuit focused on the end-goal of maximizing value. *See Lahijani*, 325 B.R. at 288 ("[U]nder the law of the circuit, trustee avoiding powers may be transferred for a sum certain. . . . The benefit to the estate in such circumstances is the sale price, which might or might not include a portion of future recoveries for the estate.").

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[17] 11 U.S.C. § 552(a) ("[P]roperty acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.").
[18] *See, e.g.*, *In re McGuirk*, 414 B.R. 878, 879 (Bankr. N.D. Ga. 2009) ("A trustee's avoidance powers, including those under sections 547, 548 and 549 of the Bankruptcy Code, are unique statutory powers intended to benefit the estate, not a single creditor."); *see also Briar Capital v. Remmert*, 2022 WL 4137840, at *5 (collecting cases).
[19] *South Coast*, 91 F.4th at 385; *see also Simply Essentials*, 78 F.4th at 1009–10 (reasoning that the trustee's fiduciary duty to maximize the value of the estate may require the trustee to sell property, including an avoidance action, to a non-fiduciary).
[20] *South Coast*, 91 F.4th at 385.
[21] 11 U.S.C. § 1123(b)(3)(B) ("[A] plan *may* provide *for the retention* and enforcement by the debtor, the trustee, or by a representative of the estate appointed for such purpose, of any such claim or interest[.]") (emphasis added).
[22] *See South Coast*, 91 F.4th at 385 ("Section 1123(b)(3) states that a Chapter 11 bankruptcy plan *may* provide . . . .") (emphasis original).
[23] *See* 11 U.S.C. § 363(b)(1); *see also South Coast*, 91 F.4th at 385 (observing that section 363(b)(1) of the Bankruptcy Code permits a debtor to "use, sell, or lease, other than in the ordinary course of business, property of the estate" and requires only notice and a hearing).
[24] 11 U.S.C. §§ 1123(a)(5)(D) and 1123(b)(4).
[25] *South Coast*, 91 F.4th at 384.
[26] *Id.* at 383.
[27] In *McFarland v. Leyh (In re Tex. Gen. Petroleum Corp.)* ("***McFarland***"), 52 F.3d 1330, 1335 (5th Cir. 1995), the Fifth Circuit explained that the "primary concern" of the estate representative requirement under section 1123(b)(3)(B) of the Bankruptcy Code is "whether a successful recovery by the appointed representative would benefit the debtor's estate and particularly, the debtor's unsecured creditors." In *South Coast*, the preference sale arguably benefitted the debtor's estate more than the debtor's prosecution of the claim would have. The preference action was facially valued at $316,000, without accounting for the cost of prosecuting the claim to judgment and collecting on that judgment. Conversely, the parties' deal made possible the sale of intangibles to the DIP Lender that resulted in a sum certain of $700,000 cash to the estates, including $200,000 to fund administrative expenses and $500,000 to unsecured creditors. Thus, the sale of the preference claim advanced the principal policy underlying *McFarland* by guaranteeing cash exceeding the face value of the preference claim to unsecured creditors, even though the Fifth Circuit concluded that Briar Capital was not bound by section 1123(b)(3)(B) or *McFarland*.
[28] *See, e.g.*, *Wooley v. Haynes & Boone, L.L.P. (In re SI Restructuring Inc.)*, 714 F.3d 860, 864 (5th Cir. 2013) (quoting *Dynasty Oil & Gas, LLC v. Citizens Bank (In re United Operating, LLC)*, 540 F.3d 351, 355–56 (5th Cir. 2008) ("For a reservation to be effective, it 'must be specific and unequivocal'—blanket reservations of 'any and all claims' are insufficient.")); *National Benevolent Ass'n of the Christian Church (Disciples of Christ) v. Weil, Gotshal & Manges, LLP (In re National Benevolent Ass'n of the Christian Church (Disciples of Christ))*, 333 Fed. Appx. 822, 827 (5th Cir. June 11, 2009) (granting defendant law firm's motion to dismiss because plan did not "specifically and unambiguously reserve the claims" stemming from alleged prepetition attorney malpractice); *Dynasty Oil & Gas*, 540 F.3d at 355 (citing *Harstad v. First Am. Bank*, 39 F.3d 898, 902 (8th Cir. 1994) ("For a debtor to preserve a claim, 'the plan must expressly retain the right to pursue such actions[]' [and t]he reservation must be 'specific and unequivocal.'").
[29] *South Coast*, 91 F.4th at 384 (citing *Lahijani*, 325 B.R. at 288 ("The court's obligation in § 363(b) sales is to assure that optimal value is realized by the estate under the circumstances.")).

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