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BANKRUPTCY UPDATE

Avoidance Actions Against Seller Void Purchased Bankruptcy Claims

Section 502(d) Disabilities Attach to and Travel With Bankruptcy Claims, Court Rules

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Special to the Legal

In addition to adjudication of business restructurings or sales of businesses or assets, the administration of bankruptcy cases involves two substantial undertakings: the allowance and fixing of claims against the debtor and the recovery, or "avoidance," of prepetition transfers such as fraudulent transfers and preferences for the benefit of the estate. A powerful provision of the Bankruptcy Code not well known except to bankruptcy specialists connects claim administration and transfer avoidance by providing that the holder of a claim against the debtor is not allowed to participate in any distribution if the holder of the claim has not returned the preference or other avoidable transfer to the estate, even if the amount of the claim far exceeds the amount of the preference.

This provision — Section 502(d) of the Bankruptcy Code — was examined recently by the U.S. Bankruptcy Court for the District of Delaware in the context of the trading of claims in bankruptcy cases, and reaffirmed the effect of Section 502(d) on allowance and distribution must be considered by all holders of claims in bankruptcy cases.

In an opinion issued on May 4, in *In re KB Toys*, No. 04-10120 (KJC), slip op. (Bankr. D. Del. May 4, 2012), by Bankruptcy Judge Kevin J. Carey of the U.S. Bankruptcy Court for the District of Delaware, the court held that the purchaser of a claim from a claimant that received a preference prior to the bankruptcy filing would have the claim disallowed because the original claimant failed to return the preference payment to the estate. In rendering its decision, the court decided not to adopt a contrary ruling issued in the U.S. District Court for the Southern District of New York in *In re Enron*, which held that Section 502(d) only applied to the original claimant, not a subsequent purchaser who buys the claim.

BANKRUPTCY FILING

KB Toys Inc. and related entities filed for bankruptcy in January 2004. The retailer liquidated in Chapter 11, and the bankruptcy court confirmed a plan of reorganization in August 2005. The plan established the KBTI Trust to, among other things, liquidate, collect and maximize the value of certain assets, and investigate and pursue avoidance actions and other claims for the benefit of creditors, including preferences under Section 547 of the Bankruptcy Code. This process often takes years to complete.

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The *KB Toys* case is no exception. Nine holders of claims against the estate sold their claims to ASM Capital LP and ASM Capital II LLP (ASM). The opinion points out that all nine original claimants were listed on the debtors' statement of financial affairs as creditors who received payments within 90 days prior to the bankruptcy filing, which would be potentially avoidable preference transfers.

In fact, the trustee commenced adversary proceedings under Section 547 of the Bankruptcy Code to avoid the preference payments, and obtained default judgments against the original claimants. Having obtained the judgments, in July 2009, the trustee objected to their claims, now held by ASM, pursuant to Section 502(d) of the Bankruptcy Code.

COURT EYES SECTION 502(D)

Section 502(d) provides that "the court shall disallow any claim of any entity from which property is recoverable under Section 542, 543, 550, or 553 of this title or that is a transferee of a transfer avoidable under Section 522(f), 522(h), 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" (11 U.S.C. § 502(d)). According to the opinion, the issue presented is the meaning of the phrase "any claim of any entity." The trustee argued that the statute's use of the term "claim," not "claimant" requires that the claim's "disability accompanies the claim through its journey into the hands of others." ASM argued that the statute's emphasis on "entity" meant "the disability rests with the original claimant."

The opinion notes the differences of opinion regarding the "plain meaning" of Section 502(d) among several recent decisions from the U.S. Bankruptcy and District Court of the Southern District of New York. The bankruptcy court twice decided the statute's plain meaning supported the disallowance of any claim, regardless of the entity holding the claim, unless the original claimant pays its liability for the avoidable transfer, first in *In re Metiom*, 301 B.R. 634 (Bankr. S.D.N.Y. 2003), and then in *Enron v. Avenue Special Situations Fund II*, (*In re Enron*), 340 B.R. 180 (Bankr. S.D.N.Y. 2006) ("*Enron I*"). However, the district court later vacated and remanded *Enron I*, holding that the plain language of 502(d) focuses on the claimant, and whether a disability travels with a transferred claim depends on whether a transfer was a "sale" or an "assignment." (See *Enron v. Springfield Associates*, (*In re Enron*), 379 B.R. 425 (S.D.N.Y. 2007) ("*Enron II*"). Carey agreed with the decisions in *Metiom* and *Enron I*, and concluded that in light of the plain language, legislative history and decisional law, "a claim in the hands of a transferee has the same rights and disabilities as the claim had in the hands of the original claimant."

The U.S. Bankruptcy Court for the District of Delaware held that the purchaser of a claim from a claimant that received a preference prior to the bankruptcy filing would have the claim disallowed.

The court undertook a review of the history of Section 502(d) and its application to claims trading situations under prior law, and noted that the business of claims trading can be traced over almost 200 years. The court noted the legislative history of Section 502(d) was helpful in light of the debate over the clarity of the language. The opinion recites how Section 502(d) was derived from Section 57g of the Bankruptcy Act of 1898. Under Section 57g, claims of creditors who received avoidable transfers were not allowed until the transfers were surrendered to the estate. The court concluded that because Section 57g established the basis for allowance or disallowance of particular claims, such disabilities travel with the claims.

