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BANKRUPTCY LAW

Claims Acquired in Good Faith Can Still Be Disallowed

Do your due diligence before accepting transfer of a bankruptcy creditor claim; there may be risks attached

By Michael R. Herz

In certain situations, the Bankruptcy Code affords protection to good-faith transferees. Most notably, Section 363(m) ensures the validity of transfers of estate property to good-faith transferees should the transaction be appealed (provided no stay was first obtained), while Section 550(b) prohibits a trustee from recovering avoidable property from good-faith transferees that took for value and without knowledge of the voidability of the underlying transfers. However, the Third Circuit recently determined in the Chapter 11 case of *In re KB Toys*, 736 F.3d 247 (3d Cir. 2013), that good-faith transferees of creditor claims are not insulated from having the acquired claims disallowed under Section 502(d) to the extent that the original claimant had received an avoidable transfer of estate property.

Section 502(d) provides that:

> Notwithstanding subsection (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 554 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 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.

Essentially, Section 502(d) bars a creditor's claims against the bankruptcy estate when the creditor has outstanding liability to the bankruptcy estate. For instance, if a trustee or debtor-in-possession has successfully avoided a preferential transfer to a creditor pursuant to Section 547, the creditor's claims against the estate are subject to disallowance unless the creditor has turned over or paid for the avoided transfer. Absent from Section 502(d) is any express qualification safeguarding good-faith transferees, such as is promulgated in Sections 363(m) and 550(b).

A Common Practice

Given the often prolonged and tenuous nature of the bankruptcy process, in which distribution to unsecured creditors with valid claims may be years in the offing and deliver only a fraction of the claimed amount, risk-averse creditors may seek a modicum of certainty by transferring their claims at a discount to entities with the wherewithal and willingness to endure the bankruptcy process. Indeed, there are numerous entities that specialize in acquiring bankruptcy claims in the hope of an investment return. Federal Rule of Bankruptcy Procedure 3001(e) specifically accounts for the fact that claims may be transferred, and provides that a transferee of a claim may file a proof of claim in the first instance with proof of the transfer or, if a proof of claim had been filed prior to the transfer, the transferee must file "evidence of the terms of transfer" in order to inherit the claim.

In the *KB Toys* case, an entity known as ASM Capital purchased several trade claims from the original claimants via assignment agreements. The assignment agreements provided varying degrees of protection to ASM Capital, includ-

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ing indemnification clauses and restitution provisions that required the original claimants to reimburse ASM Capital in the event that the acquired claims were disallowed by the bankruptcy court. Each of the original claimants was disclosed in statements of financial affairs (SOFA), filed by the affiliated debtors, as having received potentially preferential transfers during the 90 days prior to the bankruptcy filing. The appointed trustee brought successful preference actions against the original claimants. However, each of the judgments was uncollectable due to the original claimants having gone out of business, thus exposing their claims to disallowance under Section 502(d). As a further consequence of the original claimants' business cessations, the risk of claim disallowance fell entirely on ASM Capital as the indemnification and restitution provisions of the assignment agreements were rendered worthless.

Policy Considerations

The risk assumed by ASM Capital became fully realized when the trustee sought to disallow the acquired claims pursuant to Section 502(d) on account of each original claimant's being liable for an avoidable preference. The Third Circuit determined that the statute's focus was on "claims" rather than "claimants," such that a claim subject to disallowance must be disallowed irrespective of the owner. As a result, even though ASM Capital was not liable to the estate for preferential transfers, the fact that the acquired claims in question originated from claimants with liability to the estate, and that said claimants could not restore the avoided property to the estate, subjected the claims to disallowance in the hands of ASM Capital.

The Third Circuit rooted its decision in policy considerations. Notably, a contrary holding would incentivize claimants with liability to the estate to sell their claims in order to "wash" the claims of any disability stemming from the claimant's liability, thereby fostering the incongruous result of enabling claimants to receive value for a claim that would otherwise have no value. Moreover, the bankruptcy estate would suffer the double adverse impact of having one less instrument to coerce creditors to pay for avoidable transfers, thus diminishing the funds available for distribution while also allowing for distribution on claims that would have been disallowed if not for being transferred. See *KB Toys*, 736 F.3d at 252.

An Opposing Take and the Irrelevancy Of Good Faith

Although relegated to a footnote, the Third Circuit acknowledged that there is some disagreement on the application of Section 502(d) to transferees of claims. *Id.* at 254 n. 11. In particular, the Southern District of New York (SDNY) focused its inquiry on the "claimant" rather than the "claim," and concluded that "disallowance is a personal disability of a claimant, not an attribute of the claim." See *In re Enron Corp.*, 379 B.R. 425, 443 (S.D.N.Y. 2007). Following state law, the SDNY determined that the attachment of an original claimant's personal disability to a claim transferee depended on the method of the claim's conveyance. For example, if the transferee acquired the claim through assignment, then the transferee essentially stepped into the shoes of the original claimant and procured the claim with the same limitations associated with the transferor. However, if the transferee had outright purchased the claim, the personal disabilities of the transferor would not follow the claim to the transferee.

Interestingly, the SDNY also couched its determination in policy considerations, opining that punishing a purchaser of a claim does little to further the core purpose of Section 502(d), which is to induce claimants to return property to the estate in order to assert a valid claim; purchasers of claims cannot "surrender something they do not have."

The Third Circuit countered by observing that the punitive nature of Section 502(d) is a risk that transferees of claims assume. More particularly, an entity that elects to acquire a claim does so of its own accord, and thus knowingly and voluntarily enters the bankruptcy process and submits to the attendant uncertainties therein. In this vein, a prospective transferee of a claim is in a unique position to protect itself by performing due diligence and negotiating terms with the original claimant that address and mitigate the risks of acquiring a claim, including the purchase price and contingency provisions. Claim purchasers are also typically sophisticated entities familiar with the bankruptcy process and the ramifications of acquiring a claim. As such, the Third Circuit noted that it is only fair that the transferee of a claim bear the risk in the event of claim disallowance should the original claimant fail to return avoidable property to the estate. See *KB Toys*, 736 F.3d at 253, n. 8.

The Third Circuit further noted that the good-faith exception to recovery of avoidable transfers under Section 550(b) only applies to good-faith transferees of property of the estate, and thus does not apply to transferees of claims against the estate.

Takeaway

In the light of the Third Circuit's decision, prospective transferees of claims and their counsel should undertake to thoroughly vet the claims and potential attendant risks prior to acquisition, beginning with an examination of the debtor's statement of financial affairs and any litigation commenced against the original claimant on behalf of the estate. Potential transferees may also want to consider formal protections, such as including indemnification and restitution provisions in agreements to acquire claims. However, as demonstrated in *KB Toys*, such provisions are effectively moot should the original claimant cease operations. With the lesson of ASM Capital's experience in *KB Toys* in mind, examination of the health of the original claimant may also be warranted.

Ultimately, acquiring bankruptcy claims requires a risk-reward analysis, and prospective transferees would be wise to fully apprise themselves of potential pitfalls prior to assuming any risk. It is likely, at least within the Third Circuit, that courts will presume that a transferee of a claim has performed its due diligence and was or should have been aware of the inherent risks in obtaining the claim. Consequently, even purported good-faith transferees of claims should not expect to be afforded the benefit of the doubt. ■