KB Toys: Hobgoblins Return to Haunt Bankruptcy Claims Traders

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Participants in the multibillion-dollar market for distressed claims and securities have had ample reason to keep a watchful eye on developments in the bankruptcy courts during the last decade. That vigil appeared to have been over five years ago, after a federal district court ruled in the Enron chapter 11 cases that sold claims are generally not subject to equitable subordination or disallowance on the basis of the seller's misconduct or receipt of a voidable transfer. A ruling recently handed down by a Delaware bankruptcy court, however, has reignited the debate. In *In re KB Toys, Inc.*, 470 B.R. 331 (Bankr. D. Del. 2012), the court, rejecting as unworkable any distinction between a sale and an assignment of a claim, held that several transferred trade claims should be disallowed under section 502(d) of the Bankruptcy Code because the transferors received voidable preferences. As expected, the ruling was appealed immediately.

Allowance and Disallowance of Claims in Bankruptcy

Section 502 of the Bankruptcy Code sets forth procedures governing the allowance or disallowance of a "claim or interest" in a bankruptcy case. Section 502(a) provides that a claim or interest, proof of which is filed with the court, "is deemed allowed," unless a party in interest objects. Under section 502(b), the bankruptcy court is obligated to resolve any objection in accordance with delineated criteria by ruling to allow or disallow the claim (in whole or in part). Section 502(c) directs the court in certain circumstances to estimate for the purpose of allowance certain contingent or unliquidated claims and any right to payment arising from an equitable remedy for breach of performance.

Section 502(d) creates a mechanism to deal with creditors who have possession of estate property on the bankruptcy petition date or are the recipients of pre- or postbankruptcy asset transfers that can be avoided because they are fraudulent, preferential, unauthorized, or otherwise subject to forfeiture by operation of a bankruptcy trustee's avoidance powers. Section 502(d) provides as follows:

> Notwithstanding subsections (a) and (b) of this section, the court shall disallow *any claim of any entity* from which property is recoverable under section 542, 543, 550, or 553 of this title or that is a transferee of a transfer avoidable under section 522(f), 522(h), 544, 545, 547, 548, 549, or 724(a) of this title, unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable under section 522(i), 542, 543, 550, or 553 of this title. (Emphasis added.)

As noted by the Fifth Circuit Court of Appeals in *In re Davis*, 889 F.2d 658 (5th Cir. 1989), "The legislative history and policy behind Section 502(d) illustrates that the section is intended to have the coercive effect of insuring compliance with judicial orders." Similarly, 5 COLLIER ON BANKRUPTCY ¶ 502.05[2][a], at pp. 502–58 (16th ed. 2012), explains that the purpose of the provision is "to promote the pro-rata sharing of the bankruptcy estate among all creditors and the coercion of the payment of judgments obtained by the trustee."

Claims Trading

The market for "distressed" debt is thriving and largely unregulated. The market has grown so much in size and scope that claims trading has become commonplace in nearly every major chapter 11 case. Sophisticated players in the market are aware of most of the risks associated with acquiring discounted debt but generally focus on the enforceability of the obligation in question and its probable payout or value in terms of bargaining leverage. These risks can often be assessed with reasonable accuracy by examining the underlying documentation, applicable nonbankruptcy law, the obligor's financial condition, and its prospects for satisfying its obligations in whole or in part. Other types of risk may be harder to quantify. For this reason, most claim-transfer agreements include a blanket indemnification clause designed to compensate the transferee if a traded claim proves to be unenforceable in whole or in part.

That eventuality, in addition to other risks associated with claims trading, has been brought into sharper focus during the last decade due to a series of controversial court rulings. Some of these decisions address the disallowance of a traded claim under section 502(d) because the original holder of the claim was the recipient of a voidable transfer. At issue in rulings construing the provision is the meaning of the phrase "any claim of any entity."

