

NORTON BANKRUPTCY LAW ADVISER

Monthly Analysis of Important Issues and Recent Developments in Bankruptcy Law

Editor in Chief: Hon. William L. Norton, Jr., United States Bankruptcy Judge (1971-1985), Gainesville, Georgia

Managing Editor: Hon. Keith M. Lundin, United States Bankruptcy Judge, Nashville, TN

January 2014

Issue 1

MORE CLARITY FOR CLAIMS TRADERS: “CLAIM WASHING” AFTER KB TOYS

Richard K. Milin and Yitzhak Greenberg***

The growth of bankruptcy claims trading has been described as “the most important development in corporate reorganizations in the past two decades.”¹ Indeed, buying and selling claims against the debtor can be a multi-billion dollar business even within the scope of a single bankruptcy case.² Yet despite the growth of claims trading, some of the most basic issues concerning the value and enforceability of transferred claims—and debtors’ defenses to those claims—remain unresolved.

This article discusses the rationale, scope and implications of *In re KB Toys Inc.*,³ the Third Circuit Court of Appeals decision that considered whether transferred bankruptcy claims can be disallowed under § 502(d) of the Bankruptcy Code when a prior owner of the claim has failed to return a preference or fraudulent transfer. Billions of dollars, and perhaps trillions, are potentially at stake—both for claims traders and for bankruptcy estates that may be denied this important remedy.⁴

*Richard K. Milin is of counsel at DiConza Traurig Kadish LLP, where his practice focuses on bankruptcy and commercial litigation. He can be reached at: rmilin@dtklawgroup.com.

**Yitzhak Greenberg is of counsel with Bronstein, Gewirtz & Grossman, LLC (a litigation boutique) in New York City. His practice is focused on all aspects of bankruptcy, including the representation of both debtors and creditors. He can be reached at YGreenberg@bgandg.com.

IN THIS ISSUE:

More Clarity for Claims Traders: “Claim Washing” After KB Toys	1
<i>Richard K. Milin and Yitzhak Greenberg</i>	
Recent Decisions from the Appellate Courts	11
<i>Alexandra E. Dugan Sean Michael Solomon Jay Watkins</i>	

Disallowance of Transferred Claims: *Enron v. KB Toys*

The issue in *KB Toys* arose seven years earlier in the *Enron* bankruptcy, but the court's resolution of the issue provided little guidance to debtors or claims traders. In *Enron v. Avenue Special Situations Fund (In re Enron)*,⁵ ("*Enron I*"), the United States Bankruptcy Court for the Southern District of New York was asked to decide whether claims that could have been disallowed under § 502(d) because their original owners had received preferences or fraudulent transfers would be equally subject to disallowance in the hands of transferees. This issue implicated billions of dollars in claims in *Enron* alone and there was very little relevant precedent. The bankruptcy court decided, in a closely-reasoned, forty-page opinion, that claims can indeed be disallowed in the hands of transferees. That bankruptcy court decision was reversed, however, in a

"much criticized"⁶ opinion by the district court ("*Enron II*"),⁷ and there was no further appeal. *Enron II*—which held that "assigned" claims could be disallowed but "sold" claims could not—left much confusion in its wake.⁸

In *KB Toys*, the issue that *Enron* decided reached a court of appeals for the first time: The Third Circuit squarely held that "a trade claim that is subject to disallowance under § 502(d) in the hands of the original claimant is similarly disallowable in the hands of a subsequent transferee."⁹ In *KB Toys*, the court expressly endorsed the conclusions of the bankruptcy court in *Enron I* and found the decision of the district court in *Enron II* to be "problematic," as have several commentators.¹⁰

Nevertheless, many questions remain unanswered. *KB Toys* was limited to consideration of transferred trade claims against bankruptcy estates as opposed to claims based on bonds or notes; and even with respect to trade claims, it is not yet clear whether other courts—including courts in the Second Circuit¹¹—will follow *Enron II* or *KB Toys*. The implications of *KB Toys* for the related issue whether claims can be subordinated in the hands of transferees, which was addressed in *Enron* but not in *KB Toys*, are similarly unclear.

The Facts of *KB Toys*

KB Toys concerned whether approximately \$700,000 in trade claims—claims that the debtor owed to nine different prepetition trade creditors—were enforceable against the bankruptcy estate. Two ASM Capital funds that were engaged in nationwide claims trading (together, "ASM") had purchased the claims from the original claimants after *KB Toys*' bankruptcy. The trustee of a trust created for the benefit of *KB Toys*' unsecured creditors (the "Trustee") asked the court to disallow ASM's claims because, if the original claimants had not sold the claims to ASM, the

Managing Editors:

- Hon. Keith M. Lundin, United States Bankruptcy Judge, Nashville, Tennessee
- Hon. Randolph J. Haines, United States Bankruptcy Judge, Phoenix, Arizona
- Hon. William H. Brown, United States Bankruptcy Judge (1987-2006), Memphis, Tennessee
- Hon. Thomas F. Waldron, United States Bankruptcy Judge (1984-2007), Dayton, Ohio

©2014 Thomson Reuters. All rights reserved.

