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Legal Update
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In re KB Toys, Inc.: "Disabilities Attach To and Travel With the Claim"

On May 4, 2012, the Delaware bankruptcy court in *In re KB Toys, Inc., et al.* (*KB Toys*), handed down a thoughtful decision addressing the issue of whether impairments attach to a claim or remain with its seller. The *KB Toys* court held 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."

This decision is noteworthy because it directly disagrees with certain holdings made in *Enron Corp. v. Springfield Associates, LLC* (*In re Enron Corp.*), 379 B.R. 425 (S.D.N.Y. 2007) (*Enron II*). By carefully retracing the legislative history and previous precedents, the decision of the KB Toys court, rather than shaking the claims market, should strongly reaffirm that the doctrine of *caveat emptor* should be the guiding principle of buyers of claims.

Background—*Enron I and Enron II*

In *Enron Corp. v. Avenue Special Situations Fund II, LP* (*In re Enron Corp.*), 340 B.R. 180 (Bankr. S.D.N.Y. 2006) (*Enron I*), the bankruptcy court sent a shudder through the claims market when it held that: (i) a claim subject to equitable subordination due to the conduct of its original holder is not freed from its "taint" upon the transfer of the claim to an "innocent" transferee and (ii) the "good faith" of that transferee is no defense to equitable subordination. In addition, the *Enron I* court reasoned that the doctrine of equitable subordination was not limited to claims that were directly related to the creditor's inequitable conduct, but, rather, reached any claim of the creditor necessary to effectuate the remedy provided by Section 510(c) of the Bankruptcy Code. Accordingly, it held that the claims held by the subsequent purchasers were subject to disallowance under Section 502(d) of the Bankruptcy Code.

In *Enron II*, the district court focused on the wording of Section 510(c), finding that the purpose of equitable subordination was "to undo wrongdoing by an individual creditor in the interest of other creditors." Accordingly, from the perspective of the district court in *Enron II*, equitable subordination and the associated risk of disallowance were "personal disabilities" of the claimant that could not be fixed as of the bankruptcy filing date and did not "inhere in the claim."

The district court adopted the bankruptcy court's position in *Enron I* that an "assignee [stood] in the shoes of the assignor and was subject to all equities against the assignor." However, the principles of "assignment," the district court held, do not apply to "sales" because a buyer, unlike an assignee, "does not stand in the shoes of the seller and, as a result, can obtain more than the transferor had in certain circumstances." Consequently, in vacating and remanding *Enron I*, the *Enron II* court held that, like equitable subordination, disallowance under Section 502(d) was a "personal disability" that

attached to the claimant rather than the claim. As such, this "disability" would travel to the transferee if the claim is assigned, but would not travel to the transferee if the claim is sold.

The Facts and Procedural Posture of *KB Toys*

Two months after the petition date, the debtors filed their statement of financial affairs (SOFA), which set forth all of the disbursements made to creditors during the 90 days before the petition date. The SOFA also contained a list of creditors that the debtors then believed had received potentially avoidable transfers.

Under the plan of reorganization, a trust was established to liquidate, collect and realize certain assets of the debtors through avoidance actions.

Pursuant to Section 547 of the Bankruptcy Code, the Trustee commenced adversary proceedings against the original claimants of nine claims identified on the SOFA (collectively, the "Claims"). Over the next three years, the Trustee obtained default judgments and summary judgments against each of the original claimants based upon either their failure to answer or, if they answered, their failure to successfully defend and sustain the challenge to their respective Claims.

Before the Trustee commenced its adversary proceedings, the buyer of the Claims (the "Buyer") purchased eight of the Claims; the Buyer purchased the remaining claim after the Trustee obtained a default judgment. Only four of the assignment agreements on which the Claims were purchased contained indemnification provisions.

After obtaining the nine judgments, the Trustee sought the disallowance of the Claims pursuant to Section 502(d) of the Bankruptcy Code. Applying *Enron II*, the Trustee argued that the transfers to the Buyer were "assignments" and therefore subject to disallowance. The Trustee further argued that, at a minimum, the Buyer had "constructive notice" from the SOFA that the Claims it had been assigned were potential preferential transfers. Finally, as a fail-safe, the Trustee questioned the integrity of *Enron II*'s analysis and policy concerns.

In response, the Buyer proffered two rebuttal arguments that the Claims were not subject to disallowance. First, the Buyer argued that, in accordance with *Enron II*, and regardless of the title of the document setting forth the terms of the transaction, it had purchased the Claims, not taken them in by assignment. In fact, it argued that the terms "assignment" and "sale" were used interchangeably in claims agreements, and that transfers were "always 'sales.'" Second, applying *Enron II*, the Buyer argued that the plain language of Section 502(d) placed the focus on the claimant rather than the claim. On this basis, the Buyer argued that disallowance was a personal disability of the original claimant that could not be transferred and asserted against it.

