

CLIENT UPDATE

CLAIM TRADING UPDATE: THIRD CIRCUIT HOLDS THAT SECTION 502(D) DISALLOWANCE RUNS WITH THE CLAIM

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In the first appellate court decision on the issue, the Third Circuit Court of Appeals recently held that trade claims subject to disallowance under section 502(d) of the Bankruptcy Code are disallowable “no matter who holds them.”¹ In *In re KB Toys Inc.*, the Third Circuit affirmed Bankruptcy and District Court decisions holding that trade claims subject to disallowance in the hands of an original claimant remain disallowable in the hands of a subsequent transferee. Notably, the Third Circuit’s decision directly conflicts with the decision of the District Court for the Southern District of New York in *In re Enron Corp.*, which held that disallowance is a personal disability of a claimant, not an attribute of a claim.²

BACKGROUND

KB Toys involved nine trade claims purchased by ASM Capital L.P. and ASM Capital II, LLP (collectively, “ASM”) from various creditors pursuant to assignment agreements. Each agreement required the original claimant to pay restitution to ASM if the claim it purchased was disallowed. Some of the agreements also included indemnification provisions.

¹ *In re KB Toys Inc.*, No. 13-1197, 2013 WL 6038248, at *3 (3d Cir. Nov. 15, 2013), available at <http://www2.ca3.uscourts.gov/opinarch/131197p.pdf>

² *In re Enron Corp.*, 379 B.R. 425 (S.D.N.Y. 2007).

The nine original claimants were listed on the Debtor's Statement of Financial Affairs ("SOFA") as having received a payment within 90 days of the Debtor's Petition Date and thus were potentially subject to preference actions under section 547(b) of the Bankruptcy Code.³ The Trustee brought preference actions against the original claimants and obtained judgments in each case. However, the Trustee was unable to collect on the judgments because the original claimants had gone out of business. The Trustee then filed objections seeking to disallow ASM's nine trade claims pursuant to section 502(d). The Bankruptcy Court disallowed the claims and the District Court affirmed.

DECISION

The Third Circuit began by examining the text of section 502(d), which provides for the disallowance of "any claim of any entity" which received an avoidable transfer, unless the entity has paid the amount of the transfer back to the estate. The Third Circuit stated that section 502(d) focuses on claims – not claimants – and therefore held that claims that are disallowable under section 502(d) must be disallowed no matter who holds them.⁴ The Court found that if section 502(d) protected transferred claims from disallowance, it would incentivize creditors otherwise subject to avoidance actions and therefore at risk of forfeiting their distributions under section 502(d) to sell their claims so that they could receive value for otherwise disallowable claims. The Court explained that this result would harm the estate and other creditors in two ways. First, the estate would have less money to distribute if the original claimant did not return its avoidable transfer. Second, the estate would pay on claims that otherwise would have been disallowed.⁵

The Court also rejected ASM's argument that its claims should not be disallowed because it was a "good faith" purchaser under section 550(b).⁶ The Court held that section 550(b) protects transferees who purchase property of the estate, not claims against the estate. The Court further stated that, as between the claim purchaser and the estate, the claim purchaser should bear the risks of disallowance. The Court observed that claim purchasers voluntarily enter the risky bankruptcy process and have the opportunity to perform due diligence on the claims they purchase.⁷ Applying these principles to the facts

³ See 11 U.S.C. § 547(b)(4)(A).

⁴ *In re KB Toys Inc.*, 2013 WL 6038248, at *3.

⁵ *Id.*

⁶ Section 550(b) provides, in part, that a trustee may not recover property from a transferee of an avoidable transfer who received the property for value, "in good faith, and without knowledge of the voidability of the transfer avoided." 11 U.S.C. § 550(b)(1).

⁷ *In re KB Toys Inc.*, 2013 WL 6038248, at *5.

in *KB Toys*, the Court stated that ASM could have protected itself from the risk of disallowance by reviewing the Debtor's SOFA, which would have put it on notice of the potential for preference liability, and by performing due diligence on the original claimants. The Court found that ASM was aware of the risk of disallowance when it acquired its claims, as evidenced by the restitution and indemnification provisions in its assignment agreements. The Court thus concluded that ASM was "in a better position than the estate to protect itself against the Original Claimants going out of business by factoring this possibility in to the price of the claim."⁸

The Third Circuit's decision directly conflicts with the District Court's decision in *Enron*, which drew a much criticized distinction between the assignment of a claim and the sale of a claim. The *Enron* court held that while disallowance is a personal attribute of a claimant that attaches to a claim that is assigned, it does not attach to one that is sold. The *Enron* court held that, unlike purchasers, assignees stand in the shoes of assignors and therefore take claims along with their disabilities.⁹ In *KB Toys*, the Third Circuit questioned *Enron's* analysis and noted that the state law upon which *Enron* relied "does not provide a distinction between assignments and sales."¹⁰

IMPLICATIONS

In light of *KB Toys*, claim purchasers should be sure to perform due diligence on both the claims they acquire and the creditors with whom they are trading. If courts in other jurisdictions follow the reasoning of *KB Toys*, disallowance of a claim will be a risk that all claim purchasers could face in the future, which should be taken into account in the price to be paid for the claim or allocated contractually through restitution and indemnification provisions.

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Please do not hesitate to contact us with any questions.

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⁸ *Id.*

⁹ *In re Enron Corp.*, 379 B.R. at 435.

¹⁰ *In re KB Toys Inc.*, 2013 WL 6038248, at *4 n.11.