

**Bankruptcy Express Webinar:
Are Bankruptcy Claims Sold Subject to a
"Taint"? Commentary on the Delaware
Bankruptcy Court's Ruling in the
*KB Toys Case***

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Presenter



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Claim Disabilities

- Claims may be subject to certain disabilities
 - Disallowance for failure to return a preference or fraudulent transfer under Section 502(d)
 - Equitable subordination for wrongful conduct under Section 510(b) unrelated to claims
- If a claim is subject to one or both of these disabilities, we'll refer to the claim as “tainted”



Issue

- If a claim is “tainted” in the hands of a seller, does it remain tainted in the hands of a buyer?
 - Does it matter if the claim is a trade claim, on the one hand, or a claim based on bond debt or bank debt, on the other hand?
 - Is there a “good faith, for value” defense that the buyer may assert?



Enron I (Bankr. S.D.N.Y.)

Two opinions issued by Judge Gonzalez in the *Enron* case in 2005 and 2006—one each for disallowance under section 502(d) and equitable subordination

- Bank transferred claims to purchasers
- Bank was subsequently sued for:
 - Return of preference
 - Equitable subordination
- Both counts were unrelated to transferred claims



Enron I—Section 502(d) Analysis

- Section 502(d) authorizes disallowance of “any claim of an entity from which property is recoverable” under the chapter 5 avoidance actions
- Use of the phrase “any claim” makes clear that the claim does not need to be related to the avoidance action



Enron I—Section 502(d) Analysis

- Section 502(d) is a defense to a claim
- The claim and the defense to the claim cannot be altered by transfer to an assignee
- The defense of Section 502(d) is thus a “taint” imprinted on the claim that travels with the claim from buyer to seller
- The transferee should not enjoy greater rights than the transferor
- Relies to a great extent on *In re Metiom*



Enron I—Section 502(d) Analysis

- Policy concerns
 - Claimant should not share in distribution from the estate unless it has returned the avoidable transfer
 - Solvency of transferor is not sufficient to absolve transferee of liability as it is not part of Section 502(d)
 - Claim purchasers should be aware of the risk
 - Indemnity in purchase and sale agreement will provide coercion for transferor to return avoidable transfer
 - Buyer can choose not to buy or can reduce price



Enron I—Section 502(d) Analysis

- Good faith defense not available
 - Section 550(b): “The trustee may not recover [an avoidable transfer] from a transferee that takes for value In good faith, and without knowledge of the voidability of the transfer avoided”
 - Good faith defense of Section 550(b) applies to property sought to be recovered in an avoidance action and that has been transferred to a good faith transferee
 - It does not apply by its terms to allowance of claims against the debtor



Enron I—Section 502(d) Analysis

- Good faith defense not available
 - The concept does not apply by analogy because a transferee of a bankruptcy claim knows of the financial distress of the issuer and thus cannot meet the “good faith” standard
 - Mere filing of bankruptcy is sufficient
 - Introduces a question of prepetition versus postpetition



Enron I—Equitable Subordination Analysis

- Allegations and issue
 - Transferring bank alleged to have engaged in certain inequitable conduct unrelated to transferred claims
 - Should the claims in the hands of a transferee be subject to subordination under section 510(c) of the Bankruptcy Code the same as they would in the hands of the transferor?



Enron I—Equitable Subordination Analysis

- Equitable subordination
 - Section 510(c)(1) of the Bankruptcy Code provides that, after notice and a hearing, the court may—
 - under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest ...



Enron I—Equitable Subordination Analysis

- Elements of Equitable subordination from *Mobile Steel*
 - (1) the claimant must have engaged in some type of inequitable conduct,
 - (2) the misconduct must have resulted in injury to the creditors or conferred an unfair advantage on the claimant, and
 - (3) equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Act.



Enron I—Equitable Subordination Analysis

- Transferee cannot enjoy greater rights than transferor.
- Rather, assignee stands in the shoes of assignor
- Priority of claim cannot be impacted by transfer
- Statute mentions “claim”—not “claimant”



Enron I—Equitable Subordination Analysis

- Thus, equitable subordination imprints a “taint” that travels with claim to buyer
- As with section 502(d) analysis, court:
 - advanced policy arguments, and
 - Rejected good faith defense



Enron II (S.D.N.Y.2007)

- Judge Scheindlin reverses *Enron I* with respect to the taint traveling to the purchaser for both
 - Disallowance under Section 502(d), and
 - Equitable subordination



Enron II

- Observed that equitable subordination and disallowance are not fixed as of petition date
 - Equitable subordination could be based on postpetition conduct; and
 - Disallowance under Section 502(d) can likewise be based on the postpetition receipt of an avoidable transfer i.e. a Section 549 action.



Enron II

- Equitable subordination is a personal disability that does not travel with the claim
 - Legislative history refers to misconduct on the part of the “holder”

 - Equitable subordination is not a defense that belongs to the issuer
 - Rather, it is a remedy that belongs to the creditors



Enron II

- Disallowance under Section 502(d) is a personal disability that does not travel with the claim
 - Section 502(d) requires disallowance of “any claim of any entity from which property is recoverable ... or that is a transferee of a transfer avoidable ... unless such entity or transferee has paid the amount, or turned over any such property, for which **such entity** or transferee is liable”
 - Use of phrase “such entity” means the focus is on the claimant, not the claim



Enron II

- Invoked “sale versus assignment” analysis
 - A sale of a claim would result in the purchaser taking free of any personal disabilities
 - An assignment of the claim would result in the assignee taking subject to personal disabilities



KB Toys (Bankr. Del. 2012)

- Opinion by Judge Carey in Delaware
- Addressed only *trade* claims
- Address only issue of disallowance under Section 502(d)
- In most instances, liquidating trustee brought avoidance action against transferor after claim had been sold
- Liquidating trustee sought to disallow claims in hands of transferee



KB Toys

- Court reviewed legislative history of predecessor, Section 57g of the Bankruptcy Act
- Concluded that Section 57g focused on “claims,” rather than “claimant”
- Thus, Section 502(d) imprints a “taint” on a claim that travels with the claim into the hands of a purchaser



KB Toys

- Agreed with *Enron I*
 - likely to follow *Enron I* for equitable subordination as well?

- Rejected *Enron II*
 - concepts of “assignment versus sale” are not easily distinguishable
 - cited multiple articles criticizing “assignment versus sale” analysis
 - “the exercise, in this context, is unhelpful and unrevealing of the appropriate outcome”



KB Toys

- Disruption of distress debt markets?
 - Claims buyers are sophisticated players that should perform due diligence
 - Account for risk in price
 - Obtain indemnity from seller
 - The notion that disallowance of claims in the hands of a purchaser under Section 502(d) would upset the distressed debt market is "a hobgoblin without a house to haunt"



KB Toys

- Curious open doors?
 - Applies to trade claims—makes no determination as to bank or bond debt
 - Instruments traded on “public markets” often get special protections
 - Information concerning possible avoidance actions was easily available by a simple review of the statement of financial affairs that identified prepetition transfers



Additional Comments

- Is the statutory framework in place to limit *KB Toys* to simply trade claims?
- What about unknown sellers?
- Multiple transfers?
- Conduct unrelated to claims?
- Do buyers want to rely on an indemnity lawsuit? That introduces the credit risk of the seller, not the issuer
- *KB Toys* is going up on appeal



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