Norton Bankruptcy Law Adviser (USPS# pending) is issued monthly. Published and copyrighted by Thomson Reuters, 610 Opperman Drive, P.O. Box 64526, St. Paul, MN 55164-0526. Application to mail at Periodical rate is pending at St. Paul, MN. POSTMASTER: send address changes to Norton Law Adviser, 610 Opperman Drive, P.O. Box 64526, St. Paul, MN 55164-0526.

For authorization to photocopy, please contact the **Copyright Clearance Center** at 222 Rosewood Drive, Danvers, MA 01923, USA (978) 750-8400; fax (978) 646-8600 or **West's Copyright Services** at 610 Opperman Drive, Eagan, MN 55123, fax (651) 687-7551. Please outline the specific material involved, the number of copies you wish to distribute and the purpose or format of the use.

This publication was created to provide you with accurate and authoritative information concerning the subject matter covered; however, this publication was not necessarily prepared by persons licensed to practice law in a particular jurisdiction. The publisher is not engaged in rendering legal or other professional advice and this publication is not a substitute for the advice of an attorney. If you require legal or other expert advice, you should seek the services of a competent attorney or other professional.

Trustee could have challenged them under § 502(d). The claims were subject to disallowance in the hands of the original claimants because the original claimants each received prepetition payments from the debtor that were recoverable as preferences under §§ 547 and 550. Section 502(d) provides in part:

the court shall disallow any claim of any entity from which property is recoverable under section . . . 550 . . . unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable[.]¹²

The Third Circuit noted that the debtor's statement of financial affairs ("SOFA") had identified all of the original claimants as potential preference recipients, and that the Trustee subsequently obtained judgments against them, though the judgments proved uncollectable. Also, ASM purchased one of the claims after the Trustee's judgment had already been entered.¹³

Given these facts, the Third Circuit stated the issue as "whether a trade claim that is subject to disallowance under § 502(d) in the hands of the original claimant is similarly disallowable in the hands of a subsequent transferee."¹⁴ The answer, the court said, is yes. The court noted that the courts below had come to the same conclusion. The bankruptcy court had disallowed ASM's claims because "[d]isabilities attach to and travel with the claim" under § 502(d) and because ASM was a sophisticated entity that did too little due diligence to be considered a "good faith purchaser."¹⁵ Further, the district court "believed the plain language of § 502(d) was ambiguous but it otherwise adopted the reasoning of the Bankruptcy Court."¹⁶

KB Toys' Interpretation of § 502(d)

The Third Circuit began by setting out this well-worn interpretive methodology: "If the [statutory] text is clear and unambiguous, this Court must simply apply it. . . . Yet . . . courts

'must not be guided by a single sentence or member of a sentence, but look to the provisions of the whole law, and to its object and policy.'¹⁷ In addition, "if the statutory text is ambiguous, a court may look to the legislative history."¹⁸

The court did not entirely follow this methodology, however, because it did not expressly decide whether § 502(d) was ambiguous. Instead, the court simply set forth its own interpretation of the statute as follows:

The language of § 502(d) states that "any claim of any entity" who received an avoidable transfer shall be disallowed. Thus, the statute operates to render a category of claims disallowable—those that belonged to an entity who had received an avoidable transfer. Further, the statute provides that such claims cannot be allowed until the entity who received the avoidable transfer, or the transferee, returns it to the estate. . . . Accordingly, "any claim" falling into this category of claims is disallowable until the avoidable transfer is returned. Because the statute focuses on claims—and not claimants—claims that are disallowable under § 502(d) must be disallowed no matter who holds them.¹⁹

The Third Circuit's failure to address whether § 502(d) is ambiguous was an important omission, because the court noted that the district court believed it ambiguous, and the bankruptcy court provided a seemingly unanswerable demonstration: it simply cited conflicting prior case law.²⁰

Moreover, the Third Circuit's interpretation is open to question, in part because it did not fully consider the statute's ambiguity. The court correctly recognized that the key phrase in § 502(d) provides that "the court shall disallow any claim of any entity" that received an avoidable transfer.²¹ The court did not appear to recognize, however, that its interpretation of this phrase resulted from its choice of one of at least two equally plausible meanings of the word "of." The Third Circuit assumed that the statute's reference to a claim "of" an entity

means, as the court put it, a “claim *that belonged to*” the entity.²² Claim “of” an entity could also refer to a “claim *asserted by*” the entity, however, and if the phrase is interpreted in this way, courts cannot disallow transferred claims—the entity asserting a transferred claim normally will not have “received an avoidable transfer.”²³

That the Third Circuit’s interpretation of § 502(d) depends on its unexplained preference for one possible reading of an ambiguous word does not make its interpretation wrong, of course. It does imply, however, that the court’s conclusions are inadequately justified. As a result, other courts may be reluctant to adopt the Third Circuit’s analysis.

