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Priya Ghodasara*

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Abstract

Speculating on bad debt dates back to the 1790's when investors purchased claims against the original thirteen colonies. While claims trading has become more streamlined, complex bankruptcies have elevated the financial risk of engaging in the process. Nonetheless, claims trading is undoubtedly a lucrative market, especially for those who are willing to master the art and take on the risk. The bankruptcy trustee's avoiding powers have a tremendous impact on the claims trading market. In many of these cases the claim would have been disallowed in the hands in the hands of the original claimant, pursuant to the Trustee's power to avoid preferential transfers and fraudulent conveyances. However, courts have been unclear whether claims that would have been disallowed in the hands of the transferor should also be disallowed in the hands of the subsequent transferee. A claim transferee's worst nightmare is investing money in purchasing a claim and then finding the claim to be disallowed, leaving them with zero payment on their investment. KB Toys and Enron have created both clarity and confusion for claim traders.

KEYWORDS: Enron, KB Toys, Markets, Claims, Trading, Finance

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Speculating on bad debt dates back to the 1790's when investors purchased claims against the original thirteen colonies. While claims trading has become more streamlined, complex bankruptcies have elevated the financial risk of engaging in the process. Nonetheless, claims trading is undoubtedly a lucrative market, especially for those who are willing to master the art and take on the risk.

The bankruptcy trustee's avoiding powers have a tremendous impact on the claims trading market. In many of these cases the claim would have been disallowed in the hands in the hands of the original claimant, pursuant to the Trustee's power to avoid preferential transfers and fraudulent conveyances. However, courts have been unclear whether claims that would have been disallowed in the hands of the transferor should also be disallowed in the hands of the subsequent transferee. A claim transferee's worst nightmare is investing money in purchasing a claim and then finding the claim to be disallowed, leaving them with zero payment on their investment. KB Toys and Enron have created both clarity and confusion for claim traders.

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INTRODUCTION

The irony of bankruptcy is that within a single bankruptcy proceeding there exists a multi-billion dollar market—the claims trading

market.[1] At the commencement of a bankruptcy case, creditors find themselves in a state of limbo, unsure whether their claims will be paid or even allowed.[2] Thus, creditors seek to sell their claims at a discount to avoid waiting for the bankruptcy process to come to a certain realization on the value of their claim.[3] By selling their claim, they can avoid a delayed or potentially reduced payment.[4] Claim traders take on these theoretically risky claims, because "they believe that efficient pricing will enable them to realize a profit when the claim is paid."[5] However, this begs the question—what happens if the transferred claim should have been disallowed in the hands of the original claimants?[6] Few courts have attempted to answer this daunting question but even those that have, leave unanswered questions about the future of claims trading.[7]

In a recent case, *In re KB Toys*, the Third Circuit held trade claims that would have been disallowed in the hands of the original claimants, would also be disallowed in the hands of the transferees.[8] In contrast, *In re Enron* held disabilities are specific to each claimant and do not follow from the original claimant to the transferee unless the claim was transferred via assignment.[9]

While the Court's ruling in *KB Toys* applied narrowly to trade claims[10] and *Enron* did not indicate how its analysis would treat different types of claims,[11] this could be the first step in changing the market of claims trading.[12] The scope of unanswered questions in the wake of this evolution includes the fate of bank claims and publically traded debt.[13] This note will principally discuss the evolution of the claims trading market for trade claims post-*Enron* and *KB Toys*.

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1. *See* Richard K. Milin & Yitzhak Greenberg, *More Clarity For Claims Traders: "Claim Washing" After KB Toys*, 1 NORTON BANKR. L. ADVISOR 1 (Thomson Reuters), January 2014, at 7.
2. *See* Walter Benzija, *Cloudy with a Chance of Disallowance: Does § 502(d) Inhere to the Claim or Claimant?*, 33 AM. BANKR. INST. J. 14, *14 (Feb. 2014).
3. *See id.*
4. *See id.*
5. *Id.*
6. *See* Milin & Greenberg, *supra* note 1, at 1.
7. *See id.* at 7.
8. *In re* KB Toys Inc., 736 F.3d 247, 249 (3d Cir. 2013).
9. *In re* Enron Corp. (*Enron II*), 379 B.R. 425, 448-49 (S.D.N.Y. 2007).
10. *KB Toys*, 736 F.3d at 249.
11. *Enron II*, 379 B.R. at 428.
12. *See* Milin & Greenberg, *supra* note 1, at 9.
13. *Id.* at 7.

Part I of this paper provides a thorough overview of the process of filing a claim and the claims trading process. Additionally, Part I will begin to unravel the dilemma posed when claims are transferred throughout the claims administration process. Part II discusses key cases, in particular, *KB Toys*, *Enron I* and *Enron II*, which have made determinations as to whether claims that would be disallowed in the hands of an original claimant, would also be disallowed in the hands of subsequent transferees. Finally, Part III discusses the effects of *Enron* and *KB Toys* on the future of the claims trading market and provides a two-prong approach to mitigating the effects of *Enron* and *KB Toys* to the claims trading market.

I. CLAIMS TRADING: AN OVERVIEW

Part I begins with an overview of how claimants file proof of claims in a bankruptcy case. Next, this Part examines why claims may be disallowed and how the disallowance of claims poses a dilemma in the claims trading process.

A. FILING A PROOF OF CLAIM

When an individual or entity files for bankruptcy protection, especially in mega Chapter 11 cases[14], creditors clamor to "claim" their right to what is left in the estate or may derived from the liquidation of assets.[15] Pursuant to the debtor's duties under the Bankruptcy Code, the debtor is required to file a schedule of assets and liabilities.[16] The schedule indicates which creditors the debtor believes it owes money

14. Marshall S. Huebner & Elliot Moskowitz, *The Prevalence and Utility of 'Roadmap' Decisions in Bankruptcy Mega-Cases*, FINANCIER WORLDWIDE, *available at* http://www.davispolk.com/sites/default/files/huebner.moskow.financier.worldwide.apr14.PDF (April 2014) (explaining that Mega Cases are Chapter 11 bankruptcies that "involve $100 million or more in assets, over 1000 entities and/or a high degree of public interest").

15. *See generally* Federal Rules of Bankruptcy Procedure, Rule 3002 (Rule 3002(c)(5) (referring to the "bar date" which is the date by which creditors must file a proof of claim; creditors are given at least 90 days notice of the bar date.).

16. 11 U.S.C. § 521(a)(1)(B)(i) (2012); *see also* Federal Rules of Bankruptcy Procedure, Rule 1007(a).

and how much each is owed.[17] Each creditor, whether listed on the schedule or not, is responsible for verifying the amount they are owed.[18] Creditors that are unlisted or believe their claim is incorrect on the schedule may file a proof of claim, representing the creditor's right to payment.[19] The Bankruptcy Code defines a claim as a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured."[20]

As discussed in the Introduction, creditors trade their claims to other persons or entities willing to take on the uncertainty of payment on the claim.[21] The claims discussed in this note will primarily refer to claims filed in Chapter 11 Reorganizations, as Chapter 11 bankruptcies are major venues for claims trading.[22] Generally, Chapter 11 of the Bankruptcy Code is utilized by businesses, such as corporations, sole proprietorships, and partnerships.[23]

B. THE CLAIMS TRADING DILEMMA

1. The Claims Trading Process

Bankruptcy claims trading means exactly what it sounds like: "the buying and selling of claims against companies seeking relief under the Bankruptcy Code."[24] Pursuant to the Federal Rules of Bankruptcy Procedure 3001(e), a creditor can sell this "right to payment"[25] to someone who is willing to enter an auction of illiquid assets.[26] Although

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17. *Id.*

18. *See* Federal Rules of Bankruptcy Procedure, Rule 3001(a).

19. *Id.*

20. 11 U.S.C. § 101(5)(A) (2012).

21. Benzija, *supra* note 2, at *14.

22. Jeffrey N. Rich & Eric T. Moser, *Bankruptcy Claims Trading: Basic Concepts*, PRACTICAL LAW COMPANY, http://www.r3mlaw.com/Articles/Bankruptcy-Claims-Trading-Basic-Concepts.pdf, 1 (last visited, Apr. 20, 2014).

23. U.S. COURTS, CHAPTER 11: REORGANIZATION UNDER THE BANKRUPTCY CODE, *available at* http://www.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyBasics/Chapter11.aspx.