The Story Thus Far

Although its precursors were lurking in the background, the bankruptcy claims-trading debate with respect to section 502(d) began in earnest during 2005 and 2006, after controversial rulings by the bankruptcy court overseeing the chapter 11 cases of failed energy broker Enron Corporation and its affiliates had traders scrambling for cover due to the potential for acquired claims to be equitably subordinated or disallowed on the basis of the seller's misconduct. *See Enron Corp. v. Springfield Associates, L.L.C. (In re Enron Corp.)*, 2005 WL 3873893 (Bankr. S.D.N.Y. Nov. 28, 2005); *Enron Corp. v. Avenue Special Situations Fund II, LP (In re Enron Corp.)*, 340 B.R. 180 (Bankr. S.D.N.Y. 2006) (collectively, "*Enron I*"). The decisions had players in the distressed-securities market rushing to limit their exposure by building stronger indemnification clauses into claims-transfer agreements.

The rulings' "buyer beware" approach, moreover, was greeted by a storm of criticism from lenders and traders alike, including the Loan Syndications and Trading Association; the Securities Industry Association; the International Swaps and Derivatives Association, Inc.; and the Bond Market Association. According to these groups, if *caveat emptor* is the prevailing rule of law, claims held by a bona fide purchaser can be equitably subordinated even though it may be impossible for the acquiror to know, despite having conducted rigorous due diligence, that it was buying loans from a "bad actor."

Although it garnered the most attention, *Enron I* was not the first decision to address the disallowance of assigned claims under section 502(d) of the Bankruptcy Code or its predecessor. The Eighth Circuit Court of Appeals confronted the issue more than a century ago in *Swarts v. Siegel*, 117 F. 13 (8th Cir. 1902), disallowing an assigned claim under section 57g of the Bankruptcy Act of 1898 because the original holder had received a preference, and remarking that "[t]he disqualification of a claim for allowance created by a preference inheres in and follows every part of the claim, whether retained by the original creditor or transferred to another, until the preference is surrendered."

More recently, a New York bankruptcy court reached the same conclusion under the current statute in *In re Metiom, Inc.*, 301 B.R. 634 (Bankr. S.D.N.Y. 2003), characterizing the attempted destruction of a section 502(d) claim defense by means of assignment of the claim as "a pernicious result" and observing that "[t]he assignment should not, and does not, affect the debtor's rights vis a vis the claim; it is incumbent, instead, on prospective assignees to take into account possible claim defenses when they negotiate the terms of their assignments."

The defendants in *Enron I* had relied on an unpublished opinion issued by a Texas district court in *Section 1102(A)(1) Comm. of Unsecured Creditors v. Williams Patterson, Inc. (In re Wood & Locker, Inc.)*, 1988 U.S. Dist. LEXIS 19501 (D. Tex. 1988), as support for the proposition that a claim in the hands of a transferee can be disallowed only if the transferee is subject to avoidance liability. In that case, the creditors' committee commenced preference litigation against a creditor who had assigned its claim to a bank. The bank was permitted to intervene in the avoidance action and later commenced a separate adversary proceeding seeking a declaratory judgment that it was not subject to preference liability under sections 547 and 550, and that its assigned claim could not be disallowed under section 502(d), and thus it was entitled to receive distributions under the debtor's chapter 11 plan. The bankruptcy court granted summary judgment in the bank's favor on these issues.

On appeal, the district court explained that, under the former Bankruptcy Act, a creditor had the option of: (i) retaining a preference and forgoing any distribution from the estate; or (ii) seeking recovery from the estate by filing a proof of claim. The trustee could "bring[] the creditor within the bankruptcy court's summary jurisdiction" and invoke section 57g as a defense only in the latter case. "Such is not the case under the modern Code," the district court observed, emphasizing that "the analytical tool to unlock the mysteries of Sec. 502(d) is to examine the enumerated sections to determine whether the transferee has liability. Where there is no liability under those sections, Sec. 502(d) is not triggered."