The Third’s Circuit’s interpretation of § 502(d) also depends, in part, on the court’s resolution of a second ambiguity: Whether the statute “focuses” on claims or on claimants. The Third Circuit states point blank that the “statute focuses on claims—and not claimants.”²⁴ Yet, Judge Scheindlein of the U.S. District Court for the Southern District of New York was equally sure in *Enron II* that “[t]he plain language of section 502(d) focuses on the claimant as opposed to the claim and leads to the inexorable conclusion that disallowance is a personal disability of a claimant, not an attribute of the claim.”²⁵ Given this disagreement by two thoughtful courts, one might conclude that the phrase “any claim of any entity” does not actually “focus” either on “claims” or on “claimants.”

According to the methodology the Third Circuit stated but did not entirely follow, the ambiguity of § 502(d), required the court to examine the statute’s legislative history of “the provisions of the whole law, . . . its object and policy.”²⁶ These issues, which the Third Circuit addressed even though its statutory interpretation made doing so unnecessary, are discussed below.

The “Object and Policy” of § 502(d)

Although the Third Circuit presented its statutory interpretation as dispositive, the court also asserted that any alternative interpretation would “contravene the aims of § 502(d).” The court identified two such aims from prior case law: “ensur[ing] equality of distribution of estate assets,” and “coercing compliance with judicial orders.”²⁷

The Third Circuit explained that permitting disallowance of transferred claims is necessary to ensure equal distribution of estate assets because, if a claimant that received an avoidable transfer could “wash away” any risk of disallowance simply by selling its claim, the claimant could unfairly retain both its avoidable transfer and the proceeds from its sale of the claim. The Court recognized that “the original claimant would have an incentive to sell its claim—so it could receive some value for an otherwise valueless claim—and the transferee would have an incentive to buy the claim—because once the claim is in its hands, the claim is eligible to receive a distribution.”²⁸ The result, the court stated, “would negatively impact the other creditors in two ways. First, because the original claimant has not returned the avoidable transfer, the estate has less money and the other creditors would receive smaller amounts Second, the estate would pay on a claim that would have been otherwise disallowed.”²⁹

The court’s “claim washing” rationale has implications far beyond the issue of equal distribution: It actually implies that disallowance of transferred claims is necessary if disallowance is to serve any purpose at all, because allowing “claim washing” would allow claimants to eliminate the risk of disallowance at will. Accordingly, when the Third Circuit turned to the second aim of § 502(d)—coercing compliance with court orders to return avoidable transfers—it employed precisely the same rationale:

Section 502(d) 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. . . . To allow [a] sale to wash the claim entirely of the cloud would deprive the trustee of one of the tools the Bankruptcy Code gives trustees to collect assets[.]³⁰

The Third Circuit's "claim washing" rationale seems likely to be given considerable weight by other courts. Moreover, even though the Third Circuit expressly limited its holding to transferred trade claims, other courts are likely to recognize that its rationale applies equally to justify disallowance of other types of transferred claims as well as requests to subordinate transferred claims under § 510(c). Debtors' estates may have the greatest need to preserve the coercive power of disallowance when trade claims are at issue because there is generally a greater risk that trade creditors will go out of business than, for example, the debtor's lenders. Even with respect to lenders, however, the coercive power of disallowance may help to reduce the delays and costs of recovering avoidable transfers, and courts are likely to be reluctant to allow claimants to "wash" this power away. Accordingly, the Third Circuit's adoption of the "claim washing" rationale may prove to be something of a "game changer" for claims traders.

It should be noted that *Enron I* did not rely on the "claim washing" rationale even though the court concluded that transferred claims are properly subject to disallowance. In *Enron I*, the bankruptcy court declined to "speculate as to the extent to which the unavailability of the defense of disallowance would provide alleged avoidance recipients with an incentive to engage in 'claim washing.'"³¹

The facts of *KB Toys*, however, eliminated any need to speculate: all nine of the original claimants "washed" their claims by selling them and then going out of business without returning the avoidable preference payments. If the Third Circuit had required *KB Toys* to

pay *ASM* the full value of the transferred claims despite the resulting inequity, the claims would have been successfully washed free of all risk of disallowance, *ASM* would have been rewarded for helping the original claimants to "wash" their claims, and the court would have established both a precedent and an incentive for claimants to wash their claims in the future. Thus, *KB Toys* calls into question one of the basic assumptions of *Enron II*: "Insolvency of the transferor is not of grave concern The possibility that a transferor who is able to sell its claim . . . will be insolvent is not very great."³²

Legislative History of § 502(d)

Having decided that the text, object and policy of § 502(d) all favor authorizing the courts to disallow transferred claims, the Third Circuit next determined that the legislative history of the statute "supports this conclusion."³³ The court explained that § 502(d) is derived from § 57(g) of the Bankruptcy Act of 1898, which stated:

