Claim Purchasers BEWARE

Michael Sweet

Purchasers of assets from a bankruptcy estate enjoy the benefit of knowing that the assets acquired are free and clear of liens, claims and encumbrances. However, purchasers of claims against a bankruptcy estate may not enjoy the same advantage. Courts have issued conflicting opinions on the question of whether claims against the estate purchased by third parties are free of claims by the bankruptcy trustee for avoidance actions or equitable subordination.

In order for a creditor to share in distributions from a bankruptcy estate, the claim must be "allowed." The prerequisite to allowance is that a proof of claim must be filed. In a chapter 11 case, a claim is deemed filed if the claim appears in the schedules and is not scheduled as disputed, contingent, or unliquidated. If a claim in a chapter 11 case does not appear in the schedules or is scheduled as disputed, contingent or unliqudated the holder of the claim must file a proof of claim in order to have the claim allowed. In cases under all other chapters, a proof of claim must be filed as a prerequisite to allowance.

If a claim is filed, or deemed filed, and no objection is made, the claim is allowed and the creditor can share in any distribution according to the claim's status and priority.

Creditor's claims may not be allowed for various reasons. The bases for disallowance are itemized in Bankruptcy Code § 502(b) which has nine subsections. These include that the claim is unenforceable under applicable law or that the claim is for unmatured interest

Additionally, the Bankruptcy Code directs the court to disallow any claim of any entity (i) from which property is recoverable as property of the estate or (ii) that is a transferee of a transfer avoidable under chapter 5 of the Bankruptcy Code, unless such entity or transferee has turned over the property or repaid the amount of the avoidable transfer. Bankruptcy Code § 502(d). If the estate claims that a creditor owes a prepetition debt to the debtor or received a preferential payment before the bankruptcy case began, then that creditor's claim will not be allowed until the debt has been paid or the preference returned. This section provides leverage to a debtor or a trustee who is seeking to reduce the claims against a debtor's estate because the courts have permitted the creditor's proof of claim to be disallowed (at least temporarily) even before the adverse claim has been adjudicated.

But can the debtor or trustee similarly avoid or reduce a claim when the claim has been sold or otherwise transferred to a third-party? One decision out of the Southern District of New York indicates that the response could be negative: In 2007 the United States District Court for the Southern District of New York decided *Enron Corp. v. Springfield Associates, L.L.C.*, 379 B.R. 425 (Bankr. S.D.N.Y. 2007). When the bankruptcy petition was filed Citibank held claims against Enron for prepetition loans. Postpetition Citibank transferred its claims to Springfield. Enron sued Citibank and Springfield seeking equitable subordination of the Citibank claim (now owned by Springfield) and disallowance of the claim based on allegations that Citibank had received and failed to repay avoidable transfers. Motions to dismiss were denied by the bankruptcy court.

On interlocutory appeal the district court held that it should first decide whether equitable subordination and disallowance were claim characteristics or personal disabilities. If they were attributes of a claim, they would travel with the claim whereas if they were personal disabilities their application to transferees would depend upon the mode of transfer. The court decided that both equitable subordination and disallowance were personal disabilities.

The court then discussed the difference between assignment and sale. Assignment is a contractual transfer of a right, interest, or claim from one person to another. The assignee stands in the shoes of the assignor and subject to all equities against the assignor. In other words, an assignee of a claim takes with whatever limitations it had in the hands of the assignor. By contrast, a purchaser does not stand in the shoes of the seller and as a result can obtain more than the transferor had.

> Although characteristics that inhere in a claim may travel with the claim regardless of the mode of transfer, the same cannot be said for personal disabilities. 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*. 379 B.R. at 436.

In 2011 another district court judge in the Southern District of New York relied upon the *Enron* decision. *Longacre Master Fund, Ltd v. ATS Automation Tooling Systems Inc.*, 456 B.R. 633 (S.D.N.Y. 2011), vacated and remanded, 496 Fed. Appx. 135 (2d Cir. 2012). At issue was an indemnification provision in a claim purchase agreement which required repayment of the purchase price if the sold/assigned claim was objected to. The district court stated:

> [B]ecause the Agreement affected a sale and not a pure assignment of the Claim, for the reasons stated in *Enron Corp. v. Springfield Assocs., LLC* . . .no section 502(d) objection . . .would have constituted an Impairment in the first instance. 456 B.R. at 640.