24. Rich & Moser, *supra* note 22, at 1.

25. *Id.*

26. Edward S Weisfelner, *How Distressed Claims Trading May Impact Your Reorganization Strategy*, *in* NAVIGATING TODAY'S ENVIRONMENT: THE DIRECTORS' AND OFFICERS' GUIDE TO RESTRUCTURING 1, 2 (Globe White Page ed., 2010)

various types of bankruptcy claims are traded on the market, this note will focus on trade claims.[27] Trade claims are unsecured obligations of the debtor, generally held by the debtor's vendors, suppliers, service providers, landlords, lawyers, unions and employees.[28] Trade claims fall into three categories: general unsecured claims, priority claims, and unsecured claims with de facto priority.[29] General unsecured claims are always the last to be paid; therefore, there is no guarantee they will be paid in full.[30] On the other hand, priority claims must be paid in full, unless, the creditor waives full payment.[31]

One of the biggest incentives for claim-holders to sell their claim is the financial relief correlated with discontinuing participation in the bankruptcy.[32] If a creditor sells his claim, he no longer has to deal with the nuisance of following the bankruptcy or concerning himself with fighting for payment on his claim.[33] The transferor can reduce his legal expenses for evaluating its claim and participating in the time-consuming[34] bankruptcy process.[35] Thus, the key reason transferors sell claims is to receive a quicker or more certain realization on their claim.[36]

Additionally, in the likely occurrence the claim is sold for a loss, the buyer can obtain a tax deduction.[37] Claims are generally sold for much less than the value of the claim because of the risks associated

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(explaining that SecondMarket is a platform for "illiquid assets" such as bankruptcy claims).

27. Rich & Moser, *supra* note 22, at 1 (noting other types of claims traded on the market include secured claims and counterparty claims).

28. *See id.*

29. *See id.*

30. *See id.*

31. *See id.*

32. Rich & Moser, *supra* note 22, at 2.

33. Benzija, *supra* note 2, at *14.

34. Maureen Farrell, *Lehman Bankruptcy Bill: $1.6 billion*, CNN (March 6, 2012, 4:06 pm). By March 2012, the fees for lawyers and consultants in the Lehman Brother's bankruptcy were nearly $1.6 billion. The bankruptcy consulting firm, Alvarez & Marsal, has collected more than $512 million in fees since January 2012. The Debtor's law firm, Weil, Gotshal & Manges LLP is set to collect nearly $383 million and the firm representing the Official Committee of Unsecured Creditors has already billed $133 million.

35. *See* Rich & Moser, *supra* note 22, at 1.

36. Benzija, *supra* note 2, at *14.

37. Rich & Moser, *supra* note 22, at 2.

with claims trading.[38] However, the tax savings the business receives can marginally recoup this loss.[39]

On the flipside, transferees acquire these claims in hope to collect a profit when the claim is paid.[40] At first look, it seems reckless to buy a right to payment when payment isn't guaranteed.[41] However, aside from desire for profit, buyers often participate in the claims trading market in order to obtain a "controlling block" of claims within a particular claim category, allowing them to play a tremendous role in shaping the reorganization plan.[42] This allows a transferee to gain leverage in the bankruptcy case and obtain equity in the reorganized company.[43]

While the claims trading market seems like a nightmare to those who are risk-averse, it can be an extremely lucrative market.[44] The benefit of claims trading flows through the entire financial system.[45] Claims trading provides liquidity in an otherwise illiquid market.[46] Because claims trading gives banks, insurance companies, trade creditors and other financial institutions an exit option, "lending institutions are apt to provide increased capital to borrowers."[47] In 2009, the claims trading market was approximately $500 billon.[48] Although the number of bankruptcies has decreased tremendously since the 2008 economic crisis, in 2012 the claims trading market was still valued at approximately $41 billion.[49]

2. The Claims Trading Hypothetical

Hypothetically, if Creditor A had received a preferential payment less than ninety days before Company X filed for bankruptcy, the Trustee would likely use its avoiding powers to recover the preferential

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38. Benzija, *supra* note 2, at *14.
39. *See* Rich & Moser, *supra* note 22, at 6.
40. Benzija, *supra* note 2, at *14.
41. *See* discussion *infra* Part I.B.3.
42. *See* Weisfelner, *supra* note 26, at 3.
43. *See* Rich & Moser, *supra* note 22, at 2.
44. *See* Benzija, *supra* note 2, at *14.
45. *See* Weisfelner, *supra* note 26, at 1.
46. *Id.* at 3.
47. *Id.*
48. *Id.* at 2.
49. *See* Rich & Moser, *supra* note 22, at 1.

payment Creditor A received.[50] Until the preferential payment is returned to the estate, Creditor A may not receive payment on any of its allowed claims.[51] Complications arise when Creditor A sells its claims to Creditor B, but does not return its preferential payment to the bankruptcy estate. The lack of clarity under the Bankruptcy Code, especially under Section 502(d), has led to cloudy approaches to determining whether Creditor B's claim should be allowed.[52]

3. Disallowance of Claims

After a proof of claim has been filed, pursuant to Section 502 of the Bankruptcy Code, claims may be allowed or disallowed.[53] While a claim may be allowed under Section 502 of the Bankruptcy Code, it is not necessarily paid in the distribution of the estate.[54] In particular, unsecured claims are distributed by way of the level of priority under Section 507 of the Bankruptcy Code.[55] Domestic support obligations are among the first to be paid, followed by administrative expenses.[56] Thus, as the level of priority of a claim decreases, the risk of non-repayment on the claim increases.[57]

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50. *See* 11 U.S.C. § 547(b)(4)(A) (2012) ("[T]he trustee may avoid any transfer of an interest of the debtor in property . . . made on or within 90 days before the date of the filing of the petition . . . .").

51. *See* 11 U.S.C. § 502(d) (2012) ("[T]he court shall disallow any claim of any entity from which property is recoverable under section . . . 547 . . . of this title, unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable . . . .").

52. *See id.*; Benzija, *supra* note 2, at *14 (noting ambiguity in language of Section 502(d)).

53. 11 U.S.C. § 502 (2012).

54. 11 U.S.C. § 507 (2012). "The claims standing on the highest rung must be paid in full before any claims on the next rung can be paid anything." *See* John D. Ayer, Michael L. Bernstein & Jonathan Friedland, *Chapter 11—"101"*, The Am. Bankr. Inst. J. (Feb. 24, 2004), *available at* http://www.kirkland.com/siteFiles/kirkexp/publications/2392/Document1/Friedland_Priorities.pdf (last visited Oct. 22, 2014).

55. 11 U.S.C. § 507(a)(3) (unsecured claims have third level of priority).

56. *Id.* § 507(a)(1)–(2).

57. *See* Ayer, Bernstein & Friedland, *supra* note 54 ("[I]n many cases the priority claims will eat up the assets before we ever get to the residual non-priority class.").

Among the many reasons a claim may be disallowed, including an untimely filing of the claim[58] and unenforceability of the claim against the debtor,[59] this note will focus on disallowance of claims pursuant to the Trustee's power to avoid certain transfers outside the estate.[60] The wrinkle in claims trading arises from these avoiding powers.[61]

Section 547(b)(4)(A) of the Bankruptcy Code gives the Trustee power to avoid preferential payments made to creditors ninety days before the commencement of the case[62] or unauthorized and fraudulent transfers of property of the estate two years prior to the filing of the bankruptcy petition.[63] Pursuant to § 502(d), "the court shall disallow any claim from any entity from which property is recoverable" or that is a transferee of an avoidable transfer, unless the transferee has paid the avoidable amount, or turned over that property.[64]

> Section 502(d) creates a mechanism to deal with creditors who have possession of estate property on the bankruptcy petition date or are the recipients of pre- or post-bankruptcy asset transfers that can be avoided because they are fraudulent, preferential, unauthorized, or otherwise subject to forfeiture by operation of a bankruptcy trustee's avoidance powers.[65]

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58. 11 U.S.C. § 502(b)(9) (2012) ("[T]he court, after notice and a hearing, shall determine the amount of such claim in lawful currency of the United States as of the date of the filing of the petition, and shall allow such claim in such amount, except to the extent that . . . proof of such claim is not timely filed . . . .").

59. *See id.* § 502(b)(1).

60. *See id.* § 502(c).

61. *See id.* § 502(d) (2005); *see also* 11 U.S.C. § 550 (2012). "[T]he cloud on the claim continues until the preference payment is returned, regardless of whether the person or entity holding the claim received the preference payment." *In re* KB Toys Inc., 736 F.3d 247, 254 (3d Cir. 2013).

62. 11 U.S.C. § 547(b)(4)(A) (2012) ("[T]he trustee may avoid any transfer of an interest of the debtor in property . . . made on or within 90 days before the date of the filing of the petition . . . .").

63. *Id.* § 548(a)(1)(A) (2012) ("The trustee may avoid any transfer . . . if the debtor voluntarily or involuntarily made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred,
indebted . . . .").

64. *Id*. § 502(d).