The claims of creditors who have received or acquired preferences, liens, conveyances, transfers, assignments or encumbrances, void or voidable under this title, shall not be allowed unless such creditors shall surrender such preferences, liens, conveyances, transfers, assignments, or encumbrances.³⁴

If the Third Circuit had interpreted the phrase "claims of creditors" in Bankruptcy Act § 57(g) in the same way that it interpreted "claim of any creditor" in § 502(d) of the Bankruptcy Code, the court would have interpreted "claims of creditors" to mean "claims that belonged to creditors," which would imply that § 57(g) permitted transferred claims to be disallowed. Instead, however, the court relied on *Swarts v. Siegel*,³⁵ an Eighth Circuit decision which held that, under § 57(g), "[t]he 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.”³⁶ Based on *Swarts*, the Third Circuit determined that the case law interpreting § 57(g), and consequently the legislative history, supported the court’s interpretation of § 502(d).³⁷ However, because it is highly unlikely that the drafters of the Bankruptcy Act of 1898 had anything like the current claims trading market in mind, it is possible to question the relevance of this rather remote legislative history.

The Asserted “Good Faith Transferee” Defense

Having completed its analysis of § 502(d), the Third Circuit proceeded to address the defendants’ principal defense: ASM’s assertion that “the claims should not be disallowed because it purchased its claims in ‘good faith’ and is therefore entitled to the protections of a good faith purchaser under 11 U.S.C. § 550(b).”³⁸

The Third Circuit was not convinced. The court noted that, by its plain language, § 550(b) bars trustees from recovering prepetition transfers that were avoidable under § 550(a)(2), not postpetition transfers of claims against the estate, whether those claims were acquired in good faith or not. The Third Circuit also saw no reason to expand the “principles” of § 550 to protect claims traders because traders can protect themselves:

Claim purchasers . . . knowingly and voluntarily enter the bankruptcy process. Thus, a purchaser should know that it is taking on the risks and uncertainties. . . . Indeed, if the bankruptcy process were not risky and uncertain, claimants might be less likely to sell their claims. . . . Disallowance . . . is among these risks.³⁹

The court added that “ASM could have protected itself from the risk of disallowance by reviewing the Debtors’ publicly available SOFAs, which would have put it on notice of the Claims’ vulnerability to preference attacks, and performing due diligence on the Original

Claimants.”⁴⁰ Further, ASM “included indemnity and restitution provisions in the Assignment Agreements,” and was “in a better position than the estate to protect itself against the Original Claimants going out of business by factoring this possibility in to the price of the claim.”⁴¹ The court therefore found ASM’s argument that § 550(b)’s “principles” should be extended beyond the plain statutory language to be “inappropriate.”⁴²

Practical Implications of *KB Toys*

KB Toys provides an impressively straightforward analysis of an issue that many consider to be extremely complex. Even if the court’s interpretation of the text of § 502(d) is not the only possible interpretation, it is at least *one* possible interpretation, and it is consistent with what courts have uniformly recognized to be the statute’s goals. Also, even if *Enron I* was justified in declining to speculate on how often claimants would engage in deliberate “claim washing,” *KB Toys* points out that, at a minimum, exempting transferred claims from disallowance creates a powerful incentive to “wash” claims.

In addition, the facts of *KB Toys* provide important justification for the court’s conclusions. They show that, whether or not the original claimants deliberately intended to gain an unfair advantage, exempting their claims from disallowance would have exactly that effect. By selling their claims and going out of business without returning avoidable transfers, the original claimants obtained a double benefit for their stakeholders—they kept both avoidable transfers and the sale price of \$700,000 in claims. The original claimants did so, moreover, at considerable expense to *KB Toys*’ other creditors, who had to fund the Trustee’s litigation through three levels of courts. Moreover, whereas *KB Toys* and its creditors could only protect themselves by seeking to disallow the claims, ASM not only had obtained rights of indemnification, but

also could have factored the original claimants' financial condition into the purchase price, which no doubt was significantly discounted. One can only wonder whether, if the Trustee had lost in the Third Circuit, ASM would have tried to buy yet more disallowable claims.

Given that the *KB Toys* decision is at least defensible, it does not seem exceptionally vulnerable to a reversal *en banc* or a grant of certiorari by the United States Supreme Court. Further litigation of the issue is likely because, as noted above, it is a multi-billion dollar concern to claims traders and other participants in the bankruptcy process. Numerous *amici curiae* have submitted briefs on the issue in the past.⁴³ On the other hand, *KB Toys* is the first and only circuit court decision on point—there is no conflict among the circuits for the Supreme Court to resolve, and any arguments of urgency must be tempered by the fact that almost seven years have passed since the issue last surfaced in *Enron II*.

As a result, certain practical consequences follow. Claims traders should continue to demand indemnification or rights of rescission for the risks of disallowance and subordination. Also, it may be worth doing due diligence as to claim sellers' finances when a purchased claim is particularly large. At a minimum, claims traders are now charged with reviewing debtors' SOFAs, and possibly with identifying the defendants in debtors' adversary proceedings, if they are to attempt a "good faith" defense. Also, it may be wise for debtors to consider *KB Toys* and *Enron II* in deciding where to file a bankruptcy case if the debtor has creditors who have large claims that may be subject to subordination or disallowance and who accordingly may seek to "wash" their claims.

