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Third Circuit Holds That Claims Are Disallowable Under Section 502(d) Of The Bankruptcy Code No Matter Who Holds Them

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In a recent opinion, the United States Court of Appeals for the Third Circuit (the "Third Circuit") held that a trade claim that is subject to disallowance under section 502(d) of title 11 of the United States Code (the "Bankruptcy Code") is similarly disallowable in the hands of a subsequent holder of the claim – in other words, section 502(d) disabilities travel with the claim (whether received by assignment or sale). *In re KB Toys Inc., et al*., Case No. 13-1197 (3d Cir. Nov. 15, 2013) (*"KB Toys"*). In reaching its holding, the Third Circuit disagreed with Judge Shira A. Scheindlin's relatively recent decision in *In re Enron Corp*., 379 B.R. 425 (S.D.N.Y. 2007) (*"Enron II"*), in which the court concluded that equitable disallowance under section 510(c) of the Bankruptcy Code and disallowance under section 502(d) are not attributes of, and therefore do not travel with, a claim but are personal disabilities of the individual claimants (unless the claim is transferred by assignment, rather than a sale).

In a prior Willkie article, District Court Vacates Bankruptcy Court's Enron Decisions Regarding Equitable Subordination and Disallowance (the "*Enron II* Memorandum"), we discussed the *Enron II* decision and noted that it did not clearly amplify the factors that would apply in distinguishing between sales and assignments of claims. This was one of the many factors that led the Third Circuit in *KB Toys* to conclude that the Court's reasoning in *Enron II* was problematic and should not be followed. A more thorough discussion of the *KB Toys* decision and its potential implications follows.

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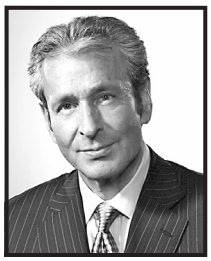

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Facts

The *KB Toys* debtors commenced their chapter 11 cases in January 2004 and filed their Statements of Financial Affairs ("SOFAs") two months later. As required, each SOFA disclosed all payments made within the 90-day period prior to the chapter 11 filing (which is the non-insider preference period under section 547 of the Bankruptcy Code). Shortly after the filing of the SOFAs, two ASM Capital entities ("ASM") purchased nine trade claims (the "Claims") against the *KB Toys* debtors through assignment agreements. Although only four of the assignment agreements contained a generic indemnification provision, each agreement contained a specific restitution provision shifting the risk of disallowance of the relevant Claims back to the original claimants (the "Original Claimants"). Notably, each Original Claimant was listed on a SOFA as having received a payment within 90 days of the chapter 11 filing.

Ultimately, preference actions were commenced against each of the Original Claimants (eight of the Claims transfers had taken place before the actions were commenced and the remaining transfer was made after a judgment was obtained). Judgments were obtained in each case, although the judgments were not collectable because the Original Claimants all had gone out of business. As a result, the liquidating trustee appointed under the *KB Toys* plan filed an objection seeking disallowance of the Claims under section 502(d) of the Bankruptcy Code, contending that each of the Original Claimants had received a preference before transferring its Claim to ASM. The bankruptcy court's disallowance of the Claims under section 502(d) was affirmed by the Delaware District Court, and ASM appealed.

Section 502(d) Of The Bankruptcy Code

Section 502(d) of the Bankruptcy Code provides, in relevant part, that:

> the court shall disallow *any claim of any entity* from which property is recoverable under sections 542, 543, 550, or 553 of this title or that is a transferee of a transfer avoidable under section 522(f), 544, 545, 547, 548, 549, or 724(a) of this title, unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable under section 522(i), 542, 543, 550, or 553 of this title. (emphasis added)

The Delaware Lower Court Decisions

After considering the language of the statute and its related legislative history, the Delaware bankruptcy court (Judge Gross) concluded that the purchaser of a trade claim is subject to the same section 502(d) challenges as the original claimant and that related section 502(d) "disabilities attach to and travel with the claim." Judge Gross also declined to find that ASM was a good faith purchaser, noting that ASM was a sophisticated claims trader, was very familiar with the bankruptcy process, had access to the SOFAs and easily could have discovered the potential for disallowance under section

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502(d). The Delaware District Court, while stating that it believed the plain language of the statute was ambiguous, nonetheless adopted the reasoning of the bankruptcy court.

The Third Circuit Opinion

Starting with the text of section 502(d), the Third Circuit noted that the statute provides that "*any claim of any entity*" who received an avoidable transfer shall be disallowed, thereby rendering a category of claims disallowable. It therefore concluded 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." In reaching its conclusion, the Third Circuit determined that to decide otherwise would thwart the aims of section 502(d), including ensuring the equality of distribution of estate assets.[1] This would be so, in the Third Circuit's view, because if the transferred claim were protected from disallowance, an original claimant holding a claim subject to avoidance would have an incentive to transfer a claim (to receive a distribution on a claim that otherwise would be disallowed), resulting in the claim being cleansed in the hands of the transferor (who could then receive a distribution on the claim). Thus, creditors would be negatively impacted in two ways. One, the estate would have less money because the recipient of the avoidable transfer would not be forced to return it in order to receive a distribution. And two, the estate would have to make a distribution on a claim that otherwise would be disallowed. The court also concluded that to hold otherwise would undermine the second aim of section 502(d), forcing compliance with judicial orders, inasmuch as section 502(d) can be used to compel an original claimant to comply with an order to return an avoidable transfer in order to receive a distribution on its claim. Ironically, both aims of section 502(d) were considered by the *Enron II* court when it reached the opposite conclusion.

