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Claims Trading — Taking The Good With The Bad

Law360, New York (April 30, 2014, 4:46 PM ET) -- Over the years, claims trading has become the norm in bankruptcy cases. Claims are bought and sold for various reasons, including to liquidate a position, make money and/or leverage a claim into ownership of the debtor. Regardless of the reason, litigation has arisen as to whether the buyer of a claim will be subject to the same attacks as the original claim owner. Based upon recent case law, the courts seem to be saying yes.

Recently, in KB Toys,[1] the Third Circuit considered whether Section 502(d) could be used to disallow a claim that was sold to a third party, which was not the actual recipient of the preferential or fraudulent transfer. Under Section 502(d) of the Bankruptcy Code, “the court shall disallow any claim of any entity from which property is recoverable ... or that is a transferee of a transfer avoidable ... unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable ...”[2]

Section 502(d) of the Bankruptcy Code is often used to object to claims and ultimately disallow claims unless the claim holder returns the preferential or fraudulent transfer to the debtor’s estate. According to the Third Circuit, the third-party claims buyer inherited the risk that this purchased claim may be disallowed under Section 502(d) of the Bankruptcy Code because the original claim holder received a preferential or fraudulent transfer and had not returned that transfer to the debtor’s estate and the claim was disallowed on this basis.

In reaching its decision, the Third Circuit first focused on the plain language of the statute. Specifically, Section 502(d) states, in pertinent part, that “the court shall disallow any claim of any entity from which property is recoverable ....”[3] The Third Circuit reasoned that since “any claim” is disallowable until the avoidable transfer is returned to the estate, the identity of the holder of the claim is irrelevant.[4] Therefore, even if the claim is sold to a third party, which did not receive the avoidable transfer, the claim may still be disallowed under the plain language of Section 502(d).

After focusing on the statutory language, the Third Circuit discussed two goals of Section 502(d) — the first, “to ensure equality of distribution in estate assets” and the second, to “coerc[e] compliance with judicial orders.”[5]

With respect to the first goal, the Third Circuit stated that if a transferred claim could be protected from disallowance under Section 502(d), the original claimant, who received the avoidable transfer, may have an incentive to sell its claim and “wash” the claim of any disability.[6] Such an incentive could harm other creditors as the avoidable transfer may not be returned to the bankruptcy estate[7] and the bankruptcy estate would have to pay a claim that otherwise would have been disallowed, thereby reducing distributions to all creditors.

With respect to the second goal of Section 502(d), the Third Circuit noted that Section 502(d) of the Bankruptcy Code can be used to “compel an original claimant to comply with a judgment and return the preferential payment as a condition of collecting on its claim.” If the creditor fails to comply by returning the preferential transfer, the trustee can disallow the creditor’s claim. If a claim could be sold and therefore not subject to disallowance under Section 502(d), a trustee would be deprived “of one of the tools the Bankruptcy Code gives trustees to collect assets.”[8]

The Third Circuit also discussed the policy considerations with respect to who should bear the risk related to the return of avoidable transfers — the estate or the claims purchaser. The Third Circuit stated that claim purchasers should bear this risk.

Claim purchasers voluntarily choose to take part in the bankruptcy process by buying the claim. They are in a position to mitigate any risk of disallowance through due diligence and/or shifting the risk back to the seller through contractual protections (such as adjusting the purchase price or including a buyback or indemnification obligation). The Third Circuit noted that the estate is not in a position to mitigate any such risk as to its ability to recover avoidable transfers.

The Third Circuit next examined the legislative history of Section 502(d) going as far back as pre-Bankruptcy Code case law in support of its holding. Examining Section 57(g) of the Bankruptcy Act of 1898 and Swarts v. Siegel,[9] the Third Circuit stated that “the case law interpreting Section 57(g) is consistent with our interpretation of § 502(d).”

