

BANKRUPTCY CLAIMS TRADING GETS DIRTIER AS THIRD CIRCUIT IN *KB TOYS* RULES THAT § 502(d) DISALLOWANCE CANNOT BE “WASHED” FROM CLAIMS

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The Third Circuit Court of Appeals in *In re KB Toys Inc.* affirmed a Delaware District Court decision holding that bankruptcy “claims” subject to disallowance under § 502(d) in the hands of a claimant who received recoverable property or an avoidable transfer and failed to return it to the estate are “similarly disallowable in the hands of a subsequent transferee.”¹ The Third Circuit found that § 502(d) disallowance attaches to and travels with the claim and “the cloud on the claim continues until the [avoidable transfer or recoverable property] is returned.”

At issue in the case, a claims purchaser, ASM, purchased nine trade claims through agreements that included a restitution provision requiring the original claimant to pay ASM if the claim was disallowed in bankruptcy. In addition, each of the original claimants was listed on the Statement of Financial Affairs (“SOFA”) disclosing all payments they received within ninety (90) days of the Debtors’ petition date, transfers which are vulnerable to attack as avoidable preferences. The Trustee brought and obtained preference judgments against each of the original claimants. The preference judgments, however, were uncollectible because the original claimants all went out of business. The Trustee asserted that the claims were disallowable in the hands of ASM under § 502(d) because each of the original claimants received an avoidable preference before transferring its claim to ASM, even though ASM itself did not receive an avoidable transfer.

Section 502(d) provides that “the court shall disallow *any claim of any entity* from which property is recoverable ... or that is a transferee of a[n] [avoidable] transfer” under certain provisions of the Bankruptcy Code “unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable.” (emphasis in Opinion).

Focusing on the phrase “any claim of any entity,” the Third Circuit found that the plain language of “the statute operates to render a category of claims disallowable—those that belonged to an entity who had received an avoidable transfer.” 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.”

The Third Circuit reasoned that to hold otherwise would incentivize claimants and claims purchasers to attempt to “wash” claims of their disability in contravention of § 502(d)’s twin aims to ensure equality of estate distributions and to coerce compliance

with judicial orders. The estate and creditors would be harmed because the estate would have less money if recoverable property and avoidable transfers were not returned and the estate would pay on claims that should otherwise be disallowed.

Additionally, the Third Circuit found that claim purchasers, not the estate, should bear the risk that recoverable property and avoidable transfers are not returned because purchasers are sophisticated parties who voluntarily choose to participate in the bankruptcy and are in a position to mitigate such risks through due diligence, accounting for such risk in the purchase price, and shifting the risk of disallowance back to the original claimant through indemnity and restitution provisions in the claim purchase agreement.

The Third Circuit further stated that whether or not the claims purchaser benefited from the recoverable property or avoidable transfer is “irrelevant” to disallowance under the plain language of § 502(d).

Finally, the court rejected the assertion that the claims purchaser was entitled to the protections of a good faith purchaser under § 550(b), which protects purchases “for value, ... in good faith, and without knowledge of the voidability of the transfer avoided.” The court found that § 550(b), on its face, is limited to good faith purchasers of *property of the estate* and was inapplicable as a claim against the estate is not property of the estate. Next, the court concluded that there is “no reason or precedent to extend the ‘principles’ of § 550(b) to protect” claims purchasers who knowingly and voluntarily enter the bankruptcy process to profit off the risks inherent in bankruptcy and could protect themselves through due diligence and restitution provisions in their claim purchase agreements.

KB Toys muddies the distressed claims trading landscape as the Third Circuit expressly rejected the seminal decision of the Southern District of New York in *Enron II* holding “that disallowance is a personal disability of a claimant, not an attribute of the claim.”² Under *KB Toys*, claims purchasers will be unable to “wash” claims of § 502(d) disallowance and must protect themselves through due diligence and restitution agreements with the original claimants. *KB Toys* will also impact claimants who may be unable to sell their claims and “opt out” of the risks of bankruptcy or do so only at an increased discount. Accordingly, the risk of § 502(d) disallowance under *KB Toys* must be carefully considered by both purchasers and sellers.

¹ Opinion of the Court, *In re KB Toys, Inc.*, No. 13-1197 (3d Cir. Nov. 15, 2013).

² *Enron Corp. v. Springfield Assocs., L.L.C. (In re Enron Corp.)*, 379 B.R. 425, 443 (S.D.N.Y. 2007) (“*Enron II*”).