The Propriety of Monetizing Preference Claims: Another Circuit Court Weighs In

By Eric S. Chafetz & Brittany M. Clark, Lowenstein Sandler LLP

Abstract

This article explains the impact of a recent decision by the Fifth Circuit Court of Appeals on the monetization of preferences that were sold to a third party. This court is now the third circuit to allow the sale of a preference of an insider to a non-estate representative. The decision provides lawyers across the country with more case law to maximize value in a case with limited resources. This ruling, relying on monetizing instead of dismissing or abandoning the claims, will likely add to the practice and we will see third parties engage in the purchase and pursuit of preferences that would otherwise have been likely abandoned or not pursued by the debtor.

The recent decision by the Fifth Circuit Court of Appeals (the "Fifth Circuit" or the "Court") in *Matter of South Coast Supply Company*[1] adds to the growing list of circuit courts that have held that preference claims arising under Bankruptcy Code Section 547 can be sold and pursued by non-estate representative third parties. This trend, if it continues, could provide debtors, secured lenders, and creditors' committees increased flexibility to monetize potentially valuable claims that a bankruptcy estate could not otherwise pursue due to a lack of estate resources in the first instance. Additionally, it could allow them to quickly monetize the last few pending preference actions and be able to close a bankruptcy case and stop incurring ongoing administrative costs that would otherwise accrue if those claims would continue to be pursued. Nonetheless, this decision is a significant development because the Fifth Circuit includes Texas, one of the most popular venues for the filing of large Chapter 11 cases. While the decision could be narrowly construed, as the Fifth Circuit was careful to state that the issue needed to be decided on a case-by-case basis, here, in connection with the sale of a single insider[2] preference action, the holding will undoubtedly be relied upon by stakeholders across the country.

The Elements of a Preference Claim

A preference action is a type of "avoidance" action arising under Sections 547 and 550 of the Bankruptcy Code.[3] Avoidance actions are claims that allow a debtor, bankruptcy trustee, or other estate fiduciary, oftentimes after confirmation of a plan or in a Chapter 7 case, to "avoid" or unwind transfers, and then recover the transfers (or their value) so the recovered amounts can be redistributed to the debtor's creditors.

A preferential transfer, or a preference, is:

1. a transfer of a debtor's interest in property;
2. by an insolvent debtor, with there being a presumption of insolvency;
3. to, or for the benefit of, a creditor;
4. on account of a preexisting or antecedent debt (i.e., an invoice with credit terms);
5. made within 90 days before the bankruptcy filing date (or if the creditor is an insider, within one year of the filing); and
6. that allows the recipient of the preferential transfer to receive more than it would have otherwise received in a Chapter 7 liquidation.

See 11 U.S.C. § 547.

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[1] 91 F.4th 376 (5th Cir. 2024).

[2] While neither the Fifth Circuit nor the District Court (defined herein) opinion explicitly mention whether the Preference Claim (defined herein) was an insider claim, the plaintiff's (Briar Capital) complaint in the District Court and the confirmed Plan (defined herein) referred to the Preference Claim as an insider preference claim and relied on a one-year lookback period.

[3] While individual states have their own preference statutes, such statutes are beyond the scope of this article.

I. Factual Background and Procedural History

South Coast Supply Company (the "Company" or the "Debtor"), an industrial products distributor, began experiencing financial difficulties in 2016. In response, the Company's then chief financial officer, Robert Remmert ("Remmert"), extended an $800,000 loan to the Company that was memorialized in a loan agreement (the "Loan Agreement"). In accordance with the Loan Agreement, the Company made weekly payments to Remmert commencing on June 15, 2016, and repaid Remmert a total of $320,628.04 through 47 separate checks. However, the Company stopped making payments when Remmert resigned in October 2017.

Following his departure, Remmert sent a demand letter (the "Demand Letter") to the Company requesting payment of $405,261.87, which was less than the balance due under the Loan Agreement. On October 20, 2017 (the "Petition Date"), three days after the Demand Letter was sent, the Company filed for Chapter 11 relief in the Bankruptcy Court for the Southern District of Texas (the "Bankruptcy Court"). The Debtor's only secured creditor was Briar Capital Working Fund Capital LLC ("Briar Capital"), which asserted a secured claim exceeding $2.5 million, backed by property valued at nearly $4 million.