65. Charles M. Oellerman & Mark G. Douglas, *KB Toys: Hobgoblins Return to Haunt Bankruptcy Claims Traders*, JONES DAY PUBLICATIONS 1 (July/August 2012),

The motive of this section is to promote equality amongst creditors, so that entities cannot share in the distribution of the estate's assets until they have returned recoverable property and avoidable transfers.[66] However, it is unclear whether a subsequent transferee of a claim can collect on its claim, if the original transferor has not returned that preferential payment.

a. Legislative History of Section 502(d)

Section 502(d) of the Bankruptcy Code is derived from Section 57(g) of the Bankruptcy Act of 1898.[67] Section 57(g) states "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."[68] In order to determine whether the focus of Section 502(d) was the claim or claimants, courts looked to how past courts interpreted the phrase "claims of creditors" in Section 57(g).[69] If the focus of "claims of any creditor" was the claim, Section 57(g) would have permitted transferred claims to be disallowed.[70] Alternatively, if the focus of the section was the claimants, disabilities would remain with the claimant and would not travel with the claim. Thus, a claim would only be disallowable in the hands of the original claimant.[71]

While courts may look to legislative history of Section 502(d), it is still unclear if the focus of Section 502(d) is the claim or claimant. This

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available at http://www.jonesday.com/kb-toys-hobgoblins-return-to-haunt-bankruptcy-claims-traders.

66. 11 U.S.C. § 502(d) (2012); Andrea Saavedra, *Section 502(d) of the Bankruptcy Code Permits Disallowance of Claims Transferred to Third Parties Where the Underlying Avoidance Action Remains Unresolved*, WEIL, GOTSHAL & MANGES LLP BANKRUPTCY BULLETIN (June 2006).

67. *In re* KB Toys Inc., 736 F.3d 247, 254 n.9 (3d Cir. 2013) ("Other courts have recognized that section 57(g) is relevant to the interpretation of § 502(d)."); s*ee In re* LaRoche Indus., Inc., 284 B.R. 406, 409 (Bankr. D. Del. 2002) (examining a case interpreting section 57(g) when faced with an issue arising under § 502(d)).

68. Bankruptcy Act of 1898, §§ 212, 249 (codified at 11 U.S.C. §§ 612, 649 (1976)) (repealed Oct. 1, 1979).

69. Milin & Greenberg, *supra* note 1, at 7.

70. *See In re* Enron Corp. (*Enron II*), 379 B.R. 425, 439 (S.D.N.Y. 2007).

71. *Id.*

leaves open the question of what happens to trade claims in the hands of a subsequent or immediate transferee, when the trade claim would have been disallowed in the hands of the original claimant because of an avoidable preference or fraudulent conveyance: enter—*In re KB Toys*,[72] *Enron I*[73] and *Enron II*.[74]

b. Disallowance Under § 550

Section 550 of the Bankruptcy Code is dedicated to the Trustee's avoiding powers against immediate and mediate transferees of the property of the estate.[75] In the context of claims trading, the original claimants would be the initial transferee, and all subsequent transferees would be immediate and mediate transferees.[76] In the hypothetical discussed in Part I.C.(a), Creditor B would be the immediate transferee.[77]

Immediate and mediate transferees have an affirmative good faith defense if they took the transferred property for value, in good faith and without knowledge of the violability of the transfer.[78] Unfortunately for claims traders, the courts have unilaterally held that Section 550 provides a good faith defense to the transfer of property but not the transfer of a claim.[79] Thus, the good faith defense of Section 550 is not applicable in the claims trading context.[80]

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72. *Id.* at 249.

73. *In re* Enron Corp. (*Enron I*), 340 B.R. 180 (Bankr. S.D.N.Y. 2006), *vacated and remanded*, 379 B.R. 425 (S.D.N.Y. 2007).

74. *Enron II*, 379 B.R. at 425.

75. 11 U.S.C. § 550 (2012).

76. *See id.*

77. *See id.*

78. *Id.* § 550(b)(1).

79. *Enron I*, 340 B.R. at 206 ("[A] claim as defined under [§] 101(5), is not, and has never been, considered property of the estate (it is being asserted against) under [§] 541 of the Bankruptcy Code.").

80. *In re* KB Toys Inc., 736 F.3d 247, 255 (3d Cir. 2013) (holding that Section 550 is not applicable to claims trading because the subsequent transferee did not purchase property of the estate).

II. CLAIMS TRADING CASE LAW

Part II provides a deep recitation of the facts and court's analysis in *KB Toys*, *Enron I* and *Enron II*. This section also provides an overview of older cases that view Section 502(d) with a different lens.

A. KEY CLAIMS TRADING CASE LAW

1. In re KB Toys

a. The Facts

Between April 7, 2004 and May 22, 2007, ASM Capital L.P and ASM Capital II LLP ("KB Transferees"), purchased nine claims ("KB Claims") executed by Assignment Agreements from various trade creditors ("KB Original Claimants").[81] In line with standard practice of claims trading, four of the claims contained generic indemnification clauses.[82] These indemnification clauses contained "provisions designed to protect [claim traders] from defects that [were] not readily known or knowable at the time of transfer."[83] In this case, the specific provisions shifted the risk of disallowance back to the KB Original Claimants by requiring them to pay restitution to KB Transferees if the KB Claim was deemed disallowed.[84]

Prior to the KB Claim Transferee's purchase of the claims, each KB Original Claimant was listed on the Statement of Financial Affairs ("SOFA") as receiving a payment within ninety days of the petition date.[85] Because each KB Original Claimant had received preference payments, the trustee brought and obtained judgment on each preference action.[86] All but one of the claims was purchased prior to the Trustee's

81. *Id.* at 250.

82. *Id.*

83. Benzija, *supra* note 2, at *14 (citing *KB Toys*, 736 F.3d at 250).

84. *In re KB Toys*, 736 F.3d at 250.

85. *Id.* ("Each SOFA required the disclosure of all payments made within the 90 days immediately preceding the Petition Date.").

86. *Id.*

judgment on the preference actions.[87] Unfortunately for the Trustee, the judgments in each preference action were not collectable because the KB Original Claimants went out of business.[88] Thus, the Trustee sought to disallow the claims transferred to the KB Transferees.[89]

b. The Court's Analysis

"The Trustee contended that the [KB] Claims [were] disallowable under § 502(d) because each [KB] Original Claimant received a preference before transferring its Claim to [the KB Claim Transferees]."[90] The court outlined the process and factors it would consider to make its determination.[91] First, the court turned to the text of the statute, noting that a textual analysis would call for the court to apply the text of the statute if the text is clear and unambiguous.[92] If the statutory text was ambiguous, the court's next step would be to look at the legislative history of the statute.[93] While undertaking a statutory interpretation of § 502(d), the court would also look at the Bankruptcy Code holistically and consider all of the provisions of the Code.[94] Lastly, and arguably more importantly, the court looked to the object and policy of the statute.[95]

While sidestepping the question of whether the statute is clear and unambiguous, the Third Circuit began by finding the language of § 502(d) rendered a whole category of claims disallowable—claims that had received avoidable transfers.[96] Therefore, "'any claim' falling into

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87. *Id.* (noting KB Transferee's purchased eight of the claims before the Trustee commenced preference actions and one was obtained after the Trustee obtained a judgment).

88. *Id*.

89. *Id.* (noting the Trustee did not seek to avoid the transfer, but rather to assert the claims were disallowed because the KB Original Claimants had received a preference).

90. *Id.*

91. *See id.* at 251-54.

92. *Id.* at 251; *see* Roth v. Norfalco LLC, 651 F.3d 367, 379 (3d Cir. 2011) (holding if the text of the statute is plain, the Court's inquiry ends).

93. *In re KB Toys*, 736 F.3d at 251; *see* Official Comm. Of Unsecured Creditors of Cybergenics Corp. *ex rel.* Cybergenics Corp. v. Chinery, 330 F.3d 548, 559 (3d Cir 2003) ("[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.").

94. *In re KB Toys*, 736 F.3d at 251; *see Cybergenics*, 330 F.3d at 559.

95. *Cybergenics*, 330 F.3d at 559.

96. *In re KB Toys*, 736 F.3d at 252.

this category of claims is disallowable until the avoidable transfer is returned." [97] "Because the statute focuses on claims—and not claimants—claims that are disallowable under § 502(d) must be disallowed no matter who holds them."[98] Thus, the claim's disallowance traveled with the claim and was not washed of its disallowance.[99] Notably, the court refused to cite a distinction in the rule for claims that were sold, rather than assigned.[100]

In looking to the legislative history of § 502(d) the Third Circuit looked to its past equivalent, § 57(g) of the Bankruptcy Act of 1898.[101] The court looked to *Swarts v. Siegal* to determine whether § 502(d) is consistent with past court's interpretation of § 57(g).[102] In *Swarts*, the court held that the "[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."[103] Thus, the Third Circuit concluded the legislative history of § 502(d), namely § 57(g), was consistent with the Third Circuit's interpretation of the law.[104]

Additionally, in looking to the law's "object and policy,"[105] the Court in *KB Toys* cited policy objectives for its interpretation of the statute.[106] If the court allowed original claimants to "wash" their claim of any disability by selling it, the original claimant would still receive value for a claim that would have otherwise been disallowed.[107] If these

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97. *See id.* at 251-52.

