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KB Toys: Reintroducing Uncertainty Regarding Section 502(d) Disallowance for Transferred Claims

Key Takeaway

In a recent decision in the Chapter 11 case of *In re KB Toys, Inc.*, the United States Bankruptcy Court for the District of Delaware disallowed trade claims purchased post-petition by a claims purchaser because the original holder of the trade claims had not yet returned the property it had received as a preferential transfer. Relying on the language in Section 502(d) of the Bankruptcy Code, the Bankruptcy Court concluded that the trade claims purchaser held those claims subject to the same rights and disabilities as the seller of such claims. As a result, the claims would be disallowed until the original holder returned the property it had received as a preferential transfer. This decision is important because the Court held that the claims purchaser was not entitled to the protections of a good faith purchaser. Accordingly, the risk of purchasing a claim subject to disallowance could fall squarely onto the shoulder of the claims buyer, and not the claims seller, unless the seller agrees to indemnify the buyer under such circumstances.

Overview

Section 502(d) of the Bankruptcy Code provides that a court must disallow the claim of an entity that is the transferee of a transfer that is avoidable as a preference or a fraudulent transfer until it returns the voidable transfer. The policy underlying this provision is that a creditor who received a voidable transfer should not be permitted to participate in a distribution from the debtor's estate on account of any claims it holds until it returns the voidable transfer that it received.¹

Several years ago the United States District Court for the Southern District of New York, in *In re Enron Corp.*, 379 B.R. 425 (S.D.N.Y. 2007) ("**Enron II**"), overruled a decision of the United States Bankruptcy Court for the Southern District of New York in *In re Enron Corp.*, 340 B.R. 180 (Bankr. S.D.N.Y. 2006)

¹ *In re KB Toys, Inc.*, Case No. 04-10120 (KJC), Dkt. No. 6012 at 14 (Bankr. D. Del. May 4, 2012) (citing *In re Enron Corp.*, 340 B.R. 180, 201 (Bankr. S.D.N.Y. 2006)).

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(“**Enron I**”), and held that the disallowance of a claim under section 502(d) of the Bankruptcy Code is a personal disability of the claimant, and not an attribute of the claim, and, therefore, the personal disability will travel to the transferee of a claim if the claim is assigned, but will not travel to the transferee if the claim is sold.² Although *Enron II* was widely criticized because the words “assignment” and “sale” are often used interchangeably in the documents evidencing the claims transfer, the distressed debt market adapted their practices to fit within the parameters of this decision. Most importantly, *Enron II* provided claims buyers with the ability to acquire claims through a sale transaction without being burdened with the disabilities (and the potential misconduct) of a claims seller.

Earlier this month the Delaware Bankruptcy Court reached a different conclusion. In *KB Toys*, the trustee designated to pursue avoidance actions and object to claims (“**Trustee**”) sought to disallow under section 502(d) nine trade claims that had been sold post-petition to ASM Capital, L.P. and ASM Capital II, LLP (collectively, “**ASM**”). Each of the transferors of the trade claims were listed in the debtors’ Statement of Financial Affairs as having received potential preferential payments in the 90 days preceding the commencement of the debtors’ bankruptcy cases. Additionally, ASM acquired one of the trade claims after the Trustee had successfully brought a preference action against the transferor. The issue before the Court was whether ASM had purchased the trade claims subject to the same rights and disabilities as the original holders and, therefore, subject to disallowance under section 502(d) of the Bankruptcy Code.

The Trustee argued that the trade claims were assigned, not sold, to ASM, and so ASM should step into the shoes of the assignors. The Trustee also argued that even if ASM had purchased the claims, ASM had constructive, if not actual, knowledge of the potential preferential transfer risks, and therefore, was not a good faith purchaser. Finally, the Trustee questioned the *Enron II* court’s analysis and holding that claims that are sold are not subject to the same disabilities in the hands of the transferee.

In its defense, ASM first argued that notwithstanding the use of “assignment agreements” and references to “assignee” and “assignor” in the agreements, the parties’ intent was to sell the claims, which intent should outweigh any references to an assignment, assignor, or assignee. ASM also adopted the *Enron II* court’s reasoning that because section 502(d) focuses on the claim and not on the claim itself, disallowance under section 502(d) is a personal disability that was not transferred to ASM in the sale of the trade claims.