Approximately five months after the Petition Date, the Bankruptcy Court authorized the Debtor to obtain debtor-in-possession financing ("DIP Financing") from Solstice Capital, LLC ("Solstice"). Briar Capital was provided with adequate protection under the DIP Financing facility in the form of a first priority lien on all property acquired prior to the date the DIP Financing was first advanced, while Solstice was granted a first priority lien on all property acquired after the initial DIP Financing advancement date. Subsequently, on April 23, 2018, the Debtor filed a preference action under Section 547 of the Bankruptcy Code against Remmert seeking to recover the $320,628.04 he had received under the Loan Agreement within the one-year period prior to the Petition Date (the "Preference Action" or "Preference Claim").

Thereafter, on May 16, 2018, the Debtor filed a proposed plan of reorganization that provided for the sale of all of the Debtor's intangible assets, including intellectual property, to Solstice for $500,000. Solstice also agreed to pay up to $200,000 to satisfy administrative and priority claims. Under the plan, Briar Capital would have received certain of the Debtor's property in satisfaction of its secured claim, but no recovery on account of its administrative claim. General unsecured creditors would have also received $500,000. Briar Capital objected to confirmation of the plan, arguing that its claim was not treated in accordance with Section 507(b)[4] of the Bankruptcy Code.

[4] If the adequate protection granted to safeguard a secured creditor's collateral is deemed insufficient, Section 507(b) of the Bankruptcy Code provides a secured creditor with a superpriority claim ahead of all other administrative claims. *See* 11 U.S.C. § 507(b). Briar Capital argued that during the pendency of the bankruptcy, and according to the Debtor's own calculations, there was a decrease in the value of the Debtor's inventory and accounts receivable by approximately $446,000. Therefore, pursuant to a separate cash collateral order, Briar Capital asserted it was entitled to adequate protection for this decrease in value.

Thereafter, in response to Briar Capital's confirmation objection, on June 25, 2018, the Debtor filed a second plan of reorganization (the "Plan") that incorporated the same sale as the original plan and sought approval of a settlement (the "Settlement") reached between the Debtor and Briar Capital concerning the treatment of Briar Capital's claims. Among other things, the Settlement provided that Briar Capital would (i) release its security interest in $700,000 of the sale proceeds so these amounts could be distributed to unsecured creditors and administrative claimants, and (ii) waive its administrative claim. In return, Briar Capital would receive certain inventory and accounts receivable, including the proceeds thereof, and the Debtor's interest in the Preference Action.

Remmert objected to confirmation of the Plan, arguing that it should only provide for the Preference Action to be assigned to Briar Capital and not other potential claims against Remmert, including, but not limited to, claims for breach of fiduciary duty and fraudulent transfer. Over Remmert's objection, the Bankruptcy Court confirmed the Plan, which incorporated the Settlement including the sale of the Preference Action and other potential claims. The confirmation order explicitly addressed the assignment of all of the claims to Briar Capital. The order also permitted Briar Capital to prosecute the claims on the Debtor's behalf and retain any amounts recovered, even if those amounts exceeded the amount owed on account of its secured claim.

Over a span of three years, Briar Capital and Remmert engaged in litigation over the Preference Action, which commenced in the Bankruptcy Court as an adversary proceeding (the "Adversary Proceeding"). However, in August 2018, Remmert filed a motion to withdraw the reference of the Adversary Proceeding, prompting the Bankruptcy Court judge to issue a report and recommendation to the Southern District of Texas Houston Division (the "District Court") advising that withdrawal of the reference to the Bankruptcy Court was appropriate. Consequently, the case was reassigned to the District Court. Shortly before trial, Remmert filed a motion to dismiss the Preference Action pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure, arguing that Briar Capital lacked standing to pursue the Preference Claim. The District Court granted Remmert's motion to dismiss the Preference Action.

Due to the lack of Fifth Circuit precedent, the District Court relied on case law from certain bankruptcy courts and held that the sale of the Preference Action was impermissible and Briar Capital lacked standing to pursue the claim because a successful recovery would not benefit the Debtor's estate or unsecured creditors.[5] Consequently, the District Court dismissed the

[5] To address whether Briar Capital had standing to pursue the Preference Action, the District Court employed the *McFarland* test. The *McFarland* test provides that pursuant to Section 1123(b) of the Bankruptcy Code, "a party other than the debtor or the trustee that seeks to enforce a claim must show (1) that it has been appointed, and (2) that it is a representative of the estate." *McFarland v. Leyh (In re Tex. Gen. Petroleum Corp.),* 52 F.3d 1330, 1335 (5th Cir. 1995). The District Court concluded that Briar Capital lacked standing to pursue the Preference Action because a successful recovery by Briar Capital would not benefit the Debtor's estate or unsecured creditors, and the Plan explicitly allowed Briar Capital to retain any proceeds recovered from the claims. In essence, the District Court concluded it was impermissible for Briar Capital's recovery from Remmert to not benefit anyone but Briar Capital.