98. *Id.* at 252.

99. *Id.* at 252-53.

100. *Id.* at 254 n.11 ("Enron II's reliance on this supposed state law distinction may also be problematic for several reasons. First, the state law on which it relies does not provide a distinction between assignments and sales. Second, resort to state law in a bankruptcy case must be done with care.").

101. *Id.* at 254. "The legislative history provides that § 502(d) is derived from present law, which, as the Bankruptcy Court noted, was section 57(g) of the Bankruptcy Act of 1898." *Id.* at 253 (internal citation omitted).

102. *In re KB Toys*, 736 F.3d at 253.

103. *Id.* (quoting Swarts v. Seigel, 117 F. 13, 15 (8th Cir. 1902)).

104. *Id.* ("[T]he case law interpreting section 57(g) is consistent with our interpretation of § 502(d).").

105. Official Comm. of Unsecured Creditors of Cybergenics Corp. *ex rel.* Cybergenics Corp. v. Chinery, 330 F.3d 548, 559 (3d Cir 2003).

106. *In re KB Toys*, 736 F.3d at 252.

107. *Id.*

transferees were permitted to recover on their claim, the guaranteed consequence was less money for the estate to distribute to other creditors.[108] If every claim could be washed of disability, every claimant with a claim subject to disallowance would transfer his or her claim,[109] undermining one of the aims of § 502(d).[110] A large purpose of § 502(d) is to assist the Trustee in creditor compliance with judicial orders.[111] Once a judgment is issued with respect to a claim, § 502(d) compels claimants to return preferential payments as a condition of receiving payment on their claim.[112] However, if the claim is washed of any disability after it's transferred, the Trustee's power to disallow problematic claims is rendered useless.[113]

2. Enron I and II

a. The Facts

Prior to filing for bankruptcy protection, Enron entered into short-term credit agreements with several banks.[114] At various points after the Enron bankruptcy filing, Citibank and other syndicate banks, transferred claims to parties such as Deutsche Bank via a Purchase and Sale Agreement and an Assignment and Acceptance.[115] Additionally, claims were transferred to Avenue Special Situations Fund II, LP ("Avenue"), DK Acquisition Partners, LP ("DK"), RCG Carpathia Master Fund Ltd. ("RCG"), Rushmore Capital–I, LLC ("Rushmore I") and Rushmore Capital–II, LLC ("Rushmore II") (collectively, the "Enron Transferees").[116] Specifically, on February 22, 2002, a claims transfer ("Enron Claims") was made from Citibank to Deutsche Bank.[117] On

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108. *Id.*

109. *Id.*

110. *Id.* "The twin aims of the section 502(d) are 'to assure an equality of distribution of the assets of the bankruptcy estate' and 'to have the coercive effect of insuring compliance with judicial orders.'" *In re* Enron Corp. (*Enron II*), 379 B.R. 425, 435 (S.D.N.Y. 2007) (citing *In re* Davis, 889 F.2d 658, 661-62 (5th Cir. 1989).

111. *Enron II*, 379 B.R. at 435 (S.D.N.Y. 2007).

112. 11 U.S.C. § 502(d) (2012).

113. *In re KB Toys*, 736 F.3d at 252.

114. *Enron II,* 379 B.R. at 428.

115. *Enron II*, 379 B.R. at 428-29.

116. *In re* Enron Corp. (*Enron I*), 340 B.R. 180, 185 (Bankr. S.D.N.Y. 2006), *vacated and remanded*, 379 B.R. 425 (S.D.N.Y. 2007).

117. *Enron II*, 379 B.R. at 429.

May 15, 2002, Deutsche Bank transferred its Enron claims to Springfield through a Purchase and Sale Agreement.[118] Most of these transfers included general indemnity clauses protecting the transferor in an event the claim receives less favorable treatment.[119]

On September 24, 2003, Enron filed an action in the Bankruptcy Court for "disallowance of the transferors' claims under section 502(d) of the Bankruptcy Code based on allegations that the transferors received and failed to repay certain avoidable transfers[,]" along with several other claims for equitable subordination and compensatory and punitive damages.[120]

b. Enron I

The Bankruptcy Court for the Southern District of New York found that a claim disallowable in the hands of an original claimant could be equally disallowable in the hands of a subsequent transferee.[121] The Bankruptcy Court noted the lack of case law on this issue but "where an entity, subject to an avoidance action, holds a claim—a right to payment or remedy—against the debtor and transfers such claim, the section 502(d) disallowance applies to the transferred claim unless and until the amount owed to the estate as a result of the avoidance action is received by the bankrupt estate.[122] Thus, the "identity of the holder of a claim is irrelevant when the estate takes action against such claim under section 502(d) because '[t]he claim and the defense to the claim under section 502(d) cannot be altered by the claimant's subsequent assignment of the claim to another entity . . . that has not received an avoidable transfer.'"[123]

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118. *Id.*

119. *Id.* at 428.

120. *Id.* at 429.

121. *Enron I*, 340 B.R. at 183.

122. *Id.* at 194-95 ("The Court has not found any case law mandating that the creditor who received an avoidable transfer be the same entity that actually asserts such claim against the debtor in the bankruptcy proceeding in order for a debtor to assert a section 502(d) disallowance against such claim.").

123. *Id.* at 195 (quoting *In re* Metiom, Inc., 301 B.R. 634, 642-43 (Bankr. S.D.N.Y. 2003)).

The Bankruptcy Court also factored policy considerations for its finding that claims could not simply be washed of their disabilities.[124] The Court sought to prevent creditors from transferring their claims to wash them of disability.[125] Allowing claim washing would eviscerate the meaning of § 502(d) because entities that received voidable transfers could share in the distribution, even indirectly, without returning preferences and fraudulent conveyances.[126]

c. Enron II

In *Enron II*[127], the District Court overturned the Bankruptcy Court's ruling in *Enron I*. The District Court began its analysis by looking at the plain language of § 502(d).[128] The Court highlighted that § 502(d) requires disallowance of "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 that amount, or turned over any such property, for which such *entity* or *transferee* is liable."[129] The court deduced that the plain language focused on the claimant, referenced as the entity or transferee in the statute, and not on the claim itself.[130] Thus, disallowance is a "personal disability" that attaches to the claimant and not an attribute of the claim itself.[131]

The Court supported its analysis by citing the opportunistic purpose of § 502(d).[132] Section 502(d) gives creditors a chance to collect on their claim, even if they received a preference or fraudulent conveyance.[133] However, this opportunity is only available if the *claimant* surrenders any fraudulent or preferential transfers.[134] The Court insinuated that this

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124. *Enron I*, 340 B.R. at 199-205.

125. *Id.* at 199-202 ("One of the consequences would be to encourage the creditors to 'wash' the claims free of any possibility of disallowance by simply transferring them.").

126. *Id.* at 201.

127. *In re* Enron Corp. (*Enron II*), 379 B.R. 425 (S.D.N.Y. 2007).

128. *Enron II*, 379 B.R. at 431-32.

129. *Id.* at 443 (citing 11 U.S.C. § 502(d) (2012)) (emphasis added).

130. *Enron II*, 379 B.R. at 443 ("The 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.").

131. *Id.*

132. *Id.*

133. 11 U.S.C. § 502(d) (2012).

134. *Enron II*, 379 B.R. at 443.

purpose of § 502(d) would not be served if the attribute of disallowance attached to the claim because the subsequent transferee never received the preference to begin with.[135] Thus, the statute would be punitive and would require transferee's to surrender something they do not have, namely the avoidable assets.[136]

The court extended its analysis by distinguishing between the assignment and sale of claims and the legal consequences of each type of transfer.[137] An assignment is "a contractual transfer of a right, interest, or claim from one person to another."[138] An assignee "stands in the shoes of the assignor"[139] and assumes any attached limitations if the claim was in the hands of the assignor.[140] Theoretically, an assignee cannot get more than an assignor has because in an assignment the assignor and assignee swap places.[141] On the other hand, when a claim is sold, a purchaser does not necessarily take on all of the rights of the seller.[142] Further, a purchaser cannot stand in the shoes of a seller because theoretically the purchaser can obtain more than the transferor had.[143]

Moreover, the court analyzed whether transferred claims derived the "personal disabilities" of the original claimant.[144] The court determined that disallowance is a personal attribute that belonged to the claimant and not the claim itself.[145] Thus, sales of claims do not transfer

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135. *See id.* at 435, 445 ("This is a question of allocating the burden and risk of pursuing the bad actor transferor between two groups of innocents: the creditors as a whole or the transferee.").

136. *Id.* at 443.

137. *Id.*

138. *Id.*

139. Goldie v. Cox, 130 F.2d 695, 720 (8th Cir. 1942).

140. Caribbean S.S. Co., S.A. v. Sonmez Denizcilik Ve Ticaret A.S., 598 F.2d 1264, 1266–67 (2d Cir. 1979).

141. *See* Fleet Capital Corp. v. Yamaha Motor Corp., U.S.A., No. 01 Civ. 1047, (AJP), 2002 WL 31174470, at *32 n.39 (S.D.N.Y. Sept. 26, 2002) (citing BLACK'S LAW DICTIONARY (6th ed. 1990)).