The Scope of *KB Toys*: Unanswered Questions

Although the holding and rationale of *KB Toys* are clear, substantial issues remain as to the decision's scope and the likelihood that

other courts will follow it. Preventing "claim washing" is only one relevant policy; *Enron II* maintains, and some courts may agree, that other policies are more important.⁴⁴ Also, even if a court is inclined to follow *KB Toys*, the Third Circuit expressly limited its decision to trade claims. As a result, even if *KB Toys* was correctly decided, it is difficult to be certain how transferred bank claims and publicly traded debt will be treated, or whether transferred claims can be equitably subordinated under § 510(c) of the Bankruptcy Code.

A. Bank Claims and Offsetting Policies

It may seem obvious that *KB Toys* will mandate disallowance of transferred bank claims, at least within the Third Circuit. The Third Circuit's interpretation of § 502(d) and the court's "claim washing" rationale apply equally to bank claims, and the court repeatedly cites to *Enron*, which concerned transferred bank claims, without distinguishing it as inapplicable.

Courts concerned to protect claims trading as a matter of policy, however, may consider taking an alternative view. Bank claims differ from trade claims in that they are typically larger than the average trade claim and the debtor is less likely to have contractual defenses, which makes bank claims more marketable. Bank claims also usually originate with regulated financial institutions that are likely to be able to honor any avoidance action judgments the debtor may obtain. As a result, exempting transferred bank claims from disallowance may be more important to claims traders than exempting trade claims, and courts may have less offsetting concern that banks will fail to return avoidable transfers to debtors' estates.

Despite these considerations, it seems likely that courts will apply *KB Toys* to bank claims, because protecting the claims trading market is an economic policy, not a legal one. The

Bankruptcy Code allows transfers of claims, but does not encourage them, and the economic consequences of claims trading are controversial.⁴⁵ Further, although courts may be able to assert, as some have argued in the past, that claims trading helps the reorganization process,⁴⁶ they can point to very little support for that position in the Bankruptcy Code or its legislative history. As a result, given that interpretive canons at least formally limit courts to consideration of policies intrinsic to the Bankruptcy Code—and more particularly to the specific policies that underlie the statutory provision to be interpreted—unbiased courts, particularly within the Third Circuit, are likely to apply the *KB Toys* analysis to bank claims as well as to trade claims.⁴⁷

It is possible that a court would conclude, as *Enron II* did, that a purely legal policy supports exempting transferred bank claims (or even trade claims) from disallowance: “the law’s consistent protection of bona fide purchasers for value.”⁴⁸ *Enron II* cites no support for the view that the law is “consistent” in protecting purchasers, however, and the law’s protections in fact appear to be quite limited when the item purchased is not negotiable and the purchaser is able, as claims purchasers are able, to do “due diligence” to protect itself. Accordingly, given that commentators generally have not endorsed *Enron II*’s view of the common law, and that the Third Circuit specifically criticized that view, it seems unlikely that the law’s general protections for good faith purchasers would lead other courts to exempt transferred bank claims from disallowance.

B. Publicly Traded Bonds

Although *Enron II* appears to overstate the law’s protections for good faith purchasers, there are nonetheless legal principles that may justify the courts in exempting certain types of transferred bankruptcy claims from disallowance. Publicly traded corporate bonds, for example, are often designed to be as nego-

tiable as cash, and unlike individually negotiated bank debt, to be payable to anyone who may own them. Further, a bankrupt corporation’s obligation to pay sums due on defaulted bonds is often owed to an indenture trustee; the identity of individual holders is irrelevant.

Given that § 502(d) is ambiguous, that its relevant legislative history is more than a century old, and that *KB Toys* is limited to trade claims, a court may well decide to exempt transferred publicly traded bonds from disallowance. The court could base its decision on established law making publicly traded bonds freely transferrable in a way that bank debt is not, without relying on a policy-based endorsement of claims trading—though it should be noted that bonds are one of the most commonly traded types of bankruptcy claims, and they may become the “fulcrum securities” that are key to a reorganization. The court could also conclude that, if a negotiable bond remains negotiable after a transfer, the transferor is granting transferees no greater rights than the transferor already had. Indeed, Bankruptcy Rule 3001(e) already treats transfers of claims based on a “publicly traded note, bond, or debenture” differently, exempting them from certain filing requirements.

Further, if bonds were intended to be as freely traded as cash prior to bankruptcy and intended only to ensure payment by and through a trustee after bankruptcy, it would seem difficult to argue that an individual holder’s receipt of a preference should reduce his or her bond’s collectability. In essence, a cash-equivalent claim that can never be tainted will never need to be “washed.”

