Purchaser of Trade Claims Takes Subject to Disallowance Based on Sellers' Failure to Repay Preference Liability

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On May 4, 2012, in the *KB Toys* case, Bankruptcy Judge Kevin J. Carey of the United States Bankruptcy Court for the District of Delaware disallowed certain trade claims purchased on the secondary market because the sellers of those claims had not repaid their preference liability.[1] In so ruling, the court 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.[2] The court rejected the analysis from 2007 of the United States District Court for the Southern District of New York in *Enron* that concluded on appeal (in reversing the bankruptcy court) that disallowance pursuant to Section 502(d) created a "personal disability" that did not transfer with claims when they are sold to good faith purchasers on the open market.[3]

The Bankruptcy Court's Analysis

ASM Capital, L.P. and ASM Capital II, L.P. (collectively, "ASM") purchased certain trade claims from trade creditors (the "Original Trade Creditors") whose provision of goods or services gave rise to the claims. The liquidating trustee brought preference actions against the Original Trade Creditors—in most cases after but in one case before ASM purchased the claims—and obtained default or summary judgments that established the Original Trade Creditors' preference liability. The trustee then sought to disallow the trade claims held by ASM pursuant to Section 502(d) on the grounds that the previous holders of those claims, the Original Trade Creditors, had not repaid their preference liability.[4]

The bankruptcy court framed the issue as "whether the purchaser of a trade claim holds the purchased claim subject to the same rights and disabilities, and is subject to Bankruptcy Code § 502(d) challenge, as is the original holder of the claim."[5] The court initially focused on the language of Section 502(d), which provides in relevant part: "[T]he court shall disallow any claim of any entity . . . that is a transferee of a transfer avoidable under section . . . 547 . . . of this title, unless such entity or transferee has paid the amount . . . ." Because courts had disagreed about the plain meaning of

this section,[6] the bankruptcy court also looked to the legislative history and rationale of the previous cases to guide its analysis.

With respect to the legislative history, the bankruptcy court determined that Section 502(d) of the Bankruptcy Code is derived from Section 57g of the Bankruptcy Act of 1898 (repealed 1978). The court interpreted Section 57g as establishing the basis for allowance or disallowance of particular ***claims***—focusing on the claims themselves as opposed to the holders of the claims. This supported its thesis that Section 57g of the old Bankruptcy Act (and thus its successor, Section 502(d) of the current Bankruptcy Code) provided a disability that traveled with the claim from seller to buyer.[7]

The bankruptcy court also found persuasive two New York bankruptcy court opinions—*In re Metiom* and the bankruptcy court's opinion (subsequently reversed) in *Enron*. The bankruptcy court adopted the *Metiom* court's view that Section 502(d) provided a defense to the claim that "cannot be altered by the claimant's subsequent assignment of the claim to another entity . . . ."[8]Rather, the prospective assignees must consider these possible defenses when they negotiate the terms of assignment of the claims.[9] The bankruptcy court also extensively quoted the *Enron* bankruptcy court's opinion and highlighted its view that a transfer of a claim does not change the character of the claim itself, but rather merely substitutes parties.[10]

Rejection of the District Court's *Enron* Opinion from the Southern District of New York

The Bankruptcy Court in the *KB Toys* case then turned its analysis to the district court opinion in *Enron*. It first recognized that, based on its plain reading, the district court ruled that Section 502(d) imposes a personal disability on the claimant—not the claim—and thus the personal disability does not travel with the claim to a new holder. In addition, the *Enron* district court opined that the purpose of Section 502(d) "would not be served if a claim in the hands of a claimant could be disallowed even where the claimant never received the preference to begin with, and as a result, could not be coerced to return it."[11]

The *KB Toys* court then discussed how the *Enron* district court buttressed its opinion with an analysis that distinguished between an "assignment" of a claim and a "sale" of a claim. 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.[12] 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). The *Enron* district court thus stressed that "sales of claims on the open markets are indisputably sales."[13]

