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## Third Circuit Holds That the Risk of Section 502(d) Disallowance Travels with a Purchased Claim

In an appeal arising out of a claims objection in the chapter 11 liquidation of KB Toys, Inc. and affiliated debtors (the “Debtors”), the United States Court of Appeals for the Third Circuit recently held that a trade claim subject to disallowance under section 502(d) of the Bankruptcy Code in the hands of the original claimant remains so in the hands of a subsequent transferee.<sup>1</sup> The Court concluded that section 502(d) “render[s] a category of claims disallowable—those that belonged to an entity who had received an avoidable transfer”—and this disability travels with the claim.<sup>2</sup> In so holding, the Third Circuit disagreed with a decision six years earlier by the District Court for the Southern District of New York which held that a section 502(d) disability is personal to a particular claimant rather than an attribute of a claim and that, as a result, such disability only travels to a transferee if the claim is transferred though an assignment as opposed to a sale.<sup>3</sup>

### Background

The Debtors filed their chapter 11 cases in early 2004. Between April 2004 and May 2007, ASM Capital, L.P. and ASM Capital II, LLP (together, “ASM”)—entities that regularly purchased claims in bankruptcy cases—purchased nine claims from certain of the Debtors’ trade creditors (the “Original Claimants”). The related assignment agreements expressly shifted the risk of disallowance to the Original Claimants by requiring the Original Claimants to pay restitution if the purchased claims were disallowed. Some of the assignment agreements also included indemnification clauses.

In March 2004, before ASM purchased any of the claims, the Debtors filed a Statement of Financial Affairs that indicated that the Original Claimants had received some payments from the Debtors during the ninety-day period before the filing of the Debtors’ chapter 11 cases (*i.e.*, the preference period for non-insiders under section 547 of the Bankruptcy Code). A subsequently-appointed liquidating trustee brought preference actions against the Original Claimants, obtaining judgments that proved uncollectable because the Original Claimants went out of business.<sup>4</sup> On July 31, 2009, the liquidating trustee sought to

<sup>1</sup> *In re KB Toys Inc.*, No. 13-1197, 2013 WL 6038248 (3d Cir. Nov. 15, 2013) (“KB Toys”).

<sup>2</sup> *Id.* at \*3.

<sup>3</sup> *Enron Corp. v. Springfield Associates, L.L.C. (In re Enron Corp.)*, 379 B.R. 425, 436 (S.D.N.Y. 2007) (“Enron”) (J. Scheindlin).

<sup>4</sup> ASM purchased most of the claims before the liquidating trustee brought the preference actions; only one claim was purchased after a judgment was obtained.

disallow ASM's claims under section 502(d), which provides for disallowance of "*any claim of any entity*" that received—and failed to repay—an avoidable transfer.<sup>5</sup> The liquidating trustee maintained that ASM's claims were subject to disallowance despite the fact that the Original Claimants received preferential payments, not ASM.

After considering the plain language and legislative history of section 502(d), the Bankruptcy Court disallowed ASM's claims, concluding that a trade claim purchaser is subject to the same section 502(d) risk as the original claimant.<sup>6</sup> It further held that ASM was not entitled to rely on the protections for "good faith purchasers" under section 550(b) of the Bankruptcy Code because a claims purchaser is aware (or should be aware) of the risk that the bankruptcy claim it purchases will be disallowed.<sup>7</sup> The District Court affirmed and ASM appealed to the Third Circuit Court of Appeals.<sup>8</sup>

### Analysis

Like the lower court, the Third Circuit considered the plain language of section 502(d), which provides that "any claim of any entity" that received an avoidable transfer shall be disallowed until the entity that received the avoidable transfer (or its transferee) returns it to the bankruptcy estate. The Court 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."<sup>9</sup>

The Third Circuit recognized that ruling otherwise would permit (and encourage) creditors receiving avoidable transfers to sell their claims and "wash" them of any section 502(d) disability; a sale would enable the original claimant to receive value for its claim without returning any avoidable transfers to the

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<sup>5</sup> Specifically, section 502(d) of the Bankruptcy Code provides as follows:

Notwithstanding subsections (a) and (b) of this section, 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.

