

Client Alert

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Buyer Beware: Third Circuit Confirms Claims are Subject to Disallowance Despite Sale to Third Party

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The Third Circuit in *In re KB Toys, Inc.*¹ recently affirmed a decision of the Delaware District Court, holding that trade claims are subject to disallowance under section 502(d) of the Bankruptcy Code despite their subsequent sale to a third party. This case is of particular interest to investors in distressed debt.

Generally, section 502(d) of the Bankruptcy Code provides that a bankruptcy court shall disallow “any claim of an entity” that is the transferee of an avoidable transfer (such as a preference or fraudulent conveyance), unless the property subject to avoidance is returned to the estate. In *KB Toys*, the Third Circuit considered whether a trade claim that is subject to disallowance under section 502(d) with respect to the original claimant is also disallowable in the hands of a subsequent transferee.

Following the petition date, ASM Capital, L.P. and ASM Capital II, LLP (together, “ASM”), a claims trading business, purchased nine claims from various trade creditors via assignment agreements. Four of the assignment agreements contained generic indemnification clauses, and all of the nine agreements contained restitution provisions dealing with bankruptcy-specific risks, which shifted the risk of disallowance back to the original claimant (the trade creditors) by requiring them to pay restitution to ASM if the claim was subsequently disallowed. The debtors’ post-confirmation liquidation trustee brought preference actions against each of the original claimants, but they were all uncollectible because the trade creditors had all gone out of business. The bankruptcy court then disallowed the claims and concluded that the purchaser of a trade claim is subject to the same 502(d) challenge as the original claimant – in other words “[d]isabilities attach to and travel with the claim.” ASM appealed to the district court, which affirmed, and then appealed to the Third Circuit.

The Third Circuit first considered the plain language of section 502(d), which provides that “any claim of any entity” who received an avoidable transfer shall be disallowed. The Third Circuit noted that the language deals with categories of claims, not claimants, and held, therefore, that claims that are disallowable under section 502(d) are disallowed regardless of who holds them.

To find otherwise, according to the Third Circuit, would also contravene certain policy considerations. For example, the Third Circuit extrapolated that protecting a transferred claim from disallowance would offer an original claimant who received an avoidable transfer incentive to sell its claim to wash it of any disability. This would give the original claimant value for a worthless claim, which would negatively impact other creditors by depriving the estate of funds because the avoidable transfer would not be returned and the estate would have to pay on a claim which otherwise would have been disallowed.

¹ No. 13-1197 (3d Cir. Nov. 15, 2013).

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The Third Circuit held that claims purchasers must bear the risk that avoidable transfers are not returned. The court noted that (i) claims purchasers are sophisticated purchasers who are aware of the risks posed by a bankruptcy case and voluntarily choose to take part in the process, (ii) unlike other creditors, they are in a position to mitigate risk (through indemnity clauses), and (iii) ASM included provisions in the respective assignment agreements that directly dealt with bankruptcy risks. Therefore, the court reasoned, ASM was aware that disallowance of the claims could attach to and travel with the claims.

ASM also made the argument that it purchased the claims in good faith and, therefore, they should not be disallowed. The Third Circuit found that section 550(b) of the Bankruptcy Code, which protects good faith purchasers of property of the estate from avoidance actions in certain circumstances, was not applicable in this scenario. The Third Circuit explained that ASM did not purchase property of the estate, but rather it purchased claims against the estate. The Third Circuit also pointed out that claims purchasers such as ASM knowingly and voluntarily enter into the bankruptcy process with the knowledge of potential risks, including disallowance of claims pursuant to section 502(d) of the Bankruptcy Code. Furthermore, in this instance in particular, ASM was on notice of the claims' vulnerability to preference actions, because the claims were listed in the debtors' statements of financial affairs and ASM could have performed due diligence before purchasing them. ASM also had the ability to include indemnity clauses and restitution provisions in the related assignment agreements or factored the risk into the price of the claim.

For these reasons, the Third Circuit affirmed the decision of the district court, finding that a trade claim subject to disallowance pursuant to section 502(d) of the Bankruptcy Code in the hands of the original claimant is also disallowable in the hands of a subsequent transferee.²

Whether the Third Circuit's opinion in *KB Toys* will have any significant effect on the market for bankruptcy claims is questionable. Notwithstanding the *Enron* decision, assignment agreements in respect of bankruptcy claims have customarily been drafted on the assumption that preference, fraudulent transfer, and other disallowance risk could travel with the claim, and have contained mechanisms (including representations, holdbacks, and disallowance put rights) for making the buyer whole in such a scenario. Claim buyers already typically assess the creditworthiness of the original claimant, and often require generous holdbacks (i.e., retention of some or all of the purchase price pending allowance of the claim by final order) where there are questions about the seller's solvency (since clawback/disallowance put provisions are irrelevant if the seller is no longer in business). On a final note, the claims considered in *KB Toys* were trade claims. While the Third Circuit did not qualify its decision as solely applicable to claims of this type, and the analysis employed would seem to apply to all categories of claims, there is a possibility that other types of claims, such as those for bond and bank debt, could be treated differently by a court.

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² The ruling is consistent with those reached by two other bankruptcy courts (see *Enron Corp. v. Avenue Special Situations Fund II, LP (In re Enron Corp.)*, 340 B.R. 180 ("Enron I"); *In re Metiom, Inc.*, 301 B.R. 634 (Bankr. S.D.N.Y. 2003)). However, two district courts have reached opposite conclusions (see, e.g., *Enron Corp. v. Springfield Assocs., L.L.C. (In re Enron Corp.)*, 379 B.R. 425 (S.D.N.Y. 2006) (vacating and remanding *Enron I*) (district court viewed language of 502(d) as focused on the claimant rather than the claim itself, which led to the conclusion that the disallowance was a personal disability of a claimant, not an attribute of a claim)).

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