The severity of the cautionary tale writ large in the bankruptcy court's *Enron* decisions was ultimately ameliorated on appeal in 2007. District judge Shira A. Scheindlin vacated *Enron I* in *Enron Corp. v. Springfield Associates, L.L.C. (In re Enron Corp.)*, 379 B.R. 425 (S.D.N.Y. 2007) ("*Enron II*"), holding that "equitable subordination under section 510(c) and disallowance under section 502(d) [of the Bankruptcy Code] are personal disabilities that are not fixed as of the petition date and do not inhere in the claim." The key determination, she explained, is whether the claim transfer is in the form of an outright sale or merely an assignment. If a claimant purchases its claim, as opposed to taking it by assignment, operation of law, or subrogation, Judge Scheindlin explained, "assignment law principles have no application with respect to personal disabilities of claimants . . . [and] purchasers are protected from being subject to the personal disabilities of their sellers." This distinction, she observed, is "particularly imperative" in the distressed-debt market, where sellers are frequently anonymous and buyers have no way of knowing whether the seller (or any preceding transferee) has engaged in misconduct or received an avoidable transfer. According to Judge Scheindlin, it is unclear how such "unknowable risk" could be priced by the market. By contrast, she explained, parties to true assignments can readily contract around the risk of subordination or disallowance by means of indemnification clauses drafted to protect the assignee. Despite Judge Scheindlin's holding, the ordeal (and the uncertainty it spawned) left a bad taste in the mouths of market participants.

The next significant development in the bankruptcy claims-trading saga was the subject of a ruling handed down by the Second Circuit Court of Appeals in September 2009. Addressing the matter before it as an issue of first impression, the court held in *ASM Capital, LP v. Ames Department Stores, Inc. (In re Ames Dept. Stores, Inc.)*, 582 F.3d 422 (2d Cir. 2009), that section

502(d) does not mandate disallowance, either temporarily or otherwise, of administrative claims acquired from entities that allegedly received voidable transfers.

Although the ruling was a positive development for claims traders, the Second Circuit skirted the $64,000 question on claim transfers; in view of its conclusion, the court stated that:

> we find it unnecessary to reach [the claim purchaser's] alternative argument that, even if section 502(d) did extend to administrative expenses under section 503(b), it could be invoked only against the recipient of the alleged preferential transfer and not against a subsequent holder of a claim that originated with the alleged transferee.

Thus, traders were left to speculate whether the Second Circuit, like the district court in *Enron II*, would have drawn any distinction between assigned and purchased claims in this context.

The latest salvo in the bankruptcy claims-trading fireworks in the context of section 502(d) was discharged by the Delaware bankruptcy court in *KB Toys*.

KB Toys

KB Toys, Inc., and various related entities (collectively, the "Debtors") sought chapter 11 protection in January 2004 in Delaware. On August 18, 2005, the bankruptcy court confirmed a liquidating chapter 11 plan for the Debtors. Among other things, the plan established the "KBTI Trust" for the purpose of realizing the value of the Debtors' assets, including causes of action, for the benefit of creditors. The trustee commenced litigation against certain trade creditors between 2006 and 2008, seeking to avoid as preferential transfers various payments made by the Debtors during the 90 days prior to their chapter 11 filings.

Nine of those preference recipients (the “Original Holders”) sold their claims (the “Sold Claims”) postpetition to ASM Capital, LP, and ASM Capital II, LLP (collectively, “ASM”). ASM purchased some of the claims prior to confirmation of the Debtors’ plan, acquiring others after confirmation. Some of the “assignment agreements” contained indemnification clauses, while others did not.

The court entered default or summary judgments against all of the Original Holders in the preference actions. Except for one claim that it acquired after the trustee obtained a default judgment, ASM purchased all of the claims from the Original Holders before the trustee commenced the preference litigation. The trustee sought an order disallowing the Sold Claims pursuant to section 502(d).