<sup>11</sup> U.S.C. § 502(d) (emphasis added).

<sup>6</sup> *In re KB Toys, Inc.*, 470 B.R. 311, 334 (Bankr. D. Del. 2012) (J. Carey).

<sup>7</sup> *Id.* at 343.

<sup>8</sup> The District Court found that plain language of section 502(d) was ambiguous, but it otherwise adopted the reasoning of the Bankruptcy Court. *KB Toys* at \*2.

<sup>9</sup> *Id.* at \*3. The Third Circuit also noted that the legislative history behind section 502(d) supports the conclusion that potential disallowance runs with the claims. *Id.*

bankruptcy estate and give the transferee the right to receive a distribution on a claim that would have been disallowed in the hands of the original claimant.<sup>10</sup> The Court noted that permitting such a result would contravene the purposes of the statute—ensuring equality of distribution among creditors and coercing compliance with orders for the return of avoidable transfers.

The Third Circuit recognized that its construction requires claims purchasers to assume the risk that original claimants will fail to return avoidable transfers.<sup>11</sup> The Court viewed this risk allocation as appropriate and fair because claims purchasers typically are sophisticated entities that (a) appreciate the risks and uncertainties associated with the bankruptcy process and elect to purchase claims anyway, and (b) are well-positioned to mitigate the risk of disallowance by conducting diligence on a claim and making corresponding adjustments to the purchase price.<sup>12</sup> The Court noted that a purchaser could shift the risk of disallowance back to the original claimant by contract and that ASM’s assignment agreements included these types of provisions.<sup>13</sup>

The Court acknowledged that, in *Enron*, the District Court for the Southern District of New York concluded that disallowance does not travel with the claim in a sale transaction but instead operates as a personal disability tied to a particular claimant.<sup>14</sup> For the reasons discussed above, the Court rejected this approach; it separately noted that *Enron*’s reliance on a perceived distinction between assignments and sales was problematic, given that the relevant state law does not draw a clear distinction between those types of transfers.<sup>15</sup>

The Third Circuit finally turned to and rejected ASM’s argument that its claims should not be disallowed because ASM purchased the claims in good faith and thus qualifies for the protections of a good faith purchaser under section 550(b) of the Bankruptcy Code.<sup>16</sup> The Court held that section 550(b), on its face, only shelters transferees who purchase “property of the estate” (as opposed to claims *against* the estate). The Court was not inclined to extend the principles of section 550(b) to protect ASM, noting that ASM—a sophisticated entity that knowingly and voluntarily entered the bankruptcy process—assumed the

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<sup>10</sup> *KB Toys* at \*3.

<sup>11</sup> *Id.* at \*3, n.8.

<sup>12</sup> *Id.*

<sup>13</sup> *Id.* at \*1, n.4. The Court concluded that ASM understood that section 502(d) disallowance could attach to, and travel with, purchased claims because ASM’s assignment agreements included these types of provisions. *Id.* at \*4.

<sup>14</sup> *Id.* at \*4, n.11.

<sup>15</sup> *Id.*

<sup>16</sup> *Id.* at \*4. Section 550(b) bars a trustee from recovering from a transferee that takes for value, in good faith, and without knowledge of the voidability of the transfer avoided. *See* 11 U.S.C. § 550(b).

inherent risk that its purchased claims would be disallowed.<sup>17</sup> The Court noted that, while ASM claimed it lacked knowledge of the voidability of the transfers, at the time ASM purchased the claims, each Debtor had already filed a Statement of Financial Affairs indicating that payments were made to the Original Claimants within the preference period.<sup>18</sup>

## Conclusion

While this Third Circuit decision diverges from that of the District Court involved in *Enron*, the outcome is unlikely to surprise the claims trading market. In the wake of *Enron*, the market sought to mitigate the risk of section 502(d) and address lingering uncertainties regarding its application to purchasers with strong contractual language. *KB Toys* underscores that contractual protections, such as indemnification clauses and restitution provisions, combined with adequate diligence on the claims and their previous holders, are the only real source of protection available to a purchaser in a claims transaction.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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<sup>17</sup> *KB Toys* at \*4.

<sup>18</sup> *Id.*