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Practical Implications for Claims Traders in the Wake of KB Toys

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December 5, 2013 - Another wrinkle has emerged in the ever-evolving business of buying creditors' claims against bankrupt entities. In a recent decision the Court of Appeals for the Third Circuit held that a debtor can use Bankruptcy Code section 502(d) to disallow a claim from a creditor that had received preferential payments within 90 days of the bankruptcy, even if that claim were subsequently sold to an innocent third party. *In re KB Toys Inc.*, No. 13-1197, — F.3d — (3d Cir. November 15, 2013). The Third Circuit's decision contrasts with a 2007 decision by the District Court for the Southern District of New York, and it raises new potential risks and burdens for anyone buying claims.

Under the bankruptcy code, a trustee can "avoid" preferential payments to creditors and recover the transferred assets for the benefit of the estate's other creditors. The trustee can also use Bankruptcy Code section 502(d) to disallow the claims of a creditor unless and until it returns the preference to the estate.

In 2007, the Southern District of New York was presented with the issue of whether a trustee could still use section 502(d) to disallow claims after the creditor that had received the avoidable preference sold them to an innocent third party. Overruling two previous bankruptcy court decisions that allowed trustees to disallow such claims, the District Court ruled that a third party who bought a claim, with no knowledge of the preference, would not be subject to section 502(d). *In re Enron Corp.*, 379 B.R. 425 (S.D.N.Y. 2007). This decision removed a substantial source of risk for parties buying claims from creditors in bankruptcy, especially when information about a potential claim is limited and the price of delay can be high.

In *KB Toys*, the Third Circuit came to the opposite conclusion, finding that section 502(d) applies to a claim no matter who currently owns it. Whether bought with knowledge of the preference or without, the claim can be disallowed until the preference is returned. That is good news for trustees and for creditors who didn't receive a preference, because it will help prevent creditors from taking advantage of their influence to get an outsized portion of the estate, but potentially bad news for claims traders, who will be taking on the risk that the claims they are buying might be rendered worthless by section 502(d).

It is too early to tell how the other circuits will respond, but *KB Toys* is likely to impact the business of buying and selling claims. Any party buying claims, but especially those operating in the Third Circuit (which includes Delaware, New Jersey, and Pennsylvania) should consider prompt steps to protect themselves. The *KB Toys* and *Enron* courts disagreed about where the burden of 502(d) should fall, compare *In re Enron Corp.*, 379 B.R. at 448 (“the burden and risk is better carried by creditors as a whole in favor of the bona fide purchaser in the context of a sale”), with *In re KB Toys Inc.*, — F.3d at *5 (“[the buyer] could have protected itself from the risk of disallowance by . . . performing due diligence on the Original Claimants”), but by closely scrutinizing claims and by adding indemnity provisions to their transfer agreements, savvy parties can put the burden of disallowance where it belongs – on the creditors who received the avoidable preferences in the first place.

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