Preference Action due to lack of subject matter jurisdiction and Briar Capital appealed to the Fifth Circuit.

II. The Fifth Circuit's Decision

Addressing a novel issue for the Fifth Circuit, the Court held that (i) preference claims arising under Section 547 of the Bankruptcy Code are property of the estate that may be sold, and (ii) a plaintiff does not need to be a "representative of the estate" to have standing to pursue a validly purchased preference claim.

Preference Actions Are Property of the Estate

The Fifth Circuit concluded that preference actions are property of the estate based on a plain reading of the Bankruptcy Code.

First, the Court determined that preference claims fall under the expansive definition of property of the estate in Section 541(a)(1) of the Bankruptcy Code, and as applied by the Supreme Court in *United States v. Whiting Pools, Incorporated*.[6] The Fifth Circuit reasoned that preference claims constitute estate property because they represent a right of action established by federal bankruptcy law to avoid and recover the transfer of property of the estate. Therefore, the Court concluded that preference actions squarely fall within the plain statutory definition of property of the estate and may be sold under Section 363(b) of the Bankruptcy Code.

Second, the Court also concluded that preference actions constitute property of the estate under Section 541(a)(7) of the Bankruptcy Code, which provides that estate property includes "any interest in property that the estate acquires after the commencement of the estate." The Fifth Circuit agreed with Briar Capital's argument that a right of action that accrues post-petition is estate property if it (i) is created with or by property of the estate or (ii) arises out of property that is already part of the estate. Relying on legislative intent, the Fifth Circuit observed that Congress enacted Section 541(a)(7) to clarify that Section 541 is an "all-embracing" definition and to ensure that property interests created from estate property are themselves considered estate property.

In further support of its conclusion, the Court relied on decisions from the Eighth Circuit[7] and Ninth Circuit's Bankruptcy Appellate Panel (the "Ninth Circuit B.A.P."),[8] which had previously held that avoidance actions are property of the estate that can be sold. In *Simply Essentials*, the

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6 462 U.S. 198, 205 (1983).

7 *In re Simply Essentials, LLC*, 78 F.4th 1006, 1011 (8th Cir. 2023).

8 *In re Lahijani*, 325 B.R. 282, 288 (B.A.P. 9th Cir. 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.") (citing *In re P.R.T.C., Inc.*, 177 F.3d 774, 781 (9th Cir. 1999); *In re Prof'l Inv. Props. of Am.*, 955 F.2d 623, 625–26 (9th Cir. 1992)).

estate had insufficient funds to pursue avoidance actions against certain creditors, which resulted in the debtor seeking to sell avoidance actions to a non-estate representative under Section 363(f) of the Bankruptcy Code. A creditor objected to the sale, contending that avoidance actions are not estate property that can be sold under Section 541(a) of the Bankruptcy Code. The United States Bankruptcy Court for the Northern District of Iowa approved the sale over the creditor's objection, and the creditor appealed. The Eighth Circuit affirmed the bankruptcy court's decision, citing the Supreme Court's decision in *Whiting Pools*, and emphasizing that a debtor's lack of possessory interest of property prior to the petition date does not negate the property's inclusion in the estate.

In its analysis, the Eighth Circuit explained that due to the debtor's right to (i) file for bankruptcy and (ii) file avoidance actions to recover property, the debtor had an inchoate interest in avoidance actions prior to the petition date. Furthermore, the court observed that even if the debtor lacked a prepetition interest in avoidance actions, such actions would still be property of the estate under Section 541(a)(7) of the Bankruptcy Code, which encompasses any property interest acquired post-petition by the estate. The Fifth Circuit concurred with the Eighth Circuit's rationale and noted that its own precedent also required a broad reading of Section 541(a)(7) of the Bankruptcy Code. Thus, the Fifth Circuit concluded that the Preference Action indeed falls within the scope of property of the estate as outlined in Sections 541(a)(1) and 541(a)(7) of the Bankruptcy Code.