More than a century prior, the Swarts court 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.”[10]

Finally, raised as a defense by the claims purchaser, the Third Circuit rejected the notion that the purchaser was entitled to the defense of a good-faith purchaser available under Section 550(b) of the Bankruptcy Code. The Third Circuit stated that, on its face, Section 550(b) did not apply because the purchaser in KB Toys did not purchase property of the estate but instead purchased claims against the estate. Moreover, the court refused to extend the principles of Section 550(b) to claim purchasers because they:

are entities who knowingly and voluntarily enter the bankruptcy process. Thus, a purchaser should know that it is taking on the risks and uncertainties attendant to the bankruptcy process. Indeed, if the bankruptcy process were not risky and uncertain, claimants might be less likely to sell their claims to a claim purchaser. Put differently, a claim purchaser's opportunity to profit is partly created by the risks inherent in bankruptcy. Disallowance of a claim pursuant to § 502(d) is among these risks.[11]

The Third Circuit’s decision diverges from the decision of the United States District Court for the Southern District of New York in In re Enron Corp.[12] In Enron Corp., when determining whether a transferred claim could be disallowed under Section 502(d) of the Bankruptcy Code, the district court focused on whether the claim was transferred via a “sale” or “assignment.”

In reaching its decision, the district court held that “[a] personal disability that has attached to a creditor who transfers its claim will travel to the transferee if the claim is assigned, but will not travel to the transferee if the claim is sold.”[13] Therefore, based on the Enron Corp. decision, many claims buyers have structured their deals as sales and not assignments.

In In re Fairfield Sentry Ltd.,[14] the court considered whether a seller of a claim should be allowed to “undo” the sale. In that case, the holder of a Securities Investor Protection Act claim against Bernard L. Madoff Investment Securities sold its SIPA claim after months of good-faith negotiations in an arms-length transaction.[15]

Three days after selling the claim, the trustee responsible for administering the Madoff estate executed a multibillion dollar settlement that greatly increased the value of the SIPA claim.[16] The seller sought to invalidate the claims trade.[17] The United States Bankruptcy Court for the Southern District of New York upheld the validity of the claims trade stating “[t]his is a pure and simple case of seller’s remorse.”[18]

Given the KB Toys, Enron Corp. and Fairfield Sentry decisions, claims buyers and sellers should take the time to conduct due diligence when purchasing or selling claims, understanding any possible challenges to a claim and understanding the status of the bankruptcy case.

Moreover, if claims are being purchased for strategic reasons, a clear understanding of any disallowance risks will assist the purchaser in negotiating an appropriate price, buyback provision and/or indemnification provision. Additionally, claim buyers may still want to structure all deals as sales and not assignments.

Lastly, the mere change in the value of a claim is likely insufficient to unsettle a sale and may mean that the buyer has bought into the wrong part of the capital structure, or a seller has sold at the wrong time. For all of these reasons, due diligence is important because a buyer or seller of a claim will likely be stuck with their contractual deal, whether good or bad.

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[1] In re KB Toys Inc.,736 F.3d 247 (3rd Cir. 2013).

[2] 11 U.S.C. § 502(d).

[3] See 11 U.S.C. § 502(d).

[4] KB Toys, 736 F.3d at 252.

[5] Id.

[6] Id.

[7] Even if the original claimant has transferred its claim, neither the Bankruptcy Code nor case law prevents a trustee from suing the original claimant for the return of a preference or fraudulent transfer. Moreover, the transfer of a claim is not a defense to an avoidance action.

[8] Id.

[9] Swarts v. Siegel, 117 F. 13 (8th Cir. 1902).

[10] Id. at 15.

[11] KB Toys, 736 F.3d at 255.

[12] In re Enron Corp, 379 B.R. 425 (S.D.N.Y. 2007).

[13] Id. at 436.

[14] In re Fairfield Sentry Ltd., 484 B.R. 615 (Bankr. S.D.N.Y. 2013).

[15] Id.

[16] Id.

[17] Id. at 618.

[18] Id. at 617.