The Bankruptcy Court’s Ruling

Bankruptcy judge Kevin J. Carey sustained the trustee’s objections to the Sold Claims. The judge squarely framed the issue before him as “whether the purchaser of a trade claim holds the purchased claim subject to the same rights and disabilities, and is subject to Bankruptcy Code § 502(d) challenge, as is the original holder of the claim.” More specifically, he explained, at issue is the meaning of the phrase “any claim of any entity” in section 502(d).

According to the trustee, because the provision states “claim” rather than “claimant,” section 502(d) should be interpreted to mean that “a disability accompanies the claim through its journey into the hands of others.” In accordance with *Enron II*, the trustee argued, the claims transferred to ASM were *assignments* and should therefore be disallowed. The trustee also contended that because KB Toys’ chapter 11 filings gave ASM constructive, if not actual, knowledge of the preferential transfers to the Original Holders, such knowledge was evidence that ASM did not purchase the Sold Claims in good faith, and the Sold Claims should therefore be disallowed.

ASM countered that "any claim of any entity" means only the "claimant," such that any disability "rests with the original claimant." According to *Enron II*, ASM argued, the Sold Claims should not be disallowed because the claims were transferred by means of *sales* rather than *assignments*. ASM argued that the parties' intention to "sell" the claims outweighed the fact that each of the transfer documents was entitled an "Assignment Agreement" and referred to the parties as "assignor" and "assignee." Although "assignment" and "sale" are often used interchangeably in claim-transfer agreements, ASM contended, claim transfers are always "sales."

Acknowledging that there is a disagreement as to the meaning of section 502(d), Judge Carey ruled in favor of ASM, observing that:

> I agree with the analysis and conclusions of the courts in *Metiom* and *Enron I* . . . : the plain language, legislative history, and decisional law support the view that a claim in the hands of a transferee has the same rights and disabilities as the claim had in the hands of the original claimant. Disabilities attach to and travel with the claim.

The judge examined the legislative provenance of section 502(d), explaining that the provision's predecessor—section 57g of the Bankruptcy Act—required disallowance of a particular "claim," indicating that "disabilities travel with claims." He also examined relevant case law, including *Swarts*; subsequent decisions holding that a claim assignee stands in the shoes of, and is subject to the same defenses that can be raised against, an assignor; *Metiom*; *Enron I*; and *Enron II*.

In determining whether a traded claim is subject to disallowance under section 502(d), Judge Carey distanced his ruling from the district court's rationale in *Enron II* that distinguished between sales and assignments. "The terms 'assignment' and 'sale' are not easily distinguishable," he wrote, and although the Bankruptcy Code defines neither term, the definition of "transfer" in section 101(54)(D) arguably includes both assignments and sales. Moreover, Judge Carey emphasized, "In this context, use of any distinction between the two terms has been widely criticized."

Judge Carey also took issue with the *Enron II* court's determination that burdening the transferee of a claim with a disability imposed on a claim by the transferor would disrupt the distressed-debt markets:

> Buyers of debt, in the Court's experience, are highly sophisticated entities fully capable of performing due diligence before any acquisition. However, even without *any* due diligence, today's claim purchasers are aware of the ever-present possibility of avoidance actions based on preference liability or fraudulent conveyances. Under the circumstances now before me, the assertion that subjecting transferred claims to § 502(d) disallowance would cause disruption in the claims trading market is a hobgoblin without a house to haunt.

According to Judge Carey, in their chapter 11 schedules and statements, the Debtors put ASM and all other potential buyers of trade claims on constructive, if not actual, notice of potential avoidance claims against the Original Holders. ASM, he wrote, "could have discovered the potential for disallowance with very little due diligence and factored the potential for disallowance into the price it paid for the trade claims." The fact that ASM used indemnity clauses in some of the assignment contracts, the judge explained, indicated that ASM "had sufficient understanding and leverage to negotiate for such provisions," and in cases where it elected not to do so, "ASM may have other remedies or chose to bear the risk." According to Judge Carey, allowing claims under these circumstances—in other words, evading a section

502(d) challenge—would make the estate the claim purchaser's insurer, "providing the claim purchaser and the seller with a benefit for which neither paid."

