Third Circuit Affirms Ruling that Purchaser of Trade Claims Takes Subjects to Disallowance Based on Sellers' Failure to Repay Preference Liability

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On November 15, 2013, the United States Court of Appeals for the Third Circuit held in *KB Toys* that certain trade claims purchased on the secondary market were subject to disallowance because the trade creditors that sold those claims had not repaid their preference liability.[1] The Third Circuit concluded that Section 502(d) of the Bankruptcy Code—which provides for the disallowance of any claim of any entity that is a transferee of a preferential or fraudulent transfer unless it has repaid the transferred amount to the bankruptcy estate—imprints a "taint" on the trade claim that travels with the claim into the hands of subsequent purchasers. In addition to its statutory construction analysis, the Third Circuit remarked that purchasers of trade claims take the risk of disallowance by involving themselves in a bankruptcy process and thereby must rely on their due diligence to price adequately the risk and their indemnities to recover any loss.

The Third Circuit's Analysis

KB Toys Inc. and its affiliated entities (the Debtors) filed bankruptcy on January 14, 2004 and, about two months later, filed their Statement of Financial Affairs (SOFA).[2] The SOFA disclosed all payments made by the Debtors in the 90-day period before bankruptcy—payments that would potentially be subject to attack as a voidable preference.[3] Over the following three years, ASM Capital, L.P. and ASM Capital II, L.P. (collectively, ASM) purchased nine trade claims from trade creditors (the Original Trade Creditors) that were listed on the SOFA as having received payments from the Debtors in the 90-day period before the bankruptcy filing.[4] After the Debtors confirmed their Chapter 11 plan, the liquidating trustee sought to disallow the trade claims held by ASM pursuant to Section 502(d) on the grounds that the Original Trade Creditors had received and not repaid preferential transfers.[5] The bankruptcy court agreed with the liquidating trustee and disallowed the claims.[6] The district court affirmed,[7] and ASM appealed to the Third Circuit.

The Third Circuit began its analysis by setting forth the relevant statutory language: "Notwithstanding subsections (a) and (b) of this section, the court shall disallow ***any claim of any entity*** from which property is recoverable [as a preferential transfer or other such avoidable transfer]." (Emphasis in original.)[8] The court focused on the language "any claim of any entity" and found with little discussion that the statute operates to "render a category of claims disallowable—those that belonged to an entity who had received an avoidable transfer."[9] Concluding that the statute focuses on claims—not claimants—the court held that the claims must be disallowed even in the hands of a purchaser.[10]

The Third Circuit supported its decision with a brief policy discussion. The court was concerned that if the transferred claim were protected from disallowance, it would permit the original claimant to "wash" the claim through a sale.[11] In that instance, the original claimant would receive cash from the buyer, and the buyer would receive funds from the debtor's estate—thereby diminishing the funds available to other creditors.[12] The estate would also lose the leverage to coerce the original claimant to disgorge its avoidable transfer, thus creating risk that the estate might never recover those funds.[13]

The court made some additional observations of perhaps greater importance to the claims trading market. It concluded that, as between an innocent buyer of a claim and an innocent estate (and its other creditors), the buyer should bear the risk of loss because it voluntarily chose to take part in a risky bankruptcy process.[14] In addition, the buyer has the opportunity to perform due diligence on the risks associated with the claim and then account for that risk in the price or otherwise shift the risk of loss back to the seller through indemnities in the claim purchase agreement.[15]

The Third Circuit also rejected the "sale versus assignment" analysis offered in the so-called *Enron II* decision by the District Court for the Southern District of New York.[16] *Enron II* held that when a claim is assigned, the assignee stands in the shoes of the assignor, and is subject to all the defenses that could have been asserted to defeat the claim in the assignor's hands. By contrast, when a claim is sold, the buyer takes free of any personal disabilities of the seller.[17] Thus, whether the disability of Section 502(d) travels with the claim to the next holder turns on whether the claim is assigned (disability travels) as opposed to sold (disability does not travel). Rejecting this analysis, the Third Circuit found that it was unsupported by the case law on which it relied and that, in any event, resort to state law in bankruptcy cases "must be done with care."[18]

The Bottom Line

The Third Circuit has now definitively ruled that a buyer of trade claims takes subject to the disability of Section 502(d). If a trade claim is subject to disallowance in the seller's hands based on its failure to return an avoidable transfer, then the buyer will take the trade claim subject to that same risk arising from the seller's preference liability. Claims buyers will have to perform due diligence on the seller (both in terms of its liability to the estate on an avoidance action, as well as its financial ability to stand behind the indemnity) to evaluate and price those risks. They should also ensure that the indemnities in the purchase agreement are strong enough to provide a right to recover any loses back against the seller. To the extent that the existing market in trade claims does not already contemplate that an acquired trade claim would be subject to disallowance on this basis, the result of the ruling may be to interfere with the efficiency of the secondary market in bankruptcy claims.

The Third Circuit's decision does not necessarily resolve other questions. For example, if a claim is sold multiple times, would subsequent purchasers have a better argument if they could show that they could not possibly perform diligence upon every previous holder in their chain of title? In addition, should the same result apply to transfers of notes, bonds, bank debt and other such instruments, as opposed to trade claims—especially if the identities of the previous holders are unknown? What about situations in which the transfers occurred prepetition when potential preference liability remained speculative? Nor does the decision, which is limited to the application of Section 502(d) of the Bankruptcy Code, address the analytically distinct question whether a claim that may be subject to equitable subordination in the hands of a seller remains so when transferred to a third-party buyer. The *KB Toys* decision in many ways was an "easy case" to find against the transferee. One can envision other scenarios that present much more difficult choices and where additional guidance from the courts will be necessary.

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[1] *In re KB Toys, Inc.*, 2013 WL 6038248 (3d Cir. November 15, 2013).

[2] *Id*. at *1.

[3] *Id*.

[4] *Id*. at *1-2.

[5] *Id*. at *2.

[6] *Id*.

[7] *Id*.

[8] *Id*.

[9] *Id*. at *3.

[10] *Id*.

[11] *Id*.

[12] *Id*.

[13] *Id*.

[14] *Id*. at *3 n.8.

[15] *Id*.

[16] *Id*. at *4 n.11 (discussing *Enron Corp. v. Springfield Assocs., LLC* (*In re Enron Corp.*), 379 B.R. 425 (S.D.N.Y. 2007)). WilmerHale represented the Loan Syndications and Trading Association, the Securities Industry and Financial Markets Association, and the International Swaps and Derivatives Association as *amici curiae* in the *Enron* proceedings before the district court.

[17] *Enron*, 379 B.R. at 435-36.

[18] *KB Toys* at *4 n.11.