142. *Enron II*, 379 B.R. at 435-36.

143. *Id.* at 435.

144. *Id.* at 443.

145. *Id.* ("Where a claimant has purchased its claim, as opposed to receiving it by assignment, operation of law, or subrogation, assignment law principles have no application with respect to personal disabilities of claimants. Thus, purchasers are protected from being subject to the personal disabilities of their sellers.").

the personal attributes of the claimant to the buyer.[146] However, when the original claimant transfers the claim via assignment, the transferor steps into the shoes of the original claimant and assumes his personal disabilities.[147]

3. Effect of Enron II: In re Longacre

Indemnification clauses play a crucial role in the claims trading process.[148] This is clearly evident in the litigation that took place within the Delphi Automotive Systems bankruptcy, *Longacre Master Fund Ltd. v. ATS Automation Tooling Systems Inc.*[149] In *Longacre*, the original claimant, ATS Automation Tooling Systems Inc., sold its $2.14 million claim to Longacre for eighty-nine cents on the dollar.[150] Although unsecured claims occasionally don't get paid at all, the high purchase price was justified because the claim was expected to be paid in full.[151]

The indemnification provision in the transfer agreement provided the transferor would repay the transferee "an amount equal to the portion of the Minimum Claim Amount subject to the Impairment multiplied by the Purchase Rate . . . , plus interest thereon at 10% per annum from the date hereof to the date of repayment" if the claim was "offset, objected to, disallowed, subordinated, in whole or in part."[152] Essentially, the provision would kick in if the claim was impaired and the issue was not resolved within 180 days.[153]

Within ninety days of the bankruptcy filing, Delphi filed a claims objection in order to reserve its right to disallow the claim.[154] As it

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146. *Id.* at 442.

147. *Id.*

148. *See* Rich & Moser, *supra* note 22, at 4 ("A seller should be wary of selling its claims if it knows that it has exposure for an avoidance action, such as a preference, because that exposure is likely to trigger a future indemnification claim by the buyer and may defeat the purpose of selling the claim.").

149. Longacre Master Fund, Ltd. v. ATS Automation Tooling Sys. Inc. (*Longacre II*), 496 F. App'x 135, 138 (2d Cir. 2012).

150. Longacre Master Fund, Ltd. v. ATS Automation Tooling Sys. Inc. (*Longacre I*), 456 B.R. 633, 637, 636 (S.D.N.Y. 2011) *vacated in part*, 496 F. App'x 135 (2d Cir. 2012).

151. *Id.* at 636 (noting the First Plan provided for full payment on all unsecured claims).

152. *Longacre I*, 456 B.R. at 637.

153. *See id.*

154. *Id.*

turned out, ATS had made a $17.3 million payment to Delphi within the ninety days prior to the bankruptcy filing.[155] Therefore, prior to selling its claim, ATS knew its claim could have been disallowed because of its preference payment.[156]

When the indemnification provision kicked in, the interest at ten percent per annum alone equaled $762,811.35.[157] If the provision was enforced, the transferee would have to pay the transferor approximately $2.67 million, about $500,000 more than the original filed claim amount.[158] Although Delphi eventually withdrew its objection, the buyer of the claim requested $817,037.17, calculated as the interest accruing at ten percent per annum on the purchase price from the date of the claim-purchase agreement to the withdrawal of the claims objection and dismissal of the adversary proceeding.[159]

The District Court considered whether the claim objection constituted an impairment of the claim or was simply a reservation of rights.[160] If the claim objection impaired the claim, the indemnification clause in the transfer agreement would kick in.[161] The District Court looked to *Enron* to determine whether the transfer constituted a sale or assignment, as the distinction was crucial to interpreting the transfer agreement. [162] The District Court found that because the transfer agreement limited the transferee's rights to those "necessary to support or enforce the [c]laim[,]"[163] and left defense rights with the seller, it must be a sale.[164] The Court noted, "a creditor retains preference liability if it *sells* its bankruptcy claim, but passes such liability if it *assigns* the

155. *Id.* at 637.

156. *See id.*

157. *Id.* at 639.

158. *Id.*

159. *Id.* at 639.

160. *Id.* at 640 ("The Adversary Proceeding having been dismissed, no vehicle exists through which such an objection could be raised, filed, or formally commenced in the future.").

161. *See id.* (Under the Transfer Agreement a claim "objected to" or made subject to offset" would be considered impaired. However, "[n]o section 502(d) objection ha[d] been actually raised, filed, or formally commenced against the Claim.").

162. *Id.* at 640.

163. *Id.*

164. *One Step Forward, Two Steps Back: An Update on Case Law Interpreting Transferee Liability in the Trading Market*, LATHAM & WATKINS BUY-SIDE BRIEFS (Oct. 19, 2012) [hereinafter BUY SIDE BRIEFS].

claim."[165] "A 'pure assignment' would leave no retained rights with the seller"[166] because an assignment would put the transferee in the shoes of the transferor.[167] Thus, no impairment on the claim was possible because there was no assignment and under *Enron II* the claim was washed of § 502(d) disallowance.[168] Additionally, the court found the objection was a reservation of rights, rather than a true objection to the claim.[169]

The Second Circuit reviewed the District Court's ruling *de novo* and determined the claim was impaired by the claims objection.[170] "Thus, even if the objection was in effect only a reservation of rights rather than an objection they intended to pursue immediately, it still constituted an objection under the purchase agreement."[171] The court noted that once the claim was objected to, it could not be deemed allowed.[172] Thus, if the claim was no longer deemed allowed, it was clearly impaired.[173]

Additionally, the Second Circuit indirectly called into question Enron's sale/assignment dichotomy but left the law unchanged.[174] The Second Circuit rejected the District Court's conclusion that the claim transfer was a sale, rather than an assignment.[175] The court held that the transfer agreement "strongly suggest[ed] that it was an assignment" because it was "(i) titled an 'Assignment of Claim'; (ii) included language stating the agreement 'unconditionally sells, transfers, and

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165. J.R. Smith & Justin F. Paget, *Selling A Bankruptcy Claim Understanding Repurchase Provisions*, 32 AM. BANKR. INST. J. 32, 32 (2013) (citing *In re* Enron Corp. (*Enron II*), 379 B.R. 425 (S.D.N.Y. 2007)).

166. BUY-SIDE BRIEFS, *supra* note 164.

167. *In re* Enron Corp. (*Enron II*), 379 B.R. 425, 442-43 (S.D.N.Y. 2007).

168. *See id.* at 443-44.

169. *Longacre I*, 456 B.R. at 637.

170. Longacre Master Fund, Ltd. v. ATS Automation Tooling Sys. Inc. (*Longacre II*), 496 F. App'x 135, 138 (2d Cir. 2012).

171. *Id.*

172. *Longacre II*, 496 F. App'x at 138 ("[E]ven if the objection was in effect only a reservation of rights rather than an objection they intended to pursue immediately, it still constituted an objection under the purchase agreement.").

173. *See id.* (The Court found that Delphi's objection clearly fell into the purchase agreement's definition of impairment, which occurred when "all or any part of the Claim is . . . objected to . . . in whole or in part . . . .").

174. *Id.* at 139 (noting the transfer contract included both the terms assignment and sale).

175. *Id.*

assigns'; and (iii) the agreement says the parties recognize 'this assignment of claim as [an] *unconditional assignment*[.]'"[176]

B. OTHER RELEVANT CLAIMS TRADING CASES

Below is a brief explanation of the facts and determinations of cases that guided the courts in *KB Toys*, *Enron I* and *Enron II*.

1. In re Wood & Locker

The facts of *In re Wood & Locker, Inc.*[177] are similar to those of *Enron* and *KB Toys*. Original claimants, William-Patterson ("Wood & Locker Original Claimants") transferred its claims to InterFirst Bank Dallas ("Wood & Locker Transferees").[178] However, the debtor, Wood & Locker, initiated a preference action against the Wood & Locker Original Claimants, halting the Wood & Locker Transferee's entitlement to any distributions.[179] The court asserted if there was no liability under the enumerated sections of § 502(d), it would not be triggered.[180] The avoidance action was triggered to recover property from Wood & Locker Original Claimants and not the Wood & Locker Transferees.[181] Hence, the Wood & Locker Transferees were third parties that were not the "kind of creditor" the trustee could recover property from.[182] Therefore, because the original claimant was liable under § 502(d) and not the transferee, the court found the disallowance provision was not triggered.[183]

176. BUY-SIDE BRIEFS, *supra* note 164 (citing *Longacre II*, 496 F. App'x at 139).
177. *In re* Wood & Locker, Inc., 1988 U.S. Dist. LEXIS 19501 (W.D. Tex. June 17, 1988).
178. *Id.* at *2.
179. *Id.*
180. *Id.* at *7-8.
181. *Id.* at *4-5
182. *Id.* at *8-9.
183. *Id.*

2. In re Metiom

In *In re Metiom*,[184] both the original claimant and subsequent transferee filed for bankruptcy protection.[185] The court found the transferee was subject to all of the equities and burdens that attached to the *property*.[186] Further, the disallowance of a claim created from one creditor followed to subsequent transferors until the preference is returned back to the estate.[187]

III. EFFECTS AND EVOLUTION OF THE CLAIMS TRADING MARKET

Part III begins with a synthesis of the court's holding in *KB Toys* and *Enron II*. Next, this section discusses the effect of the holdings in *KB Toys* and *Enron II* on the claims trading market. Lastly, this section provides a two-prong solution to the claims trading dilemma.