For the *Enron* court the answer to our question was dependent upon whether the transfer was an assignment or a sale. The Bankruptcy Code defines neither term. One commentator described this distinction between assignment and sale as "a novel distinction that flew against the long-standing interchangeability of these terms in legal practice." Adam J. Levitin, *Bankruptcy Markets: Making Sense of Claims Trading*, 4 BROOK. J. CORP. FIN & COM. 67, 92 (2009).

While the *Enron* decision supports the notion that a purchaser may not have to defend against avoidance actions based on the original claimant's conduct, a court in Delaware, the other major

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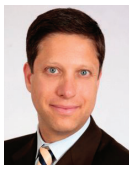
About the Author

Michael A. Sweet, a partner in the San Francisco office of FoxRothschild LLP, represents trustees and other parties in bankruptcy cases throughout the state of California as well as across the country. He also writes and speaks on bankruptcy topics, particularly in the arena of government issues related to potential Chapter 9 bankruptcy filings, and is frequently sought after by journalists as a commentator on bankruptcy and municipal bankruptcy topics. He can be reached at msweet@foxrothschild.com or 415-364-5548.



destination for Chapter 11 cases, concluded that a purchaser would always have to defend against such actions. The issue was considered by the Delaware bankruptcy court in *In re KB Toys, Inc.,* 470 B.R. 331 (Bankr. D.Del. 2012). The liquidating plan in that case authorized the trustee to liquidate, collect and maximize the value of certain assets and to investigate and pursue avoidance actions and other claims for the benefit of creditors. ASM purchased nine trade claims and filed notices of assignment. The trustee sued the original holders of these claims and obtained default judgments or summary judgments against them. Thereafter, the trustee objected to ASM's claims pursuant to § 502(d).

The issue as framed by the bankruptcy court was "whether the purchaser of a trade claim holds the purchased claim subject to the same rights and disabilities, and is subject to Bankruptcy Code § 502(d) challenge, as is the original holder of the claim." 470 B.R. at 334. The answer, according to the bankruptcy court, was "yes."

The Delaware bankruptcy court held that the plain meaning, legislative history, and decisional law support the view that 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. "Disabilities attach to and travel with the claim." 470 B.R. at 335.

Section 502(d) reads as follows:

> …the court shall disallow any *claim of any entity* from which property is recoverable . . or that is a transferee of a transfer voidable . . .unless such entity or transferee has paid the amount, or turned over such property . . . (Emphasis added.)

Should the focus be on "claim" or "entity"?

The Delaware bankruptcy court starts with section 57g, the Bankruptcy Act's predecessor to § 502(d), which stated that the claims of creditors who received avoidable transfers shall not be allowed unless the creditors surrender such preferences to the estate. The focus was on "claims," not "claimants." Case law interpreting section 57g of the Bankruptcy Act was to the same effect. *Swarts v. Siege*l, 117 F. 13 (8th Cir. 1902) ("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"). Other circuit court decisions agreed.

The Delaware bankruptcy court relied upon the canon of statutory construction that unless it can be inferred that Congress intended to change a provision of existing law prior case law interpreting the provision is still valid law when Congress incorporated the former disallowance provision into the Bankruptcy Code. It also relied upon two decisions by bankruptcy courts in the Southern District of New York (one of which was the *Enron* decision reversed by the district court). And finally, it stated that "The terms "assignment" and "sale" are not easily distinguishable."

Based on these considerations the Delaware bankruptcy court held that a trade claim purchaser holds claims subject to the same rights and disabilities under Bankruptcy Code § 502(d) as does the original trade claimant. The court made no determination about whether the same result should ensue in circumstances involving other types of transferred claims, e.g., claims involving the public markets.

It is a surprise that there is such a scarcity of judicial decisions on this issue. Claim trading is big business. And so are preference lawsuits. Indeed, in many large bankruptcies the only recovery for unsecured creditors comes from preference recoveries since today many debtors have secured obligations which exceed the value of the collateral for these obligations. Given these facts, one would have expected that the collision between these two interpretations of § 502(d) would have resulted in more opinions on what happens when the interpretations collide.

Perhaps the dearth of decisions on this issue is a result of the practice of including in claim assignments indemnity provisions which require the seller to repurchase the traded claim if it is challenged. See *Longacre Master Fund, Ltd. v. ATS Automation Tooling Systems Inc.,* 496 Fed. Appx. 135 (2d Cir. 2012).

Enron stands as the law in the Southern District of New York (although bankruptcy judges are not bound to follow it). *KB Toys* is the only decision to date in Delaware. With the split between the jurisdictions it would seem that continuing challenge would be the order of the day. 🏛