Insolvency and Restructuring Advisory

Katten
Katten Muchin Rosenman LLP

December 12, 2013

Clouds on the Horizon for Claim Purchasers in the Third Circuit

By Darius J. Goldman, Matthew W. Olsen and Bertrand J. Choe

In a decision of significance to the distressed claims trading community, the US Court of Appeals for the Third Circuit in *In re KB Toys Inc.*[1] recently held that any risk or "cloud" of disallowance under the Bankruptcy Code resulting from a creditor's receipt of an avoidable transfer cannot be separated from a claim, even when such claim is in the possession of a subsequent transferee. The Third Circuit's decision not only reaffirms the decisions of the Delaware Bankruptcy and District Courts, but is the clearest and most influential ruling to date to decide this issue in a manner contrary to the decision of the US District Court for the Southern District of New York in *In re Enron Corp.* ("*Enron II*").[2] In *Enron II*, the court held that whether the transfer of a claim separates or cleanses it from the risk of disallowance depended on whether the transfer was characterized as a "sale" or an "assignment." Given the importance of the Third Circuit with respect to large commercial chapter 11 cases, as well as the logic and clarity of the rationale in *KB Toys*, this decision should provide important guidance with respect to the expectations of distressed claim buyers participating in bankruptcy cases throughout the United States.

The *Enron II* Decision

The *Enron II* court held that disallowance under section 502(d) of the Bankruptcy Code constitutes a "personal disability," as the court interpreted the statute to focus on *claimants*, as opposed to the *claims* they hold. As such, according to the District Court in *Enron II*, the means by which a claim is transferred under applicable state law is controlling: an assignee steps into the shoes of the original claim holder and assumes both the benefits and risks associated with the claim, whereas a purchaser receives only the benefits, washing away the risk of disallowance. However, the *Enron II* court failed to provide meaningful guidance as to which factors would distinguish between a sale versus an assignment, and subsequent commentators as well as the Third Circuit in *KB Toys* have found no basis for such a distinction. As a result, claims traders have generally disregarded the *Enron II* decision as impractical to implement.

The *KB Toys* Decision

The *KB Toys* decision provides important clarity in the area of claims trading, holding unequivocally that a purchaser of a claim is subject to the risk of such claim's disallowance in the event that the claim seller has received an avoidable transfer of property of the estate or holds property of the estate subject to turnover, which it has failed to return. Accordingly, "*caveat emptor*" must be the motto for any potential purchaser, and the need for claim diligence by legal counsel who understand the bankruptcy process is now more than ever paramount when purchasing trade claims.

In reaching its decision, the Third Circuit first looked to the plain language of section 502(d) of the Bankruptcy Code, which provides that the court will disallow "any claim of any entity" that is the recipient of an avoidable transfer or a holder of property of the estate subject to turnover, unless such transfer has been paid back, or such property returned, to the debtor's estate. Unlike the court in *Enron II*, the Third Circuit interpreted the statute to emphasize claims that can or cannot be allowed. "Because the statute focuses on claims—and not claimants—claims that are disallowable under § 502(d) must be disallowed no matter who holds them."[3]

---

[1] 736 F.3d 247 (3d Cir. 2013).

[2] 379 B.R. 425 (S.D.N.Y. 2007).

[3] *In re KB Toys Inc.*, 736 F.3d at 252.

The Third Circuit also found that an analysis of practical implications supported its interpretation of section 502(d). A contrary decision would not only permit, but also incentivize, creditors whose claims are at risk of disallowance to simply sell such claims in order to wash them of any disability. In the hands of a creditor who has received an avoidable transfer of estate property or holds property of the estate subject to turnover, the claim is subject to complete disallowance under section 502(d). However, if that creditor could merely sell its claim in the secondary market free of any risk of disallowance without returning the avoidable transfer it may have received, it could receive value for an otherwise worthless claim, while the claim purchaser could, in turn, enforce the claim for undeserved value and share in a distribution of estate assets. This result would diminish the debtor's estate to the detriment of all other creditors. The Third Circuit further held that interpreting section 502(d) disallowance to be personal to the claimant and to not pass with the claim would undermine one of section 502(d)'s main purposes: to coerce creditors' compliance with judicial orders requiring the return of avoided transfers as a condition precedent to receiving distributions on their claims.