The *KB Toys* bankruptcy court fundamentally disagreed with the *Enron* district court's "assignment" versus "sale" analysis. It first noted that these concepts are not easily distinguishable and that neither is defined in the Bankruptcy Code. Next, to emphasize its rejection of that opinion, it cited multiple articles from commentators that essentially contended that the assignment-versus-sale

analysis not only introduced a novel distinction that ignores the interchangeability of those terms, but also did not provide any clear guidance for market participants going forward. And even if one could "distinguish between an assignment and a sale, the exercise, in this context, is unhelpful and unrevealing of the appropriate outcome."[14]

Having rejected the assignment-versus-sale analysis, the bankruptcy court turned to concerns of potential disruption of the distressed debt markets. In this regard, the court took the view that claims traders are sophisticated players that are capable of performing due diligence, but in any event should understand and account for the risk that avoidance actions could give rise to a defense to a claim. Indeed, the court stated that 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."[15]

The court then concluded that ASM's claims must be disallowed because of the existing preference liability of the Original Trade Creditors. It noted that the debtors' statement of financial affairs had listed the prepetition payments during the preference period, thereby putting ASM on constructive, if not actual, notice of the Original Trade Creditors potential preference liability and corresponding risk of disallowance of the trade claims under Section 502(d). ASM could have uncovered this risk with a modicum of due diligence and priced the trades accordingly or obtain, as it did in some of the trades, an indemnity from the Original Trade Creditor.[16]

The Bottom Line

The Delaware bankruptcy court has found 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 rely on their own due diligence efforts and indemnities in the purchase agreement, or simply take the risk that a trade claim might be disallowed under Section 502(d) (and discount the price accordingly).

Of critical importance, the *Enron* district court ruled that the assignment-versus-sale analysis also applied when a claim that was subject to equitable subordination in the hands of a bad actor was transferred to another party that had not engaged in misconduct. In other words, the *Enron* district court held that a good faith purchaser of claims takes free of any equitable subordination risk that may have existed while the seller held the claims.[17]Given the Delaware bankruptcy court's fundamental disagreement with the *Enron* district court's assignment-versus-sale analysis and given its overall embrace of the reasoning of the *Enron* bankruptcy court (with little deference paid to the *Enron* district court's criticism of that decision), one could reasonably expect that the Delaware bankruptcy court would likewise follow the *Enron* bankruptcy court and hold that claims in the hands of a buyer may be equitably subordinated to the same extent as they would be in the hands of the seller.

That said, the bankruptcy court did allow that its analysis applied only to ***trade claims*** purchased from the original holders and it made "no determination about whether the same result should ensue in circumstances involving other types of transferred claims." It specifically noted that drafters of the Bankruptcy Code often give special protection to transfers in "public markets."[18]Moreover, part of its analysis concerned the constructive (if not actual) notice imputed to the buyer of the trade claims given the information that was available in the schedules. Thus, the door remains open for the Delaware bankruptcy court to reach a different result with respect to (i) transfers of notes, bonds, bank debt and other such instruments, and (ii) transfers that occurred prepetition or in other circumstances where information concerning the disability was not available.

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[1]*In re KB Toys*, Inc., 2012 WL 1570755 (Bankr. D. Del. May 4, 2012).

[2]*Id*., at *11.

[3]*Id*. at *9-11 (analyzing *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.

[4]*KB Toys*, at *1-2.

[5]*Id*., at *2.

[6]*Id*., at *3 (comparing *In re Metiom, Inc.*, 301 B.R. 634, 642-43 (Bankr. S.D.N.Y. 2003) and the bankruptcy court's decision in *Enron Corp. v. Avenue Special Situations Fund II, LP (In re Enron Corp.*), 340 B.R. 180, 194 (Bankr. S.D.N.Y. 2006) with the district court's reversal of the bankruptcy court in Enron, 379 B.R. at 443.

[7]*Id*., at *5.

[8]*Id*., at *7 (quoting In re Metiom, 301 B.R. at 642-43).

[9]*Id.*

[10]*Id*., at *7-8 (analyzing *In re Enron*, 340 B.R. at 198-99).

[11] *Id*., at *9 (quoting *In re Enron*, 379 B.R. at 443).

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

[13]*Id*., at 446 n. 104.

[14] *KB Toys*, at *9.

[15]*Id*., at *10.

[16]*Id.*

[17]*Enron*, 379 B.R. at 442.

[18] *KB Toys*, at *10 n.14.