Turning to case law, the court discussed *Swarts v. Seigel*, 117 F. 13 (8th Cir. 1902), a U.S. Court of Appeals for the Eighth Circuit decision from 1902 that held that "the disqualification of a claim for allowance created by a 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." The opinion notes the reasoning in *Swarts* was followed by several other circuit courts in the years leading up to the enactment of the Bankruptcy Code. The court reasoned unless Congress intended to clearly change a provision of the existing law, prior case law interpreting a provision is still valid law. In this situation, case law interpreting Section 57g of the Bankruptcy Act was still valid law in interpreting Section 502(d) of the Bankruptcy Code.

Next, the court described how the *Metiom* and *Enron I* courts had taken a view consistent with the case law established under the Bankruptcy Act. The *Metiom* court had noted that the issue of whether a claim may be disallowed in the hands of a transferee if the transferor received an avoidable transfer had been decided over a century ago in *Swarts*. The *Metiom* court noted the established rule that "the assignee of a non-negotiable instrument is subject to all of the equities and burdens that attach to the property assigned, because the assignee receives no more than the assignor possessed." Furthermore, it is incumbent on the claim purchaser to take into account possible claim defenses when they negotiate the terms of their assignment.

The opinion notes the *Enron I* court also held a claim that is subject to disallowance in the hands of the transferor remains subject to disallowance in the hands of the transferee; the relationship between the claim and the Section 502(d) disallowance is not severed by the transfer. The court agreed with the *Enron I* court's conclusion that allowing a transferred claim in the hands of a transferee that would have been disallowed in the hands of the transferor would undercut the purpose and policy of Section

502(d). Finally, the opinion quotes the *Enron I* court's reasoning that a judicial determination that the claims should be disallowed would not seriously undermine confidence in the system of post-petition claims market because claims purchasers are, or should be, aware of the risks and uncertainties inherent in the purchase of claims, including the possibility of claims being disallowed unless and until the sellers turn over avoidable transfers.

The opinion also refers in a footnote to another recent Section 502(d) decision issued by the U.S. Bankruptcy Court for the District of Delaware. In *Giuliano v. Mitsubishi Digital Electronics America* (*In re Ultimate Acquisition Partners*), Bankruptcy Judge Mary F. Walrath dismissed with leave to amend a Section 502(d) complaint against a preference defendant because the defendant's preference liability had not yet been judicially determined. (No. 11-52663 (MFW), slip op. (Bankr. D. Del. May 1, 2012).) It has become common practice among preference plaintiffs to plead counts for both preference liability under Section 547 and claim disallowance under Section 502(d) in the complaint. Walrath declined to disallow claims on the basis that the preference claim had been asserted but not adjudicated, and held "a debtor or trustee wishing to avail itself of the benefits of Section 502(d) must first obtain a judicial determination on the preference complaint." Without such a judicial determination, according to Walrath, there is no basis for a Section 502(d) claim. Carey noted the *Enron I* court had reached a different conclusion, holding that a Section 502(d) claim should not be dismissed even though the court had not yet adjudicated an avoidance action, because a debtor may use Section 502(d) as a defense to the assertion of a claim. In the *KB Toys* case, the preference claims had been adjudicated, so this issue was not addressed.

Turning to *Enron II*, the court began by noting the district court's opposite reading of the "plain language" of Section 502(d). The *Enron II* court concluded that the statute's focus on the claimant led "to the inexorable conclusion that disallowance is a personal disability of a claimant, not an attribute of the claim." Similarly, according to the *Enron II* court, a claim transferee has no ability to surrender something it does not have: the avoidable transfer made to the original claimant.

According to the opinion, the *Enron II* court had reasoned that if a claim transfer is an assignment, the assignee takes the claim with whatever limitation it had in the hands of the assignor. However, if the claim transfer is a sale, the purchaser does not stand in the shoes of the seller. Therefore, the claim's disability will travel with it if the claim is assigned, but not if the claim is sold. The opinion notes reliance on the distinction between "sale" and "assignment" has been criticized.

Finally, the court rejected the *Enron II* court's conclusion that disallowing a transferred claim would upset the distressed debt markets. The court reasoned that claims trading markets are ancient and, despite their explosion in size, capable of comprehending and adjusting for risk. The court described the threat of disrupting the claims trading market by subjecting a transferred claim to Section 502(d) disallowance as a "hobgoblin without a house to haunt."

The court found that the debtors' statement of financial affairs listed the original claimants as potential preference defendants, thereby placing ASM and all other potential buyers of trade claims on constructive or actual notice of potential disallowance of the claims under Section 502(d). In fact, the opinion notes that several of the agreements between ASM and the original claimants contained indemnification provisions that showed that ASM was aware of the risk, and negotiated to neutralize it in some of the purchase transactions. The court rejected ASM's argument that the claim should be allowed because ASM purchased the claims in good faith and observed that ASM was aware that it was purchasing claims that were subject to potential disallowance.

THE REACH OF SECTION 502(D)

Creditors often are not aware that allowance and distribution of their claims may be delayed or disallowed entirely unless and until they resolve preference claims or other avoidance actions, which may take years. The decisions in *KB Toys* and *Ultimate Acquisition Partners* demonstrate that even sophisticated traders in bankruptcy claims must continue to consider the breadth and reach of Section 502(d) of the Bankruptcy Code.

The *KB Toys* decision likely will affect negotiations and terms of bankruptcy claims sales, including indemnity provisions. The defendants in *KB Toys* have appealed Carey's decision, and whatever the outcome on appeal, we are confident given the views expressed in case decisions interpreting Section 502(d) to date, there will be more on this topic. •