The Decision and its Supporting Rationale

The *KB Toys* court found that the legislative intent of Section 502(d), originally carried over from Section 57(g) of the Bankruptcy Act of 1898 (the "Bankruptcy Act") without any legislative modification, was to ensure that the claims of creditors who received avoidable transfers (preferential or otherwise) were not allowed until such creditors returned such transfers to the estate. As a result, the *KB Toys* court found that the legislative history of Section 502(d) supported the finding that the original claimant's disabilities travel with the claim.

In reviewing the application by courts in other circuits of both Section 57(g) of the Bankruptcy Act and its successor, Section 502(d) of the Bankruptcy Code, the *KB Toys* court found that, as early as 1902, courts had made determinations that the original claimant's preference risk followed the claim.

When the *KB Toys* court turned to review precedents within the Second Circuit prior to

Enron I and *II*, it highlighted *In re Metiom, Inc.*, 301 B.R. 634 (Bankr. S.D.N.Y. 2003) (*Metiom*), which held that under Section 502(d), the "assignee receives no more than the assignor possessed." Rather than being a novel interpretation of Section 502(d), the *KB Toys* court found that *Enron I*'s application of Section 502(d) had followed both precedents within its circuit and the pertinent earlier holdings of other circuit courts.

As a consequence, while the *KB Toys* court was willing to acknowledge that, indeed, the "terms 'assignment' and 'sale' [were] not easily distinguishable," it decided that the district court's focus on those terms in *Enron II* had missed the mark. In fact, the *KB Toys* court found that this distinction, which the district court used to underpin its application of 502(d), had been "widely more criticized." The claims market, the *KB Toys* court noted, had been around for quite some time and was populated by "highly sophisticated entities" capable of undertaking the due diligence required to purchase a claim and negotiating terms to cover avoidance risks. As such, the court disagreed with the reasoning of *Enron II* and found that the reasoning of *Enron I* was more consistent with the legislative history and previous applications of Section 502(d).

Accordingly, the *KB Toys* court held that:

- The Buyer had constructive notice, if not actual notice, of the potential avoidance actions;
- The Buyer had the option of protecting itself by the inclusion of indemnity provisions in its agreements with the original claimants and, in several instances, had availed itself of such protection;
- Where the Buyer did not purchase the claim with an indemnity coverage, it chose to bear that risk; and
- As matter of public policy, it would not allow an interpretation of Section 502(d) that would effectively leave the estate as the claim purchaser's insurer.

In sum, no purchaser should be able to recover on a claim that, if still held by the original claimant, would be unrecoverable unless and until the issue that impairs the claim has been addressed by that original claimant.

Practical Points

For practitioners, *KB Toys* re-emphasizes the importance of pre-purchase due diligence and indemnities to cover potential claim infirmities.

In addition to reviewing a debtor's filings to determine which potential claims, at first blush, will likely be challenged because the seller either has received a payment that likely falls within the ambit of Section 547 of the Bankruptcy Code, or is the beneficiary of a transfer under Section 510 of Bankruptcy Code, a buyer must obtain sufficient information from the seller of the claim to make more than a superficial analysis of (i) whether the claim is likely to be challenged, and (ii) if challenged, whether the challenge will be sustained. The allowance of time to complete such due diligence prior to the completion of the trade will be critical. Negotiations may break down and trades may fail if a buyer seeks to address due diligence inadequacies with stronger "coverage" provisions in the assignment agreement.

As the *KB Toys* court noted, "[h]istorically, indemnity provisions have been important terms in claims trading agreements." In the wake of *Enron I*, *Enron II* and *KB Toys*, indemnities are more important than ever when the subject claim at time of purchase has not been allowed by an unappealable court order or a settlement agreement. Consequently, while a seller having made the decision to sell the claim at some discount hopes to never hear from its buyer again, such seller should not be surprised to see indemnities, holdbacks and put-backs if they are selling claims prior to their allowance. The seller's challenge, therefore, is to marshal

sufficient documentary evidence to sustain the potential avoidance action and have a thoughtful perspective on whether the challenge would be successful.

The claim buyer, on the other hand, should not fear *KB Toys*, for it is squarely within keeping of the previous holdings by other circuits and, within the Second Circuit, the holdings of *Metiom* and *Enron I* (even though vacated). While indemnities should not overreach, they must be crafted to cover acts of the seller that may have an impact on the claim.[1] The buyer must elegantly use the leverage of price against the risks of disallowance because the *KB Toys* court has now decisively reaffirmed that "a claims purchaser is not entitled to the protections of a good faith purchaser."

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Endnotes

[1] For buyers of claims associated with bilateral loans and syndicated debt, such purchases should be completed using the Loan Syndication and Trading Association's documentation for distressed trades; the representations and indemnities found therein directly address the discussed avoidance risks.

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