

## Third Circuit Holds That Claim Disabilities Travel With Trade Claims in *KB Toys*

The U.S. Court of Appeals for the Third Circuit in *In re KB Toys Inc.*, No. 13-1197, 2013 WL 6038248 (3d Cir. Nov. 15, 2013) (the "Opinion"), held that trade claims that are subject to disallowance under § 502(d) of the Bankruptcy Code<sup>1</sup> in the hands of original claimants are similarly disallowable in the hands of a subsequent transferee of such claims. The Opinion also holds that subsequent transferees cannot assert as a defense to disallowance their status as a transferee that takes for value and in good faith under § 550(b) of the Bankruptcy Code.<sup>2</sup> The Opinion underscores the importance of evaluating bankruptcy-specific risk factors when trading claims, including disallowance, avoidance, and equitable subordination risks. While the Opinion purports to be narrow in scope because it applies only to trade claims, see Opinion at \*2, if the court's holding were applied more broadly, it could have significant implications in the distressed trading markets.

### The Opinion

#### A. Facts and Procedural History

ASM Capital, L.P. and ASM Capital II, LLP (collectively, "ASM") purchased nine claims (the "Claims") from trade creditors (the "Original Creditors") via assignment agreements (the "Assignment Agreements") in the chapter 11 cases of KB Toys Inc. and its affiliated debtors (collectively, the "Debtors"). *Id.* at \*1. Several but not all of the Assignment Agreements contained generic indemnity clauses in favor of ASM in the event the Claims were disallowed. *Id.* The Debtors listed the Original Creditors on their Statement of Financial Affairs ("SOFAs") as recipients of payments within the 90-day

<sup>1</sup> Section 502(d) of the Bankruptcy Code provides that, "[n]otwithstanding 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." 11 U.S.C. § 502(d).

<sup>2</sup> Section 550(b) of the Bankruptcy Code provides that, "[t]he trustee may not recover under section (a)(2) of this section from (1) a transferee that takes for value, including satisfaction or securing of a present or antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided; or (2) any immediate or mediate good faith transferee of such transferee." 11 U.S.C. § 550(b).

preference window. *Id.* at \*2. After ASM purchased most of the Claims, the Debtors' liquidating trustee obtained preference judgments against the Original Creditors, but the judgments were uncollectable because the Original Creditors went out of business. *Id.* at \*2. The liquidating trustee then moved to disallow the Claims under § 502(d) because the Original Claims owed the bankruptcy estate money, arguing that a claims purchaser (*i.e.*, ASM) is subject to the same § 502(d) challenge as the original claimant (*i.e.*, the Original Creditors). The U.S. Bankruptcy Court for the District of Delaware disallowed the Claims, and the District Court affirmed. *Id.*

## B. The Holding

The Third Circuit upheld the bankruptcy court's decision disallowing the Claims. The Opinion methodically analyzed the text, purpose, and legislative history of § 502(d), *id.* at \*2-4, and then held that ASM could not assert as a defense to disallowance its status as a transferee that takes for value and in good faith under § 550(b), *id.* at \*4-5.

*First*, the court's textual analysis hinged on the meaning of "any claim of any entity" in § 502(d). The court concluded that this phrase "operates to render a category of claims disallowable—those that belonged to an entity who had received an avoidable transfer." *Id.* at \*3. The court continued its analysis, holding that "the statute provides that such claims cannot be allowed until the entity who received the avoidable transfer, or the transferee, returns it to the estate. . . . Accordingly, 'any claim' falling into this category of claims is disallowable until the avoidable transfer is returned. Because the statute focuses on claims—and not claimants—claims that are disallowable under § 502(d) must be disallowed no matter who holds them." *Id.*

*Second*, the court buttressed its textual analysis by articulating that its holding furthers the twin aims of § 502(d): (i) disallowing the Claims promotes the equal distribution of estate assets by discouraging claim "washing" (transferring claims to cleanse disabilities), *id.*, and (ii) disallowing the Claims furthers the goal of coercing compliance with judicial orders, such as disgorgement orders, for the purpose of increasing total distributable estate value, *id.*

