In Brief: Claims-Trading Hobgoblins Redux?

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In the July/August 2012 edition of the *Business Restructuring Review*, we reported on a Delaware bankruptcy-court ruling that reignited the debate concerning whether sold or assigned claims can be subject to disallowance under section 502(d) of the Bankruptcy Code on the basis of the seller's receipt of a voidable transfer. In *In re KB Toys, Inc.*, 470 B.R. 331 (Bankr. D. Del. 2012), the court rejected as unworkable the distinction between a sale and an assignment of a claim for purposes of disallowance that was drawn by the district court in *Enron Corp. v. Springfield Associates, L.L.C. (In re Enron Corp.)*, 379 B.R. 425 (S.D.N.Y. 2007) ("*Enron II*"), *vacating Enron Corp. v. Springfield Associates, L.L.C. (In re Enron Corp.)*, 2005 WL 3873893 (Bankr. S.D.N.Y. Nov. 28, 2005), and *Enron Corp. v. Avenue Special Situations Fund II, LP (In re Enron Corp.)*, 340 B.R. 180 (Bankr. S.D.N.Y. 2006).

In *KB Toys*, the bankruptcy court ruled that several transferred-trade claims should be disallowed under section 502(d) because the transferors had received voidable preferences. According to the court, "[T]he 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 court also wrote that "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." As expected, the ruling was appealed immediately. Oral arguments before the Delaware district court are scheduled for January 2013.

On September 14, 2012, the Second Circuit Court of Appeals handed down an unpublished ruling that might have addressed the claims-trading section 502(d) controversy head on but did not. In *Longacre Master Fund, Ltd. v. ATS Automation Tooling Systems Inc.*, 2012 WL 4040176 (2d Cir. Sept. 14, 2012), the court vacated a decision declining to enforce a repurchase obligation in a claims-assignment agreement triggered by the debtor's objection to the traded claim under section 502(d).

The "Assignment of Claim" (the "agreement") provided that the assignor would be obligated to "repurchase" the claim if the claim was "impaired." "Impairment" was defined to occur when "all or any part of the Claim is . . . objected to . . . for any reason whatsoever, pursuant to an order of the Bankruptcy Court" and the objection is not resolved within 180 days. The assignor also warranted in the agreement that "to the best of [the assignor's] knowledge, the Claim is not subject to any defense, claim or right of setoff, reduction, impairment, avoidance, disallowance, subordination or preference action."

The debtor filed an omnibus objection to the traded claim (among others) under section 502(d) shortly before the court-imposed deadline for doing so expired, for the purpose of preserving its ability to prosecute preference actions associated with the claims. The assignor and the debtor ultimately settled the preference litigation, which the court later dismissed with prejudice, and the debtor withdrew its objection to the claim—13 months after the objection was filed.

The assignee of the claim sued to enforce the repurchase provisions in the agreement. According to the assignee, the assignor's failure to resolve the objection fully within 180 days triggered the obligation under the agreement that the assignor refund the purchase amount, with interest, pending resolution of the objection. The assignee acknowledged that it later would have had to return the refunded purchase amount once the objection was resolved. Even so, the assignee sought recovery of the interest due on that amount from the date of the agreement to the date the claim was fully resolved.

A federal district court (the litigation having been removed from state court) ruled against the assignee in August 2011, reasoning that the debtor's objection under section 502(d) did not amount to "impairment" under the agreement because it merely preserved the debtor's right to object, rather than being "substantive." Moreover, the district court wrote, "because the Agreement [e]ffected a sale and not a pure assignment of the Claim, for the reasons stated in [*Enron II*], no section 502(d) objection (even if one were to have been made) would have constituted an Impairment in the first instance." The court also determined that the assignor had not breached its representations and warranties regarding the absence of potential preference actions because it had no knowledge of such actions.

The Second Circuit vacated the judgment, ruling that "nothing in the language of [the agreement] requires that the objection be meritorious" to constitute impairment triggering the repurchase obligation. The court also faulted the district court's decision regarding the absence of any breach of warranty, finding that a disputed material issue of fact existed as to the assignor's knowledge of a possible preference action and related objection.

The Second Circuit briefly discussed whether the agreement constituted a sale rather than an assignment. However, it did not rule on this issue, nor did it address the district court's observations regarding *Enron II* and the purported protection from disallowance under section 502(d) of claims that have been sold rather than assigned. Still, although *Longacre* skirts this issue, the ruling should reassure the claims-trading market and reduce uncertainty regarding the enforceability of common risk-allocation provisions in claims-assignment agreements.