Based on the foregoing, *KB Toys*, *Enron I* and *Enron II* can be reconciled at least in part: *KB Toys* was properly limited to trade claims, the only type of claims before the court, though the court’s “claim washing” rationale justifies subjecting all transferred claims to disallowance absent countervailing considerations; *En-*

ron I was properly concerned not to give transferees of bank claims greater rights than the transferors already had, but arguably overreached, as *Enron II* noted, to the extent the court applied its conclusions to “[a]ll the post-petition transferees”;⁴⁹ and *Enron II* overreached in deciding that all purchased claims should be treated as if they were fully negotiable even though, under common law, they are not.⁵⁰ Whether courts in the future will focus on the specific characteristics of the claims before them, and exempt transferred claims from disallowance only when their negotiability outside of bankruptcy or another policy of law justifies doing so, remains to be determined.

C. Subordination after *KB Toys*

The implications of *KB Toys* with respect to the equitable subordination of transferred claims are complex. The governing statute—§ 510(c) of the Bankruptcy Code—has different words, purposes, legislative history and interpretive precedents than § 502(d). The *Enron I* bankruptcy court ruled that transferred claims could be subordinated based on the conduct of the transferor; *Enron II* reversed. *KB Toys*’ “claim washing” rationale, however, is as significant with respect to equitable subordination as it is with respect to disallowance; permitting claimants who are guilty of inequitable conduct to “wash” their claims could prevent § 510(c) from accomplishing any purpose whatsoever. As a result, if the disagreements between the *Enron* bankruptcy and district courts can be taken to imply that § 510(c) is ambiguous, the rationale of *KB Toys* is likely to be at least persuasive in any ruling on the equitable subordination of transferred claims.

Conclusion

Litigation concerning the subordination and disallowance of transferred claims is not yet over. *KB Toys* provided greater clarity for claims traders than *Enron II*, but the decision’s

full implications remain to be determined, and the courts have yet to deploy a truly nuanced analysis. Indeed, the courts are still presenting opposing interpretations of section 502(d) as if they were the only possible interpretations instead of admitting the statute’s ambiguity. As a result, and notwithstanding the large amounts of money at stake, the law concerning the enforceability of transferred bankruptcy claims is likely to remain uncertain for many years to come.

ENDNOTES:

¹Adam J. Levitin, Finding Nemo: Rediscovering the Virtues of Negotiability in the Wake of *Enron*, 2007 Colum. Bus. L. Rev. 83, 86 (2007).

²See, e.g., Joseph Checkler & Emily Glazer, Hedge Funds Are Among the Winners of the Lehman Spoils—Investors Profit Via Claims on Bankrupt Bank’s Assets, Wall St. J. (Sept. 13, 2013), available at <http://online.wsj.com/news/articles/SB10001424127887324755104579071332096014654> (“In the past 18 months, billions of dollars in distributions from the Lehman bankruptcy estate have been paid to investors . . . that snapped up claims in the years following the firm’s collapse. . . Paulson . . . is up more than \$1 billion on its investments in Lehman claims, while Elliott is ahead by more than \$700 million. . .”).

³In re *KB Toys Inc.*, 736 F.3d 247 (3d Cir. 2013).

⁴See, e.g., Jonathan C. Lipson, The Shadow Bankruptcy System, 89 B.U. L. Rev. 1609, 1668 (2009) (estimating the bankruptcy claims market to be greater than \$1 trillion, of which nearly \$300 billion consists of general unsecured claims); Robert D. Drain & Elizabeth J. Schwartz, Are Bankruptcy Claims Subject to the Federal Securities Laws?, 10 Am. Bankr. Inst. L. Rev. 569 (2002) (referring to the “formation of numerous distressed debt funds with assets in excess of \$1 billion”); Adam J. Levitin, Finding Nemo: Rediscovering the Virtues of Negotiability in the Wake of *Enron*, 2007 Colum. Bus. L. Rev. 83, 86-87 (2007) (“Although the exact size of the corporate bankruptcy claims trading market is unknown, it was estimated to be in the hundreds of billions

of dollars about a decade ago and has seen a prodigious growth in recent years”).

⁵*Enron v. Avenue Special Situations Fund* (In re Enron), 340 B.R. 180, 198 (Bankr. S.D.N.Y. 2006) (“*Enron I*”), rev’d, *Enron v. Avenue Special Situations Fund* (In re Enron), 379 B.R. 425 (Bankr. S.D.N.Y. 2007) (“*Enron II*”).

⁶See *In re KB Toys Inc.*, 470 B.R. 331, 341 n.12 (Bankr. D. Del. 2012). See also Philip Bentley, et al., *The Enron Claims Trading Decision: Everyone Loses, Corporate Restructuring and Bankruptcy Update: Fall 2007*, available at <http://www.kramerlevin.com/media/PublicationDetail.aspx?publication=970>.

⁷*Enron v. Avenue Special Situations Fund* (In re Enron), 379 B.R. 425 (S.D.N.Y. 2007) (“*Enron II*”).