*Finally*, the court held that ASM could not assert as a defense its status as a transferee that takes for value and in good faith under § 550(b), finding that § 550(b) only applies to purchases of *estate* property, and the Claims are not estate property. *Id.* at 4. Critically, the court declined to extend the "principles" of § 550(b) to ASM because a claims purchaser "should know that it is taking on the risks and uncertainties attendant to the bankruptcy process." *Id.* at \*5. The court continued, stating that "if the bankruptcy process were not risky and uncertain, claimants might be less likely to sell their claims to a claim purchaser. Put differently, a claim purchaser's opportunity to profit is partly created by the risks inherent in bankruptcy. Disallowance of a claim pursuant to § 502(d) is among these risks." *Id.*

## The Opinion's Impact on the Claims Trading Market

Prior to *KB Toys*, the leading case on claims disabilities came out of the Enron chapter 11 cases where the issue was whether bank-loan claims under a revolving credit facility, which were subject to disallowance under § 502(d) and equitable subordination under § 510(c) of the Bankruptcy Code in the hands of the original syndicate lender, were subject to the same disabilities in the hands of purchasers.

Then U.S. Bankruptcy Judge Gonzalez issued two published opinions, one addressing § 502(d), see *Enron Corp. v. Ave. Special Situations Fund II, LP (In re Enron Corp.)*, 340 B.R. 180 (Bankr. S.D.N.Y. 2006) (*Enron I*), and the other addressing equitable subordination, see *Enron Corp. v. Ave. Special Situations Fund II, LP (In re Enron Corp.)*, 333 B.R. 205 (Bankr. S.D.N.Y. 2005), which held that such disabilities travel with the claim regardless of its ultimate holder. Gonzalez expounded on the claims trading market more generally and noted that market participants “assume the liabilities arising from the claims when participating in the claims-transfer market.” See *Enron I*, 340 B.R. at 202. In broad strokes, Gonzalez noted that market participants can manage their risk through indemnification provisions, and even where contractual protections are unworkable (e.g., bond trading), disallowance and equitable subordination risk are inherent in the market and purchasers can demand a discount to compensate for that risk. See *id.* at 204 n.23.

On appeal, U.S. District Judge Scheindlin vacated, see *Enron Corp. v. Springfield Associates, L.L.C. (In re Enron Corp.)*, 379 B.R. 425 (S.D.N.Y. 2007) (*Enron II*), and held that “disabilities” are personal to the holder. Scheindlin held that whether the disability transferred with the claim hinged on whether the transfer was a “sale” (permitting the purchaser to take the claim free of any disability) or an “assignment” (providing that the assignee steps into the shoes of the assignor with the same disabilities as the assignor). Scheindlin provided little guidance on the difference between sales and assignments, or how that distinction works in practice, but was quick to note that her analysis would not apply to bad faith purchasers or purchasers with actual knowledge of the avoidability of a transfer against a claimant.

Many commentators, including the Third Circuit in *KB Toys*, have questioned *Enron II* as creating an unworkable framework—that is, by distinguishing between sales and assignments. *Enron II* remanded the proceedings for factual findings, but the cases settled before resolution by a higher court. *Enron II* has been persuasive authority in the Southern District of New York, and many market participants have viewed disallowance or subordination risk as minimal under the *Enron II* framework so long as they purchased claims through sales (rather than assignments) and acted in good faith and without knowledge of any disability.

Now that the Third Circuit has definitively upheld disallowance in *KB Toys*, and called *Enron II* into doubt, obtaining comprehensive indemnities from the sellers of claims will become more important to managing risks. Purchasers may evaluate more closely credit risks through the chain of title. Similarly, purchasers may focus more closely on representations and warranties with respect to prepetition conduct. To be sure, the impact of *KB Toys* on the trading of public securities, which is typically done electronically with little or no documentation, remains uncertain because the Opinion purports to apply only to trade claims. But *KB Toys* provides an important reminder that claims traders face bankruptcy-specific risk factors such as disallowance that should be considered.<sup>3</sup>

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<sup>3</sup> For a detailed analysis of the impact of the bankruptcy court's decision on the claims market, see Sean A. O'Neal & Mark A. Lightner, *Claims Disabilities Rear Their Head in 'KB Toys'*, N.Y. L.J., June 25, 2012, at S2.

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