Notably, the Third Circuit rejected the defense that a purchaser could avail itself of the good faith purchaser defense under section 550(b) of the Bankruptcy Code, as such a defense inures to the benefit of only purchasers of *property of the estate*, whereas claim purchasers acquire *claims against the estate*. Further, one of the hallmarks of distressed debt claims trading is the acknowledgment of risk involved. This risk contributes to price disparities in the marketplace, and thus "a claim purchaser's opportunity to profit is partly created by the risks inherent in bankruptcy."[4] Unlike original creditors, claim purchasers enter the market voluntarily, and should therefore understand the risks inherent in the bankruptcy process.[5] Claim purchasers are also afforded the unique opportunity to mitigate their own exposure to the risk of disallowance through proper contractual drafting.[6] *KB Toys* reinforces that it is now more important than ever to conduct proper due diligence of claims and, where possible, to include protective representations and warranties as well as indemnity and disallowance clauses in the transfer agreements.

Implications

Since 2007, the market has discounted *Enron II* as impractical to implement. Now, even if claims are purchased in a jurisdiction outside of the Third Circuit, the logic and clarity of the rationale in *KB Toys* will likely guide future court decisions concerning whether potential disallowance travels with the claim.

Regardless of the jurisdiction in which a bankruptcy case has been filed, potential claim purchasers must conduct proper due diligence of the claims they seek to acquire. Standard diligence items include, at a minimum, a review of the debtor's Statement of Financial Affairs, the debtor's schedules, the claims register, any proofs of claim (if filed), and the bankruptcy docket to see whether any objections or settlement agreements related to the claim have been filed.

Additionally, the terms of any transfer agreement must be carefully considered. The courts in both *Enron II* and *KB Toys* acknowledged the existence and validity of indemnification clauses in the purchase agreements, which clauses were designed to shift the risk to the original creditor, where it properly resides. Such clauses can take several forms, including the ability of the claim purchaser to seek blanket indemnification from the original creditor or require the seller to repurchase the disallowed portion of the claim. Accordingly, a claim purchaser should conduct appropriate diligence of not only the claim, but also its counterparty's creditworthiness because a strong contract against a weak (or insolvent) counterparty will still leave an injured purchaser exposed despite its contractual protections. The extent of drafting the transfer agreement can depend heavily on the risks identified with respect to both the claim and the original creditor, and will be negotiated differently depending on the proper diligence thereof. Thus, while the *KB Toys* decision may require claim purchasers to conduct appropriate diligence to ensure its protection from the risks associated with disallowance, it at least provides an unequivocal, uniform standard that courts can easily apply and follow.

---

4 *Id.* at 255.

5 Indeed, the Bankruptcy Court that originally decided *KB Toys* noted that the claim purchaser at issue was put on at least constructive notice of the potential disallowance of the claims purchased, as the debtors' Statement of Financial Affairs specifically listed potential preference defendants. *See In re KB Toys, Inc.*, 470 B.R. 331, 342 (Bankr. D. Del. 2012).

6 In fact, the Third Circuit noted that the agreements pursuant to which the claims at issue were purchased included indemnification clauses that specifically contemplated disallowance of the claims. Accordingly, the claim purchaser explicitly acknowledged the possibility that the claim could still be subject to disallowance despite the transfer of ownership thereof. *In re KB Toys Inc.*, 736 F.3d at 254.

Nevertheless, questions still remain regarding the risks faced by potential claim purchasers. For example, it is not clear whether the rationale in *KB Toys* is applicable to trades of other types of instruments, such as notes and other negotiable instruments, the buyers of which may be entitled to "holder in due course" status under state law. Yet *dicta* in *KB Toys* suggests such instruments will be treated no differently for purposes of section 502(d) as a result of federal bankruptcy law's preemption of inconsistent state law.[7] Additionally, *KB Toys* does not address whether a claim subject to equitable subordination under section 510(c) of the Bankruptcy Code can be cured by an arms-length sale of the claim.[8] Accordingly, while *KB Toys* brings much needed clarity to the area of claims trading, unanswered questions remain.

****

If you have any questions, please contact your Katten Muchin Rosenman LLP attorney or:

Kenneth E. Noble
New York
+1.212.940.6419
kenneth.noble@kattenlaw.com

Darius J. Goldman
New York
+1.212.940.6355
darius.goldman@kattenlaw.com

Matthew W. Olsen
New York
+1.212.940.6472
matthew.olsen@kattenlaw.com

[7] *Id.* at 254 n.11.

[8] The District Court in *Enron II* held that the sale of a claim cleanses it from the risk of disallowance under both sections 502(d) and 510(c) of the Bankruptcy Code, whereas *KB Toys* only addressed disallowance under section 502(d) of the Bankruptcy Code.

Katten
Katten Muchin Rosenman LLP www.kattenlaw.com

AUSTIN | CENTURY CITY | CHARLOTTE | CHICAGO | HOUSTON | IRVING | LONDON | LOS ANGELES | NEW YORK | ORANGE COUNTY | SAN FRANCISCO BAY AREA | SHANGHAI | WASHINGTON, DC