⁸See, e.g., Lawrence J. Kotler, *Are Equitable Subordination and Disallowance Under 11 U.S.C.A. § 502(d) Attributes of a Claim or Personal Disabilities of the Claimant*, 17 J. Bankr. L. & Prac. 2 Art. 2 (2008) (“While the District Court rectified many of the issues that were raised by the Bankruptcy Court’s earlier decisions, its distinction between a sale versus an assignment of the claim has caused significant concern in the claims trading arena, . . . Hopefully, this issue will be squarely addressed, but . . . this will have to wait until another day.”); Richard Corbi, *KB Toys and Enron: Two Opposite Decisions, Yet Both Ignored Issues and May Have Created Further Confusion*, Norton J. of Bankr. L. & Prac. Vol. 21 # 6 (2012).

⁹*In re KB Toys Inc.*, 736 F.3d at 249.

¹⁰*KB Toys*, 736 F.3d at 254 n.11. The *Enron* district court’s core distinction between the terms “assignment” and “sale” in particular “has been widely criticized.” See *In re KB Toys Inc.*, 470 B.R. 331, 341 n.12 (Bankr. D. Del. 2012) (citing relevant commentators).

¹¹*KB Toys* may even influence bankruptcy courts in the Southern District of New York to reject *Enron II*: “[w]hile prior rulings on an issue can be persuasive, neither bankruptcy court nor district court decisions are binding in the Second Circuit.” Tally M. Wiener & Nicholas B. Malito, *On the Nature of the Transferred Bankruptcy Claim*, 12 U. Pa. J. Bus. L. 35, 53 (2009); see also *In re 400 Madison Ave. Ltd. Partnership*, 213 B.R. 888, 890 n.2 (Bankr. S.D.N.Y. 1997) (internal citations omitted) (“[I]n this district, which has

both a multi-judge bankruptcy court and a multi-judge district court, only decisions of the Second Circuit Court of Appeals are controlling.”).

¹²11 U.S.C.A. § 502(d).

¹³*In re KB Toys*, 736 F.3d at 250.

¹⁴*In re KB Toys*, 736 F.3d at 249.

¹⁵*In re KB Toys*, 736 F.3d at 251 (quoting bankruptcy court).

¹⁶*In re KB Toys*, 736 F.3d at 251.

¹⁷*In re KB Toys*, 736 F.3d at 251 (quoting Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery, 330 F.3d 548, 559 (3d Cir. 2003) (en banc)).

¹⁸*In re KB Toys*, 736 F.3d at 251.

¹⁹*In re KB Toys*, 736 F.3d at 251-52 (footnote and internal citations omitted).

²⁰*In re KB Toys Inc.*, 470 B.R. 331, at 334-35 (Bankr. D. Del. 2012) (“[d]ifferences of opinion exist about the ‘plain meaning’ of § 502(d)”).

²¹*In re KB Toys*, 736 F.3d at 251.

²²*In re KB Toys*, 736 F.3d at 252 (emphasis added).

²³11 U.S.C.A. § 502(d).

²⁴*In re KB Toys*, 736 F.3d at 252.

²⁵*Enron II*, 379 B.R. at 443.

²⁶*In re KB Toys*, 736 F.3d at 251.

²⁷*In re KB Toys*, 736 F.3d at 252. See also Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery, 330 F.3d 548, 559 (3d Cir. 2003) (en banc); *Petitioning Creditors of Melon Produce, Inc. v. Braunstein*, 112 F.3d 1232, 1239 (1st Cir. 1997); *Enron II*, 379 B.R. at 434.

²⁸*In re KB Toys*, 736 F.3d at 252.

²⁹*In re KB Toys*, 736 F.3d at 252.

³⁰*In re KB Toys*, 736 F.3d at 252.

³¹*Enron I*, 340 B.R. at 200.

³²*Enron II*, 379 B.R. at 448.

³³*In re KB Toys*, 736 F.3d at 253.

³⁴11 U.S.C.A. § 93(g) (repealed) (codified Bankruptcy Act § 57(g)); see *In re KB Toys*, 736 F.3d at 253.

³⁵*Swarts v. Siegel*, 117 F. 13, 15 (8th Cir. 1902).

³⁶*Swarts v. Siegel*, 117 F. at 15.

³⁷In re KB Toys, 736 F.3d at 253 & n.10.

³⁸In re KB Toys, 736 F.3d at 254.

³⁹In re KB Toys, 736 F.3d at 255.

⁴⁰In re KB Toys, 736 F.3d at 255.

⁴¹In re KB Toys, 736 F.3d at 255.

⁴²In re KB Toys, 736 F.3d at 255.

⁴³See Enron II, 379 B.R. at 430-31.

⁴⁴See Enron II, 379 B.R. at 448.