As an important policy consideration, the Third Circuit also considered who should bear the risk of avoidable transfers not being returned – the estate or the buyer – and concluded that the answer must be the buyer for two primary reasons. First, citing the lower bankruptcy court decision considered in *Enron II*, the court noted that claims purchasers voluntarily participate in the bankruptcy process, typically are sophisticated parties and are or should be aware of the attendant risks involved in the process. Second, claims purchasers are in a position to perform due diligence, estimate the risk of disallowance when determining the price to pay and to mitigate against the potential loss (as ASM attempted to do in *KB Toys* by shifting the risk of disallowance to, and requiring restitution from, the Original Claimants). Thus, the Third Circuit concluded it is only fair to require claims purchasers to bear the risk.

In reaching its decision, the Third Circuit also noted that the legislative history behind section 502(d) supported its conclusion because the legislative history was clear that section 502(d) derived from then present law, which was section 57(g) of the Bankruptcy Act of 1898,[2] and section 57(g) had been interpreted in a manner consistent with the Third Circuit's view. In this regard, the Court of Appeals for the Eighth Circuit previously had held in interpreting section 57(g) that "[t]he disqualification of a claim for allowance created by preference inheres in and follows every part of the claim, whether retained by the original creditor or transferred to another, until the preference is surrendered." *Swarts v. Siegel*, 117 F. 13, 15 (8th Cir. 1902).

As to other case law interpreting section 502(d), the Third Circuit rejected the *Enron II* court's opposite conclusion regarding the focus of section 502(d) as being on the claimant as opposed to the claim, including its rationale that disallowance is a personal disability of a claimant determined by state law and not an attribute of the claim (unless the transferee took the claim by assignment, as opposed to by sale).[3] Noting that resort to state law in a bankruptcy case must be done with care to avoid inconsistency with bankruptcy laws, the Third Circuit determined that an approach that relied on state law that did not provide a clear distinction between an assignment and a sale would be problematic.[4]

Finally, the Third Circuit rejected ASM's arguments that it should be afforded the protections of a "good faith" purchaser under section 550(b) of the Bankruptcy Code (which provides, in relevant part, that a debtor may not recover from a transferee that takes for value, in good faith and without knowledge of the voidability of the transfer avoided), because section 550(b) only protects a good faith purchaser of *estate property*, and ASM did not purchase property of the estate (it instead purchased claims against the estate). The Third Circuit additionally emphasized that claims purchasers like ASM voluntarily enter the claims purchasing process with full knowledge of the attendant risks and uncertainties involved (including disallowance under section 502(d)).

Some Takeaways

It is not clear whether other circuit courts will reach the same conclusion as that reached by the Third Circuit, which was the first circuit court to consider this aspect of section 502(d). What is clear is that *KB Toys* will be the controlling law in the Third Circuit with respect to the applicability of section 502(d) to trade claims. In the Second Circuit, *Enron II* is still good law in its district, although it is not binding precedent on courts outside of the Southern District or other district judges within the Southern District, and conflicting decisions have been reached as to whether a district court decision is *stare decisis* when it emanates from a single-district judge in a multi-judge district.[5]

In addition, although the underlying claims at issue in *KB Toys* specifically were trade claims, as opposed to notes or securities claims, the language and analysis of the Third Circuit's opinion appears broad enough so as to be applicable to other types of claims (even though Judge Gross had expressly noted that his ruling was limited to trade claims). Indeed, the reasoning behind the decision (language of the statute, sophistication of claims purchasers and allocation of risk) suggests that the Third Circuit, at least, would apply its decision to all types of claims, not just trade claims.

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1. The purpose of section 502(d) is to "promote the pro-rata sharing of the bankruptcy estate among all creditors and the coercion of the payment of judgments obtained by the trustee." 5 *Collier on Bankruptcy* ¶ 502.05[2][a] at pp. 502-58 (16th ed. 2013).

2. Section 57(g) provided that "[t]he claims of creditors who have received or acquired preferences, liens, conveyances, transfers, assignments or encumbrances, void or voidable under this title, shall not be allowed unless such creditors shall surrender such preferences, liens, conveyances, transfers, assignments, or encumbrances."

3. As discussed in the *Enron II* Memorandum, the *Enron II* court held that disallowance under section 502(d) is a personal disability of particular claimants and not of the claims themselves, unless the transferee took the claim by assignment (the *Enron II* court believed that, unlike a buyer, the assignee of a claim stands in the shoes of an assignor, and takes the claim with whatever limitations the assignor had).

4. The Third Circuit also noted that, in addition to the bankruptcy court in *KB Toys*, two other bankruptcy courts reached the same conclusion (*Enron Corp. v. Avenue Special Situations Fund II, LP (In re Enron Corp.)*, 340 B.R. 180 (Bankr. S.D.N.Y. 2006) ("*Enron I*," vacated and remanded by *Enron II*)) (holding that claim in hands of transferee should be disallowed to same extent it would be in hands of transferor) and *In re Metiom, Inc.*, 301 B.R. 634, 642-43 (Bankr. S.D.N.Y. 2003) (holding that because section 502(d) disallows the claim, the claim and the defense to the claim cannot be altered by the subsequent transfer of the claim to an entity that did not receive an avoidable transfer).

5. Interestingly, ASM also was involved in a section 502(d) case before the Second Circuit Court of Appeals in 2009, in which the Second Circuit determined that section 502(d) did not require disallowance of administrative expense claims acquired from entities that received voidable transfers. *See ASM Capital, LP. v. Ames Department Stores, Inc. (In re Ames Dept. Stores, Inc.)*, 582 F.3d 422 (2d Cir. 2009). However, the Second Circuit expressly did not reach the issue whether, assuming section 502(d) did apply to administrative expense claims, it could be invoked against only the original claimant that received an avoidable transfer and not against a subsequent holder.