A. SYNTHESIS OF APPROACHES IN *KB TOYS* AND *ENRON II*

There are several fundamental differences between the conclusions in *KB Toys* and *Enron* that will ultimately have important ramifications for claims traders.[188] First, it's important to note that *Enron II*'s jurisdictional hook is limited to the Southern District of New York, as it was never appealed to the Second Circuit.[189] However, *KB Toys* was appealed to the Third Circuit, which marked the first Court of Appeals determination on this matter.[190]

The first disagreement between *Enron* and *KB Toys* was whether disallowance traveled with a claim or claimant.[191] In *Enron*, the Court found that the statutory construct of § 502(d) articulated that disallowance was a personal attribute that attached to the claimant,

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184. *In re* Metiom, Inc., 301 B.R. 634 (Bankr. S.D.N.Y. 2003).
185. *Id.*
186. *Id.* at 643 (emphasis added).
187. *Id.*
188. *See* Milin & Greenberg, *supra* note 1, at 9.
189. *See id.* at 2.
190. *See id.*
191. *See id.*; *In re* Enron Corp. (*Enron II*), 379 B.R. 425, 443 (S.D.N.Y. 2007) (noting focus of Section 502(d) was the claimant). *But see In re* KB Toys Inc., 736 F.3d 247, 251-52 (3d Cir. 2013) (explaining that Section 502(d) focused on a category of claims and not the claimant).

rather than a claim.[192] On the other hand, the court in *KB Toys* asserted that § 502(d) intended to apply to a category of claims that would be disallowed.[193] Thus, under *KB Toys* a claim could not be washed of disallowance regardless of who held the claim.[194] In *Wood & Locker*, unlike *KB Toys* but like *Enron*, the Court determined the focus of Section 502(d) was the claimant and not the claim.[195] However, unlike *Enron*, the Court in *Wood & Locker* found the Trustee's avoiding powers did not extend to subsequent transferees.[196] It is important to note that *Wood & Locker* was decided twenty-five years before *KB Toys*, and perhaps the policy issues discussed in *KB Toys* were not as prevalent in the late 1980s.[197]

Second, in *Enron* the court found the treatment of the disallowance of claims depended on whether the claims were sold or assigned,[198] while *KB Toys* did not make this distinction.[199] Under the *Enron* approach, disallowance only transfers to the subsequent transferee if the transfer is made via assignment.[200] However, as previously discussed,[201] *KB Toys*' analysis follows that because attributes of the claim would travel with the claim and not the claimant, a claim disallowable in the hands of the original claimant would be disallowed irrespective of who held the claim.[202] Thus, under *KB Toys* the type of transfer, whether via sale or assignment, would be of no relevance.[203]

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192. *Enron II*, 379 B.R. at 443.

193. *In re KB Toys Inc.*, 736 F.3d at 251-52.

194. *Id.* at 252.

195. *Compare In re* Wood & Locker, Inc., 1988 U.S. Dist. LEXIS 19501, at *8 (W.D. Tex. June 17, 1988) (explaining that because the focus of Section 502(d) was the claimant, the power to avoid the claim did not travel with the claim, but rather stayed with the claimant), *with Enron II*, 379 B.R. at 439 (holding that disallowance is a personal disability that does not "inhere in the claim").

196. *Id.*

197. *See generally* Aaron L. Hammer & Michael A. Brandess, *Claims Trading: The Wild West of Chapter 11s*, 29 Am. Bankr. Inst. J. 61, 64 (July/August 2010) (noting the increased complexities of Chapter 11 bankruptcy since 2007).

198. *In re KB Toys Inc.*, 736 F.3d at 252.

199. *In re* Enron Corp. (*Enron II*), 379 B.R. 425, 435 (S.D.N.Y. 2007).

200. *Id.*

201. *See* discussion *supra* Part II.A.1.b.

202. *KB Toys*, 736 F.3d at 251-52.

203. *Id.* at 254 n.11 (noting "the state law on which [*Enron II*] relies [on] does not provide a distinction between assignments and sales").

Lastly, in *KB Toys* the court narrowed its scope to trade claims,[204] while the court in *Enron* sought to expand its reach.[205] This seemed to insinuate the court's analysis under *Enron* would be uniform for all types of claims.[206] *KB Toys*' restricted scope could also limit its effect on future claims trading cases.[207]

B. THE NOT-SO-GOOD GOOD FAITH DEFENSE

Section 550(b)[208] of the Bankruptcy Code provides an important caveat to the Trustee's avoiding powers under Section 550(a).[209] As discussed above,[210] the Section 550(b) good faith defense limits the Trustee's avoiding powers when the transfer of property was made without the transferee's knowledge of the voidable nature of the property or in otherwise good faith.[211]

The subsequent transferees in both *Enron* and *KB Toys* attempted to assert a good faith defense.[212] The courts looked to the clear language of the statute, which protects a good faith transferee who purchases *property* of the estate that is avoidable by the Trustee.[213] As discussed in Part I.B(c)(ii), because the good faith defense applies to purchases of property of the estate and *not claims*, this defense was inapplicable.[214]

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204. *Id.* at 251.

205. *In re* Enron Corp. (*Enron II*), 379 B.R. 425, 428 n.5 (S.D.N.Y. 2007 ("[N]o legal and policy basis supports the premise that transferees of bonds or notes should be treated differently than those holding the transferred loan claims.").

206. *Id.* (noting "*All the post-petition transferees assume the risk*" of subordination and disallowance).

207. *See* Milin & Greenberg, *supra* note 1, at 9 ("[*KB Toys*'] decision's full implications remain to be determined[.]").

208. 11 U.S.C. § 550(b) (2012).

209. *Id.* § 550(a).

210. *See* discussion *supra* Part I.B.3.b.

211. *Id.*

212. *In re* KB Toys Inc., 736 F.3d 247, 254-55 (3d Cir. 2013); *In re* Enron Corp. (*Enron I*), 340 B.R. 180, 184 (Bankr. S.D.N.Y. 2006), *vacated and remanded*, 379 B.R. 425 (S.D.N.Y. 2007).

213. 11 U.S.C. § 550(b); *KB Toys*, 736 F.3d at 255.

214. *KB Toys*, 736 F.3d at 255.

C. EFFECTS OF *KB TOYS* AND *ENRON*

1. Case Study of Lehman Brothers

On September 15, 2008, the world changed as the fourth-largest bank on Wall Street at the time filed for Chapter 11 bankruptcy protection.[215] The Lehman Brothers Bankruptcy was approximately six times larger than any United States Bankruptcy [216] and involved hundreds of thousands of creditors worldwide.[217] While it is no secret the Lehman Bankruptcy triggered a global financial crisis,[218] it seems almost counterintuitive that within the folds of disaster, there existed a multi-billion dollar market for claims trading.[219]

As of March 2014, Lehman Brothers distributed approximately $80.4 billion to its creditors since it emerged from bankruptcy. [220] Creditors obtained approximately 26.9 cents on the dollar on their claims. [221] Approximately two-thirds of Lehman's $80.4 billion distributions, or approximately $53.6 billion, went to third-party creditors.[222]

Although the bankruptcy process has streamlined over the years, it took almost four years for the company to emerge from bankruptcy.[223] Creditors who did not want to stick around to see through their claims

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215. Jonathan Stempel, *Lehman Payout Tops $80 Billion, Creditors Get Another $17.9 Billion*, REUTERS (Mar. 27, 2014), http://www.reuters.com/article/2014/03/27/us-lehman-bankruptcy-idUSBREA2Q1DD20140327.

216. *Id.*

217. Voluntary Petition for Lehman Brothers Holdings Inc., *In re* Lehman Brothers Holdings Inc. et al., No. 08-13555 (Bankr. S.D.N.Y. 2008), ECF No. 1; Christopher Scinta & Linda Sandler, *Lehman Facing More Than 16,000 Creditors' Claims, Bloomberg (Update 1)*, BLOOMBERG (September 23, 2009), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aR9y3xb3PdNw.