⁴⁵See Enron I, 340 B.R. at 204 (“the claims trading market is not a fundamental part of the bankruptcy process, its policies, historical roots, or purpose.”); 11 U.S.C.A. § 3001 (permitting transfers of bankruptcy claims); see also Robert D. Drain & Elizabeth J. Schwartz, *Are Bankruptcy Claims Subject to the Federal Securities Laws?*, 10 Am. Bankr. Inst. L. Rev. 569, 575-76 (2002); Harvey R. Miller & Shai Y. Waisman, *Is Chapter 11 Bankrupt?*, 47 B.C. L. Rev. 129 (2005) (criticizing distressed debt investors’ impact on the Chapter 11 process); Harvey R. Miller, *Chapter 11 Reorganization Cases and the Delaware Myth*, 55 Vand. L. Rev. 1987 (2002) (same).

⁴⁶See, e.g., Adam J. Levitin, *Bankruptcy Markets: Making Sense of Claims Trading*, 4 Brook. J. Corp. Fin. & Com. L. 67, 73 (2010) (listing benefits of claims trading).

⁴⁷*Enron II* may appear to disagree concerning interpretive canons: it states that “it is proper to consider the effect that the court’s interpretation would have on the markets” because “[s]tatutes should be interpreted to avoid . . . unreasonable results whenever possible.” See 379 B.R. at 432 (citations omitted). This appears to imply the somewhat extreme view that courts are free to consider the “results” of their statutory interpretations from a policy perspective even in the absence of Congressional guidance. Significantly, however, *Enron II* also seems to disavow its own statement, asserting that “it is not for this Court, or any other court, to make the policy choices assigned to the legislative branch.” *Enron II*, 379 B.R. at 446. Instead, the Court maintains that it has ruled “based on the plain language of the statutes, their legislative histories, and the case law.” *Enron II*, 379 B.R. at 446. Of course, the Third Circuit considered and relied upon these same sources in reaching the opposite conclusions.

⁴⁸See *Enron II*, 379 B.R. at 448.

⁴⁹See *Enron II*, 379 B.R. at 428 n.5.

⁵⁰For example, transferees may not be able to enforce some trade and even bank claims because of contractual defenses quite apart from § 502(e).



**From the
Appellate Courts**

RECENT DECISIONS FROM THE APPELLATE COURTS

Alexandra E. Dugan

Sean Michael Solomon

Jay Watkins

Bradley Arant Boult Cummings, LLP

Nashville, TN

Birmingham, AL

FIRST CIRCUIT

Old Republic Nat’l Title Ins. Co. v. Levasseur (In re Levasseur), 737 F.3d 814, (1st Cir. 2013). Debt was nondischargeable under §§ 523(a)(2)(A) and 523(a)(6) because it was incurred under false pretenses. Debtor obtained funds from a home equity line that should have been closed when property was sold, but debtor did not inform bank that she sold the property.

Munce’s v. New Hampshire Dep’t of Env. Servs. (In re Munce’s Superior Petroleum Prods., Inc.), 736 F.3d 567 (1st Cir. 2013). State court fine was entitled to administrative priority under § 503(b)(1) when fine was for postpetition violation of postpetition order notwithstanding that fines arose from prepetition failure to comply with a state court injunction.

SECOND CIRCUIT

Drawbridge Special Opportunities Fund LP v. Barnet (In re Barnet), 737 F.3d 238 (2d Cir. 2013). Section 109(a) applies to a debtor under Chapter 15 because the definition of “debtor”

in § 1502 does not block application of § 109 in a Chapter 15 case.

FOURTH CIRCUIT

Jaffé v. Samsung Elecs. Co., 737 F.3d 14 (4th Cir. 2013). To determine whether to grant a German administrator the power to administer the debtor's U.S. patents, bankruptcy court appropriately used a balancing test regarding § 1522(a), attaching the protection of § 365(n).

SEVENTH CIRCUIT

In re Herman, 737 F.3d 449 (7th Cir. 2013). Not cause to reopen case under § 727(a)(4)(a) that creditor says he was not timely served with notice of the bankruptcy filing when timely notice was delivered to creditor's attorney, and a sufficient nexus existed between the attorney and the creditor at the time of the bankruptcy filing.

NINTH CIRCUIT

Jones v. Eugene, 736 F.3d 897 (9th Cir.

2013). False oath omitting assets that would have resulted in the denial of a Chapter 7 discharge had it been known at the time, justifies revocation of discharge under § 727(d)(1).

TENTH CIRCUIT

Taylov v. Taylor (In re Taylor), 737 F.3d 670 (10th Cir. 2013). Judgement debt arising from former spouse's payment of support was not domestic support obligation under § 523(a)(5) but was incurred in the course of divorce proceeding and was nondischargeable under § 523(a)(15).

UTE Mesa Lota 1, LLC v. First-Citizens Bank & Trust Co. (In re UTE Mesa Lot 1, LLC), 736 F.3d 947 (10th Cir. 2013). Notice of *lis pendens* filed in Colorado is not a transfer under § 547(b) because it merely serves as notice of pending litigation. The effect of *lis pendens* rendering title unmarketable is, on its own, not a transfer of an interest of the debtor in property.