

## **In Brief: Claims Trader Alert**

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Mark G. Douglas

A ruling handed down by the Third Circuit Court of Appeals on November 15, 2013, adds yet another chapter to the ongoing controversy 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. The decision—*In re KB Toys Inc.*, 2013 WL 6038248 (3d Cir. Nov. 15, 2013)—is an unwelcome missive for claims traders. For the first time since the enactment of the Bankruptcy Code in 1978, a circuit court of appeals has concluded that:

because § 502(d) permits the disallowance of a claim that was originally owned by a person or entity who received a voidable preference that remains unreturned, the cloud on the claim continues until the preference payment is returned, regardless of whether the person or entity holding the claim received the preference payment.

By its ruling, which the court was careful to emphasize “only concerns trade claims,” the Third Circuit has staked out what now can fairly be characterized as the majority approach to this issue. *Accord In re Metiom, Inc.*, 301 B.R. 634 (Bankr. S.D.N.Y. 2003). *But see Enron Corp. v. Springfield Associates, L.L.C. (In re Enron Corp.)*, 379 B.R. 425 (S.D.N.Y. 2007), *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).

According to the Third Circuit, to hold otherwise would contravene the aims of section 502(d), which are to ensure equality of distribution of estate assets and to compel compliance with

judicial orders. Allowing the recipient of a voidable transfer to “wash [a] claim of any disability,” the court explained, would undermine these goals. The Third Circuit rejected the approach taken by the district court in *Enron*, observing that the court’s reliance on “supposed state law” to draw a distinction between claims that are assigned and claims that are sold is “problematic for several reasons.”

The Third Circuit rejected the claim buyer’s argument that its claims should not be disallowed because it purchased the claims in “good faith” and should therefore be entitled to the protections of a good-faith purchaser under section 550(b) of the Bankruptcy Code. That provision, the court wrote, “protects a good faith transferee who purchases property of the estate,” whereas the transferee of a claim purchases claims *against* the estate, which are not estate property. Furthermore, the Third Circuit emphasized, there is neither reason nor precedent to extend the “principles” of section 550 to protect claims traders, “who knowingly and voluntarily enter the bankruptcy process.”

The Third Circuit is not the only Bankruptcy Code-era circuit court of appeals to address disallowance of transferred claims under section 502(d). In *ASM Capital, LP v. Ames Department Stores, Inc. (In re Ames Department Stores, Inc.)*, 582 F.3d 422 (2d Cir. 2009), the Second Circuit held that section 502(d) does not mandate disallowance of administrative claims acquired from entities that allegedly received voidable transfers because an administrative expense does not qualify as a “claim” within the meaning of section 502(d).

However, the Second Circuit in *Ames* skirted the \$64,000 question on claims transfers: in view of its conclusion, the court stated that:

we find it unnecessary to reach [the claim buyer'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.

In *Longacre Master Fund, Ltd. v. ATS Automation Tooling Systems Inc.*, 2012 WL 4040176 (2d Cir. Sept. 14, 2012), the Second Circuit 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). However, the court did not address the lower court's observations regarding *Enron* and the purported protection from disallowance under section 502(d) of claims that have been sold rather than assigned.

In short, the Third Circuit's ruling in *KB Toys* places the burden squarely on claims purchasers to incorporate adequate indemnification provisions into their claims-trading agreements as a way to manage the risk of disallowance under section 502(d).

A more detailed discussion of the *Enron*, *Ames*, and *Longacre* rulings can be found at <http://www.jonesday.com/KB-Toys-Hobgoblins-Return-to-Haunt-Bankruptcy-Claims-Traders> and <http://www.jonesday.com/In-Brief-Claims-Trading-Hobgoblins-Redux-12-01-2012>.