



## Bankruptcy ADVISORY ■

**DECEMBER 2, 2013**

### Third Circuit: Bankruptcy Code Section 502(d) Applies to Subsequent Transferees

In a recent decision, the Court of Appeals for the Third Circuit (the “Third Circuit”) affirmed<sup>1</sup> the bankruptcy court’s decision in *In re KB Toys, Inc.*,<sup>2</sup> and held that a claim that is subject to disallowance under section 502(d) of the Bankruptcy Code in the hands of the original claimant is similarly disallowable when that claim is held by a subsequent transferee because the section is applicable to “claims” rather than “claimants.” This holding is in contrast to a prior decision of the District Court for the Southern District of New York in *In re Enron Corp.*,<sup>3</sup> which viewed the language of section 502(d) as focusing on the “claimant” rather than the “claim,” and could have significant implications for distressed debtor investors (“Claims Traders”).

In relevant part, section 502(d) of the Bankruptcy Code provides that the bankruptcy court shall “disallow any claim of any entity from which property is recoverable” as an avoidable transfer, including fraudulent conveyances and preferences.<sup>4</sup>

#### Claims Purchasing in Bankruptcy

Claims held by creditors of a debtor are sometimes sold via a contract to Claims Traders, who invest in distressed debt, in a practice permitted by Federal Rule of Bankruptcy Procedure 3001(e).<sup>5</sup> The arrangement allows a risk-adverse creditor to obtain an immediate payment on debt it is owed. The Claims Trader, in turn, buys the claim hoping to receive a distribution from the debtor’s estate in excess of the purchase price of the claim.

<sup>1</sup> *In re KB Toys, Inc.*, No. 13-1197, 2013 U.S. App. LEXIS 23083 (3d Cir. Nov. 15, 2013) [hereinafter *KB Toys*].

<sup>2</sup> *In re KB Toys, Inc.*, 470 B.R. 331, 335 (Bankr. D. Del. 2012).

<sup>3</sup> *Enron Corp. v. Avenue Special Situations Fund II, LP (In re Enron Corp.)*, 379 B.R. 425 (S.D.N.Y. 2007) [hereinafter *Enron*].

<sup>4</sup> See 11 U.S.C. § 502(d).

<sup>5</sup> See Fed. R. Bankr. P. 3001(e). If the claim is purchased before a proof of claim is filed, the transferee may file the proof of claim. See Fed. R. Bankr. P. 3001(e)(1). If the claim is purchased after a proof of claim is filed, the transferee must file an “evidence of transfer” with the bankruptcy court. See Fed. R. Bankr. P. 3001(e)(2).

## Facts

In *KB Toys*,<sup>6</sup> ASM Capital, L.P. (the “Claims Purchaser”) purchased nine claims from trade creditors (the “Original Claimants”) of KB Toys, Inc. (the “Debtor”), via assignment agreements. Each of the Original Claimants was listed on the Debtor’s statement of financial affairs as having received payments within 90 days of the petition date and, eventually, the trustee in the case obtained judgments against each of the Original Claimants to avoid preferences that they received.<sup>7</sup> However, these judgments were uncollectable because all of the Original Claimants went out of business.

Because the judgments went unsatisfied, the trustee filed objections in the bankruptcy court seeking to disallow, pursuant to section 502(d), the claims purchased by the Claims Purchaser because each of the Original Claimants received the preference before transferring its claim to the Claims Purchaser. The bankruptcy court disallowed the claims and held that a Claims Trader is subject to the same section 502(d) challenge as an original claimant because “[d]isabilities attach to and travel with the claim.”<sup>8</sup> The district court affirmed the bankruptcy court’s decision<sup>9</sup> and the Claims Purchaser appealed.

## Court’s Holding

The Third Circuit affirmed the bankruptcy court’s decision and held that “[b]ecause the statute focuses on claims—and not claimants—claims that are disallowable under § 502(d) must be disallowed no matter who holds them.”<sup>10</sup> As the Third Circuit explained, section 502(d) operates to disallow “any claim of any entity” that received an avoidable transfer and creates a category of claims that are disallowable—namely, those claims that belong to an entity that received an avoidable transfer. Such claims cannot be allowed until the avoidable transfer is returned to the estate.

The Third Circuit reasoned that Claims Traders should bear the risk that avoidable transfers are not returned because they voluntarily choose to take part in the bankruptcy process, are typically sophisticated entities that should be aware of the risks of the bankruptcy process, and can estimate the risk of disallowance by performing due diligence on the original claimant.<sup>11</sup> Indeed, the Claims Purchaser included provisions in the assignment agreements with the Original Claimants, indicating its awareness of the risks particular to bankruptcy.

The contrary interpretation would, according to the Third Circuit, create an incentive for original claimants who received a voidable preference to sell the claim and “wash” it of its disability, and effectively permit the Original Claimant and the Claims Purchaser to obtain a windfall at the expense of the Debtor’s estate. In addition, according to the Third Circuit, the contrary interpretation would undermine the second aim of

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<sup>6</sup> Case No. 04-10120 (KJC) (Bankr. D. Del.).

<sup>7</sup> The trustee may avoid certain payments to creditors of debtors that are made within 90 days before the bankruptcy petition is filed. See 11 U.S.C. § 547(b).

<sup>8</sup> *In re KB Toys, Inc.*, 470 B.R. at 335.

<sup>9</sup> *In re KB Toys, Inc.*, No. 12-716-RGA (D. Del. May 4, 2012).

<sup>10</sup> *KB Toys*, 2013 U.S. App. LEXIS 23083, at \*9.

<sup>11</sup> See *id.* at \*11 n.8.

section 502(d), which is to coerce compliance with judicial orders requiring the return of preferential payments as a condition of collecting on a claim.

### **Conflicting Authority**

The Third Circuit's holding stands in contrast to the District Court for the Southern District of New York's holding in *Enron*, which "focused on the claimant as opposed to the claim" leading to the "inexorable conclusion that disallowance is a personal disability of a claimant, not an attribute of the claim."<sup>12</sup> The *Enron* court held that state law applies to determine the impact of the "personal disability" and concluded that the result was dependent on how the claim was conveyed. While assigned claims continue to suffer from the original claimant's disability, claims that are sold do not. Thus, claims purchased by a claims purchaser would not be avoidable if the original claimant failed to repay a voidable transfer.

### **Takeaway**

The contrast between *KB Toys* and *Enron* creates uncertainty for Claims Traders and raises the possibility that claims subject to disallowance in the Third Circuit will not be subject to disallowance in the Second Circuit. Accordingly, Claims Traders must consider the issue of avoidance and the use of section 502(d) to disallow claims in the context of pricing and documentation. There are techniques to mitigate against the 502(d) risks, and those techniques should be considered by any party wishing to engage in claims trading, especially in a case pending in the Third Circuit. That said, given that this is Third Circuit level authority, Claims Traders elsewhere (including involving cases in the Southern District of New York) should carefully consider the risks of the disallowance and the techniques to mitigate those risks.

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<sup>12</sup> *Enron*, 379 B.R. at 443.

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