218. Scinta & Sandler, *supra* note 217.

219. Kelly Bit & Lisa Abromowicz, *Hedge Funds Get Fat on Lehman's Remains*, BLOOMBERG BUSINESSWEEK (May 22, 2014), http://www.businessweek.com/printer/articles/202584-hedge-funds-get-fat-on-lehmans-remains.

220. Stempel, *supra* note 215.

221. *Id.*

222. *Id.*

223. *Id.* (noting Lehman Brothers filed petitions for Chapter 11 bankruptcy protection on September 15, 2008 and the plan for reorganization became effective on March 12, 2012).

sold early on and distressed-investing hedge funds were eager to purchase those claims.[224] For example, Paulson & Co. invested over $4 billion in claims and has already profited over $1 billion after initial distributions.[225]

Companies like Paulson & Co. did not blindly invest billions of dollars.[226] After reviewing Lehman's corporate documents to identify valuable assets that could be purchased at a discount, Paulson invested in the claims trading market.[227] However, even with their extensive research, they risked billions of dollars on claims that had the potential of being avoided by the Trustee.[228] Furthermore, some indemnification clauses with the original claimants didn't protect investors from investments in claims that could be avoided by the Trustee.[229]

2. Less Benefits for Claim Traders

Now that courts are beginning to establish the disallowance of claims in the hands of subsequent transferees, the benefits of claim trading tend to be less clear.[230] Original claimants, who want to sell their claims and separate themselves from the time and cost of a lengthy bankruptcy proceeding, still run the risk of being pulled back into the process.[231] Additionally, this involvement leads to litigation costs that were unseen at early stage of claims trading.[232]

As demonstrated by the Lehman Brothers bankruptcy, the claims distribution process of billions of dollars in claims can take years.[233] Investors like Paulson & Co. who risk billions of dollars in transferred claims may think twice about investing billions in claims that could

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224. Bit & Abromowicz, *supra* note 219.

225. Joseph Checkler & Patrick Fitzgerald, *Lehman to Dole Out Additional $17.9 Billion to Creditors*, WALL ST. J. (Mar. 27, 2014), http://online.wsj.com/news/articles/SB10001424052702304688104579465170602706210.

226. *Id.*

227. *Id.* It is important to note that in *KB Toys*, the statement of financial affairs filed at the onset of the case indicated the KB Toys Original Claimants had received preferential transfers. *In re* KB Toys Inc., 736 F.3d 247, 250 (3d Cir. 2013).

228. Checkler & Fitzgerald, *supra* note 225.

229. *Id.*

230. Oellerman & Douglas, *supra* note 65, at 6-7.

231. *Id.*

232. *Id.*

233. Smith & Paget, *supra* note 165, at 32.

eventually be disallowed.[234] Some investors may walk the line because the law is still unclear, while others may back off at the prospect of a surefire way to lose billions of dollars.[235]

If Paulson & Co. had invested in Lehman's claim trading market Post-*KB Toys* in the Delaware Bankruptcy Court, it is less likely they would have invested $4 billion.[236] Investors are more likely to be wary of investing in trade claims under a *KB Toys* jurisdiction rather than the *Enron* court's approach.[237] Under *Enron*'s current approach investors like Paulson & Co. could skirt around the rule by transferring claims through a sale, rather than assignment.[238] However, claims trading of non-trade claims are likely to fare worse under an *Enron* jurisdiction because the court did not narrow its analysis to a specific type of claim.[239] Luckily for Paulson & Co., Lehman Brother's bankruptcy was filed in the same jurisdiction as *Enron*, the Southern District of New York.[240]

3. Sale/Assignment Distinction in Future Transfer Agreements

Enron's disparate treatment between claims sold and claims transferred via assignment generated confusion for all parties involved, including courts.[241] While the court defined assignment,[242] it didn't particularly define what a sale was but rather harped on what it wasn't—

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234. Checkler & Fitzgerald, *supra* note 225.

235. *See* Milin & Greenberg, *supra* note 1, at 1 ("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.").

236. *See* Benzija, *supra* note 2, at 82 ("The pervasiveness of claims-trading guarantees that in jurisdictions where the E*nron II* holding is accepted, claims traders will be incentivized to acquire such claims.").

237. *See id.*

238. *Id.* at 15.

239. *In re* KB Toys Inc., 736 F.3d 247, 254, n.11(3d Cir. 2013).

240. Notice of Effective Date and Distribution Date at 1, *In re* Lehman Brothers Holdings Inc., et al., 445 B.R. 143, Case No. 08-13555 (Bankr. S.D.N.Y. 2011), ECF No. 26039.

241. *In re* KB Toys Inc., 470 B.R. 331, 340 (Bankr. Del. 2012) ("The terms 'assignment' and 'sale' are not easily distinguishable.").

242. *In re* Enron Corp., 379 B.R. 425, 435 (*Enron II*) (Bankr. S.D.N.Y. 2007), Adv. No. 05–01025 (S.D.N.Y 2007) ("An assignment is a contractual transfer of a right, interest, or claim from one person to another.").

an assignment.[243] While this may be troubling to most, it is also an opportunity for investors and transferors to take advantage of the caveat.[244] However, it is likely courts will catch up and this technical runaround and the sale/assignment distinction will be litigated in the future.[245]

As clearly demonstrated by *Longacre*, the dichotomy between sale and assignment created by *Enron II*[246] does not exist in real-life practice.[247] In many cases sale contracts "speak of the seller 'selling transferring and assigning' the assets at issue.'"[248] While *Enron* delineated the different legal effects of a sale and assignment, the court gave little guidance on how to determine whether a transfer agreement is a sale or assignment.[249]

Additionally, this dichotomy seems to imply the sale/assignment distinction is a technicality that can be overcome by a carefully drafted transfer agreement.[250] Transferee's will be careful to create transfer agreements that attempt to indicate the claim was transferred via a sale, rather than an assignment.[251]

D. SOLUTION TO THE CLAIMS TRADING DILEMMA: TWO PRONG APPROACH

While there is no neatly packaged solution to the claims trading dilemma caused by *KB Toys* and *Enron*, there are ways to calm the

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243. *Id.* at 435-36 ("Assignment law principles do not apply to sales.").

244. *See* BUY-SIDE BRIEFS, *supra* note 164 (noting the caveat in Enron encourages traders to carefully analyze their transfer documents to ensure they clearly indicate whether the transfer document is a sale or assignment).

245. *See id.* ("*Enron II* creates a dichotomy that does not exist in real world practice (where many sale contracts speak of the seller "selling, transferring and assigning" the assets at issue). Courts have obviously struggled to translate that dichotomy into real analysis. *KB Toys* suggests a way out of the legal morass created by *Enron II*, but it is a result that could upset settled market expectations if read broadly. Clearly these issues will require further elaboration by courts.").

246. *Enron II*, 379 B.R. at 435.

247. BUY-SIDE BRIEFS, *supra* note 164.

248. *Id.*

249. *See id.*

250. *See id.*

251. *See id.*

anxiety of claim traders.[252] In this two-prong approach, the first prong calls for claims traders to heavily negotiate, repurchase provisions and recourse actions, as to limit the damning effect if the Trustee avoids the claim.[253] The second prong calls for the creditor's committee to play a more active role in facilitating the claims trading market.[254]

1. Prong 1: Heavily Negotiated Repurchase Provisions and Recourse Actions

Most claim-purchase and assignment agreements include a repurchase agreement.[255] Claimants hesitate to agree to such clauses because it keeps them tethered to the bankruptcy case, essentially nulling their purpose for selling the claim in the first place.[256] Thus, these agreements are heavily negotiated prior to a transfer.[257]

Repurchase provisions and recourse actions provide for reimbursement in the event a claim is reduced, subordinated or even disallowed.[258] In particular, repurchase agreements require the original claimant to buy back all or some part of the claim.[259] Some provisions of repurchase agreements and recourse actions automatically kick in when a claims objection is filed while others kick in after the claim is litigated.[260] In addition to repayment of the claim, these provisions call for the transferor to pay interest from the date of the claim sale through

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252. *See id.* ("Until courts give further guidance on what specifically creates an "assignment" versus a "sale," parties to claim transfer agreements should seek legal advice on whether their documents need to be updated and refined.").

253. *See* Smith & Paget, *supra* note 165, at 32.

254. Hammer & Brandess, *supra* note 197, at 64.

255. Smith & Paget, *supra* note 165, at 32 (noting repurchase provisions are commonly included in claim-purchase agreements when parties agree to recourse actions).

256. *Id.* ("[A] repurchase obligation may convert a sale of a bankruptcy claim from a measure to reduce risk and ongoing costs to a means of significant financial exposure.").

257. *Id.* (noting the benefits of repurchase provisions for purchasers but highlighting the risks for sellers if repurchase provisions kick in and require the seller to pay back more than the amount for which they sold the claim).

258. *Id.* ("Typically, an order of the bankruptcy court reducing, disallowing or subordinating the claim will trigger a repurchase provision.").