The Court’s Reasoning

The *KB Toys* Court declined to follow *Enron II* and held that disallowance under section 502(d) attaches to, and travels with, the claim.³ The Court focused on case law interpreting section 57g of the Bankruptcy Act and a number of cases decided under the Act that held that section 57g followed the claim, not the

² *Enron II* at 436.

³ *KB Toys* at 7.

claimant. The *KB Toys* Court also noted *Enron I*'s reasoning that "a claim transfer does not change the nature of the claim in bankruptcy; rather it creates a substitution of parties."⁴ In fact, *Enron I* had highlighted that "Bankruptcy Rule 3001(e)(2) regarding the 'transfer of claim' states that '...the transferee shall be substituted for the transferor.'"⁵

The *KB Toys* Court was not persuaded by the *Enron II* court's distinction between a "sale" and an "assignment". Indeed, the *KB Toys* Court reasoned that "[t]he terms 'assignment' and 'sale' are not easily distinguishable."⁶

The *KB Toys* Court was also not persuaded by the *Enron II* court's concern that burdening a transferee with the seller's disability would create problems for the distressed trading markets. The Court noted that distressed debt traders are generally:

. . . highly sophisticated entities fully capable of performing due diligence before any acquisition . . . even without any due diligence, today's claim purchasers are aware of the ever-present possibility of avoidance actions based on preference liability or fraudulent conveyances . . . the assertion that subjected transferred claims to section 502(d) disallowance would cause disruption in the claims trading market is a hobgoblin [sic] without a house to haunt.⁷

Even if the *KB Toys* Court was inclined to follow *Enron II*, ASM could not be a good faith purchaser because it had constructive, and actual in at least one case, knowledge of the potential preference actions. Accordingly, the Court reasoned that ASM could have "discovered the potential for disallowance with very little due diligence and factored the potential for disallowance into the price it paid for the trade claims."⁸

In addition, the Court viewed the fact that ASM had included indemnity provisions in some but not all of the contracts as evidence that it had sufficient understanding and leverage to negotiate for an indemnity. In those cases where ASM did not have an indemnity provision, the Court observed that ASM may have other remedies or have chosen to bear the risk. The *KB Toys* Court appeared to be concerned with entities "washing" their claims – that is, if an entity, which had committed offensive acts that would result in its claims being disallowed, could sell its claims free of disallowance risk, the offending entity could evade the requirement of disallowance.

Finally, the Court questioned whether a claims trader in bankruptcy could be a good faith purchaser because it "is well aware (or should be aware) that it is

⁴ *Id.* at 13.

⁵ *Id.*

⁶ *Id.* at 16.

⁷ *Id.* at 18.

⁸ *Id.* at 19.

entering an arena in which claims are allowed and disallowed in accordance with the provisions of the Bankruptcy Code. . . .⁹

Unanswered Questions

The *KB Toys* decision leaves some important questions unanswered. While the decision would apply to holders of claims that have received avoidable preferences or fraudulent transfers, it is not clear whether the Delaware Court's decision would apply with equal force if the original holder of the claim was subject to equitable subordination. Section 502(d) by its express terms does not apply to equitable subordination under section 510 of the Bankruptcy Code but the Court's reasoning suggests that the equitable subordination defect would attach to the claim and travel with it to any buyer. It is also unclear whether the decision would apply if the claims being acquired were a different type of claim, such as publicly traded notes, bonds or debentures. Footnote 14 of the decision suggests that the Court intended to limit its holding to trade claims. It would be important to limit this decision to trade claims because claims buyers may not be able to obtain an indemnity from the sellers of publicly traded notes, and they may not even know the identity of such sellers because those claims are often traded through a clearinghouse. It is further unclear whether the Court's decision would preclude the good faith purchaser defense for pre-petition buyers of claims. A pre-petition buyer may not have knowledge, actual or constructive, of the debtor's financial condition or imminent bankruptcy.

This publication is intended merely to highlight issues and not to be comprehensive, nor to provide legal advice. Should you have any questions on issues reported here or on other areas of law, please contact one of your regular contacts, or contact the editors.

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⁹ *Id.* at 20-21.

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