In *Lahijani*, the Ninth Circuit B.A.P. addressed whether the United States Bankruptcy Court for the Central District of California applied the correct legal standard when approving a Section 363 sale of causes of action to a defendant for a sum certain over the objection by a creditor in the case, who wanted to pursue the causes of action. The Ninth Circuit B.A.P. held that avoidance actions (i) are property of the estate under Sections 541(a)(1) and 541(a)(3) of the Bankruptcy Code, and (ii) therefore may be sold under Section 363 of the Bankruptcy Code. The appellate panel rejected the creditor's argument that the estate did not receive a benefit where there was no carve-out of future recoveries preserved for the estate. The Ninth Circuit B.A.P. also adopted a broad view of what benefits the estate, finding that the sale price for the avoidance actions alone constituted a benefit to the estate irrespective of whether future recoveries would inure to the benefit of the estate. Citing to *Lahijani*, the Fifth Circuit embraced the Ninth Circuit B.A.P.'s expansive view of what benefits the estate, concluding that the principle of maximizing the estate applies even in cases where a creditor, like Briar Capital, pursues a claim solely for their own benefit.

The Fifth Circuit rejected Remmert's contentions that selling a preference action would (i) breach a debtor's fiduciary duty and (ii) undermine the intent of avoidance actions. The Fifth Circuit focused on how courts take a broad view about what benefits the estate. Again, relying on the Ninth Circuit B.A.P.'s decision in *Lahijani*, the Fifth Circuit emphasized that the Debtor was obligated to maximize the estate's value, which in certain instances can require the sale of a preference claim. Based on this broad interpretation, the Court determined that Briar Capital's purchase of the Preference Action was appropriate where it was waiving the right to recover on account of its administrative expense claim and its security interest in $700,000 of sale proceeds. These concrete and definitive benefits to the estate far outweighed the fact that the estate would not be receiving a percentage of recoveries from the Preference Action. In addition, the Fifth Circuit rejected Remmert's argument that the sale of the Preference Action was inappropriate because Briar Capital would potentially recover more than the amount of its claim as the Preference Action and other potential claims were being pursued solely for its own benefit. The Court observed that, to the contrary, the sale of preference claims should be addressed on a case-by-case basis. And, depending on the facts presented to the Court—here, a hypothetical estate that did not have sufficient funds to pursue preference claims—approval of a sale could result in more flexibility in asset distribution, maximize the value of the estate, and allow for a more equitable asset distribution.

A Debtor's Authority to Sell Preference Actions

Overruling the District Court, the Fifth Circuit also held that the purchaser of a preference claim does not have to be an estate fiduciary or representative of the estate in order to pursue the claim. The District Court previously held that Briar Capital lacked standing because (i) preference claims could not be sold and (ii) Section 1123(b)(3)(B) of the Bankruptcy Code mandates that only an estate representative can pursue claims belonging to the estate.

As discussed above, the Court held that preference actions can be sold under Section 363(b) of the Bankruptcy Code. In overruling Remmert's argument that the "representative of the estate" requirement is dispositive, the Fifth Circuit held that purchasers of such actions have standing to pursue the actions, regardless of whether they are estate representatives. The Fifth Circuit reasoned that while Section 1123(b) of the Bankruptcy Code *may* empower an estate representative to pursue estate claims, there are other Bankruptcy Code provisions that allow non-estate representatives to purchase and liquidate estate assets, including causes of action. For example, Section 363 of the Bankruptcy Code, governing the sale of estate property, after notice and a hearing, does not require the purchaser to be a representative of the estate, and the purchaser is oftentimes not such a representative.

Conclusion

The Fifth Circuit, following the lead of the Eighth and Ninth Circuits, is now the third circuit to allow the sale to, and subsequent pursuit of a preference claim by, a non-estate representative. However, the Fifth Circuit appears to have been very intentional in grounding its decision in the specific facts and circumstances of the case and limiting its holding to the sale of the single Preference Claim arising under Section 547 of the Bankruptcy Code against an insider. Therefore, it is unclear whether the Court would have reached the same result if the Preference Claim were against a trade creditor and not an insider (here, the Debtor's former CFO), or if the Debtor were seeking to sell multiple preference claims instead of one, and whether the same reasoning would apply to the proposed sale of a turnover claim under Bankruptcy Code Section 541, a fraudulent transfer claim under Bankruptcy Code Section 548, or a claim for an improper post-petition transfer under Bankruptcy Code Section 549, among other potential estate claims and causes of action.