Finally, Judge Carey rejected ASM's argument that the Sold Claims should not be disallowed because ASM purchased the claims in "good faith," and section 502(d) expressly incorporates the good-faith-purchaser defense set forth in section 550(b) of the Bankruptcy Code. In doing so, he agreed with the court's reasoning in *Enron I*, remarking that:

> A purchaser of claims in a bankruptcy is well aware (or should be aware) that it is entering an arena in which claims are allowed and disallowed in accordance with the provisions of the Bankruptcy Code and the decisional law interpreting those provisions. Under such conditions, a claims purchaser is not entitled to the protections of a good faith purchaser.

Outlook

The partial sigh of relief collectively exhaled by claims traders in the wake of the district court's ruling in *Enron II* has now been supplanted by the same sort of chagrin with which traders greeted *Enron I*. Even so, the story is far from over. ASM immediately appealed the ruling in *KB Toys*, so we can expect the Delaware district court to weigh in on the issue in the relatively near future. In the meantime, one unhappy ramification of *KB Toys* for traders is that courts in New York and Delaware now have different rules regarding the application of section 502(d) to traded claims. What impact the competing regimes will have on bankruptcy claims trading in those venues remains to be seen. To be sure, however, traders will likely pay greater attention to the indemnity provisions in claim-transfer agreements in an effort to limit their exposure.

Notably, the *KB Toys* court was careful to limit its ruling to "trade claims." In a footnote, Judge Carey wrote:

> The claims before me in this matter are trade claims purchased from the original holders of such claims. I make no determination about whether the same result should ensue in circumstances involving other types of transferred claims. It seems that the drafters of the Bankruptcy Rules also recognized when public markets might be affected. For example, publicly traded note, bond and debenture claims are excluded from the disclosure requirements of Fed. R. Bankr. P. 3001(e), presumably to facilitate trading of public securities.

The viability of the *KB Toys* approach in cases involving securities or claims other than trade claims is not clear. In dicta, the court in *Enron I* suggested that the same rule should apply to transferred claims based upon bonds or notes because "the post-petition purchaser of such debt instruments either knows or should know that the issuer of these securities is a debtor, so the prices of these transfers would reflect the attendant risks that the claims [might be disallowed]." Even so, the court did not hazard an opinion on whether a different rule would apply if a note or bond is traded before the debtor files for bankruptcy, when the purchaser has less reason to be aware of anything other than the possibility that the obligor may file a bankruptcy case.

Rulings addressing section 502(d) were not the only notable developments of interest to claims traders during the recent past. For example, in *In re M. Fabrikant & Sons, Inc.*, 385 B.R. 87 (Bankr. S.D.N.Y. 2008), a New York bankruptcy court took a hard look for the first time at the standard transfer forms and definitions contained in nearly every bank-loan transfer agreement, ruling that a seller's reimbursement rights were transferred along with the debt. The ruling indicated that the rights assigned to a buyer using the standard transfer forms are broad and include contingent (and even postpetition) claims. The decision also fortified the conventional wisdom that transfer documents should be drafted carefully to spell out explicitly which rights, claims, and interests are not included in the sale.

In *B-Line, LLC v. Wingerter (In re Wingerter)*, 594 F.3d 931 (6th Cir. 2010), the Sixth Circuit reversed lower-court rulings sanctioning a company engaged in the business of buying and selling consumer bankruptcy claims for failing to make "a reasonable pre-filing inquiry" to ascertain whether an acquired claim was bona fide. Had the Sixth Circuit ruled otherwise, claims traders (principally in consumer cases) faced the unwelcome prospect of increased costs associated with ensuring that each proof of claim is supported by actual documentation, rather than information more easily accessible from electronic databases, and an inability to rely on industry-standard warranties of a claim's validity by intermediate sellers.