259. *Id.*

260. *Id.*

the date that the repurchase provision was triggered to cover the cost of capital, at a rate sometimes as high as ten percent per annum.[261]

In the wake of *Enron*, *KB Toys* and *Longacre*, claimants in cases pending in the Southern District of New York and Third Circuit should pay close attention to the repurchase clauses in their transfer agreements.[262] While transferee's should seek to reduce their exposure, even original claimants should be concerned with doing their due diligence prior to selling or assigning their claims.[263] In *Longacre*, the original claimholder would have faced paying over $500,000 in excess of what they sold the claim for if Delphi had not withdrawn its objection.[264] Even when Delphi withdrew the claims objection, the transferee requested $817,000 in interest from the transferor.[265] The transferor could have hedged that risk by putting different terms in their repurchase provisions and characterizing their transfer as an assignment.[266]

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261. *Id.*

262. Oellerman & Douglas, supra note 65, at 5-6.

263. Smith & Paget, *supra* note 165, at 32.

264. *Id.* at 33.

265. Longacre Master Fund, Ltd. v. ATS Automation Tooling Sys. Inc. (*Longacre I*), 456 B.R. 633, 639 (S.D.N.Y. 2011), *vacated in part*, 496 F. App'x 135 (2d Cir. 2012) (noting the $817,000 excess was calculated as the 10% interest from the date of the Assignment agreement, December 14, 2011, until the allowance of the Claim on March 30, 2011.).

266. Smith & Paget, *supra* note 165, at 33 (showing it was irrefutable that the transfer was a sale. "As a sale, ATS's representations regarding knowledge of a preference action would be irrelevant because any resulting obligation would be a personal disability retained by ATS.").

2. Prong 2: Using the Creditor's Committee to Encourage Claims Trading

Section 1102(a) of the Bankruptcy Code charges the United States Trustee with the duty to organize and appoint a committee of creditors with unsecured claims in Chapter 11 cases.[267] The creditor's committee (the "Committee") is instrumental in investigating the financial state of the debtor, proposing a plan and, most importantly, the administration of the claimant's unsecured claims.[268] The Committee is invaluable in complex reorganizations, which as discussed in this note are venues for heavy claims trading.[269]

The heart of the Committee's role in administering the claims reconciliation process is maximizing the amount each creditor is paid on their claim.[270] The value of a claim in the claims trading market increases with the likelihood of full payment on the claim.[271] Creditors' Committees serve their constituents by either working to approve a plan that provides for high payoffs or helping claim holders find "immediate exit opportunities."[272] Thus, arguably an efficient claims trading market is part of the Committee's duties.[273]

The wrinkle in claims trading created by KB Toys and Enron makes the Committee's job that much tougher.[274] Nonetheless, there are ways a Committee can iron out some of the issues presented to all

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267. 11 U.S.C. § 1102(a) (2012).

268. *Information for Prospective Creditor Committee Members on Chapter 11 Cases*, 1 DEP'T OF JUSTICE 2, http://www.justice.gov/ust/eo/private_trustee/library/chapter11/docs/credcom.pdf.

269. *See* Milin & Greenberg, *supra* note 1, at 1.

270. Adam J. Levitin, *Bankruptcy Markets: Making Sense of Claims Trading*, 4 BROOK. J. CORP. FIN. & COM. L. 67, 111 (Fall 2009).

271. *See* BUY-SIDE BRIEFS, *supra* note 164 ("Parties' assessment of repayment risk is typically reflected in the negotiated price of a traded claim.").

272. *See generally* Levitin, *supra* note 270, at 111 ("If creditors' committees are responsible for maximizing the return for their constituents *as they exist at any particular time*, that could be accomplished either through working for a better plan *or* by providing their constituents with improved immediate exit opportunities.").

273. *See id.* at 111 (noting creditors committees are responsible for maximizing return for constituents).

274. *See generally id.* at 111-12 (explaining that "claims trading could derail plan confirmation and add delay, which might drive down the price of claims for remaining constituents").

players in the claims trading market.[275] Encouraging Committees to play a more active role in the claims trading market can counter and even reduce the complications associated with claims trading and potential avoidance actions.[276] Most broadly, the Committee can be used as a platform to encourage creditors to engage in the claims trading market.[277] The more confident a transferee is in the Committee's ability to maximize payment on a claim, the more likely the transferee will pay handsomely for purchase claims.[278]

One of the many ways Committee's can facilitate claims trading is "informing claimholders of the possibilities of claim purchases" and posting available claim trade prices.[279] Providing claim traders with information about previous claim purchases can assist transferors in evaluating the value of their claim.[280] This posting process may also help match claim sellers with purchasers, as certain transferees listed in the posting may be looking to purchase more claims.[281]

Creditors can also assist the claims trading process by posting about issues in the market.[282] From 1983 to 1991, Rule 3001(e) "required not only that parties transferring claims inform the court that a transfer of claims was taking place, but also that they disclose the consideration paid for the transferred claims."[283] The challenges to claims trading at that time centered around the availability and access of adequate information to enable transferees and transferors to make an informed decision on the claim.[284] Additionally, Courts utilized this information

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275. *See generally id.* at 111 (explaining the importance of the creditors committee in light of the benefits and drawbacks of claims trading).

276. *See id.* at 110-11 ("Creditors' committees may not be the ideal mechanism for improving market efficiency by enabling claims sellers to comparison shop among buyers' offers, but they represent the most easily achievable step in that direction.").

277. Hammer & Brandess, *supra* note 197, at 64.

278. *See* Levitin, *supra* note 270, at 111.

279. *Id.*

280. *Id.* at 110-11.

281. *Id.* at 111-12 (noting that the "Dana [Corporation's] Official Unsecured Creditors' Committee listed the contact information of claims purchasers on its website to help the creditors it represented obtain maximum value for their claims").

282. *Id.* at 111.

283. Michael H. Whitaker, *Regulating Claims Trading in Chapter 11 Bankruptcies: A Proposal for Mandatory Disclosure*, 3 CORNELL J.L. & PUB. POL'Y 303, 317 (1994).

284. W. Andrew P. Logan III, *Claims Trading: The Need for Further Amending Federal Rule of Bankruptcy Procedure 3001(e)(2)*, 2 AM. BANKR. INST. L. REV. 495, 496 (1994).

when approving claim transfers.[285] The amendment to Rule 3001(e) in 1991, eliminating disclosure requirements in claims trading has inevitably led to less protection for unsophisticated creditors.[286] While mandatory disclosures come with their own set of problems, disclosure of ongoing claims trading in a case by the Creditor's Committee will inevitably lead to increased transparency regarding the value and disabilities of claims. [287] However, "[while] increased disclosure mandates would provide greater protections for unsophisticated creditors attempting to sell their claims, such regulations would detract from many of the profitable opportunities currently enjoyed."[288]

CONCLUSION

The future of claims trading remains to be seen following the decisions in *Enron* and *KB Toys*. It is still unclear whether a claim that has been disallowed in the hands of the original claimants should be disallowed in the hand of a subsequent transferee.[289] *Enron* jurisdictions will continue to differentiate these claims based on whether the claim was transferred through a purchase-sale agreement or via assignment.[290] Even if courts clarify *Enron*'s confusing sale/assignment distinction, the fact remains that under *Enron* the disallowance of a claim is a personal attribute of the claimant that travels with the claimant.[291] In contrast, the *KB Toys* approach finds a disallowable claim in the hands of an original claimant is equally disallowable in the hands of a subsequent transferee because the disability follows the claim.[292]

Developing a solution and providing increased clarity in the fate of claims trading is important, as claims' trading is a multi-billion dollar

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285. Whitaker, *supra* note 283, at 319 ("Courts could disapprove a transfer in situations where, for example, the amount paid for claims was significantly lower than that provided in the reorganization plan.").

286. Hammer & Brandess, *supra* note 197, at 63.

287. *See* Levitin, *supra* note 270, at 111 (noting disclosure of contact information for claim traders will assist creditors with obtaining the maximum value for their claims).

288. Hammer & Brandess, *supra* note 197, at 64.

289. *See* Milin & Greenberg, *supra* note 1, at 1.

290. BUY-SIDE BRIEFS, *supra* note 164.

291. *In re* Enron Corp. (*Enron II*), 379 B.R. 425, 443 (S.D.N.Y. 2007).

292. *In re* KB Toys Inc., 736 F.3d 247, 249 (3d Cir. 2013).

market, which creates liquidity in the marketplace.[293] In the meantime, investors and creditors who seek to participate in the claims trading process should follow the two-pronged approach. Heavily negotiated indemnification agreements and recourse actions coupled with the Creditors Committee's facilitation of the claims trading process will mitigate some of the risk of claims trading.[294]

293. *See* Weisfelner, *supra* note 26, at 1-2, 7.

294. BUY-SIDE BRIEFS, *supra* note 164.