However, despite the unanswered questions, this decision provides lawyers and other restructuring professionals practicing in the Fifth Circuit, and across the country, with another tool to maximize value in cases where there are limited resources, apart from valuable preference claims arising under Bankruptcy Code Section 547. At a minimum, an undercapitalized debtor or a post-confirmation trust established to pursue causes of action—including preference claims under Bankruptcy Code Section 547—now have additional precedent to rely upon to monetize, instead of dismissing or abandoning, the claims.[9] This flexibility could allow for more timely closure of bankruptcy cases and a reduction of administrative costs, including the payment of United States Trustee fees. While other circuit courts may still weigh in on this issue, until they do, due to the Fifth Circuit's decision, stakeholders have a bit more certainty than they did before: that at least preference claims arising under Bankruptcy Code Section 547 can be sold to, and pursued by, non-estate representative third parties.

About the authors

Eric Chafetz is a trusted advisor to creditors' committees and individual trade creditors, debtors, and plan/liquidating trustees involved in complex Chapter 11 bankruptcies throughout the United States.

He advises clients across a wide range of industries on all aspects of the Chapter 11 process, from pre-filing negotiation and preparation of first day pleadings, including financing and sale documents; through the drafting and negotiation of plans of reorganization and all related ancillary documentation.

Eric also has a strong track record in bankruptcy-related litigation, including investigating and prosecuting actions against officers, directors, and lenders, as well as in prosecuting and defending preference/fraudulent transfer actions.

Eric is a frequent speaker on current bankruptcy and creditors' rights topics, including previously serving as a guest lecturer at the Columbia University School of Professional Studies, where he has lectured on such subjects as the intersection of bankruptcy and construction law. He participated in the American Bankruptcy Institute (ABI) Commission's Avoidance Power Subcommittee's study of aspects of the Bankruptcy Code involving preferences, creditors' reclamation rights, and creditors' rights under Section 503(b)(9). Eric is also a prolific author, and has published numerous articles addressing various cutting-edge issues geared toward trade and other categories of creditors, including publications by the National Association of Credit Management and Credit Research Foundation, as well as the ABI, *New York Law Journal*,

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[9] Due to the case-by-case analysis stressed by the Fifth Circuit, a debtor or other estate fiduciary may want to provide evidence that such sale would provide a greater benefit to the estate than retaining contingency counsel or litigation financing to pursue the same claim.

and *Bloomberg Law*.

Active in the firm's pro bono efforts, Eric has represented several individuals who filed for Chapter 7 bankruptcy protection and numerous non-profits seeking to dissolve.

Education
- Brooklyn Law School (J.D. 2004), cum laude
- University of Michigan (B.A. 2000)

Admissions
- New York
- New Jersey

Brittany Clark supports teams representing creditors' committees, individual creditors, debtors, liquidating trustees, and other interested parties in complex Chapter 11 cases and related adversarial proceedings.

Recent creditors' committee cases in which Brittany has been involved include Nogin, Inc., Williams Industrial Services Group, NBG Home, Pegasus Home Fashions, Benefytt Technologies, Inc., Tuesday Morning Corporation, and Vital Pharmaceuticals, Inc. (dba Bang Energy). She has also assisted in the representation of tort claimant committees in the Diocese of Camden and Roman Catholic Bishop of Oakland bankruptcy cases.

A former Lowenstein Summer Associate, Brittany previously interned for the Hon. Alan S. Trust, Chief Bankruptcy Judge in the U.S. Bankruptcy Court in the Eastern District of New York.

Brittany's other noteworthy experience includes her work as a New York City Bar Diversity Fellow and law clerk at Citizens Financial Group, where she assisted in drafting proxy statements and made recommendations to the shareholder relationship committee on supermajority voting requirements, exclusive forums, and boardroom diversity.

While pursuing her J.D., Brittany was a member of her law school's Bankruptcy Advocacy Clinic, where she supported indigent clients filing Chapter 7 and Chapter 13 petitions.

Education
- St. John's University School of Law (J.D. 2022); executive affairs editor, *American Bankruptcy Institute Law Review*; president, Asian Pacific American Law Students Association
- Fordham University (M.S.T. 2017), summa cum laude
- Gonzaga University (B.A. 2015), magna cum laude

Admissions
- New York