

# Buy-Side Briefs

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## One Step Forward, Two Steps Back: An Update on Case Law Interpreting Transferee Liability in the Claims Trading Market

### Introduction

Readers of Buy-Side Brief are no doubt aware of the enormous size and scope of the market for distressed debt. In the past decade, the Loan Syndications and Trading Association (LSTA) and market participants have taken great strides to standardize and professionalize market practices in an area that, in the past, was compared to the wild west. However, bankruptcy courts have been slower to adapt to the new world of distressed debt investing. Indeed, in the precise area where distressed debt trading and bankruptcy law most directly intersect – the rules governing bankruptcy claims trading – significant ambiguity still exists. Two recent cases, *In re KB Toys, Inc.* and *Longacre Master Fund, Ltd. v. ATS Automation Tooling Systems Inc.*, reveal exactly how muddled current case law is.

Each case poses the following question: what impairments to claims pass from sellers to purchasers of claims against a bankruptcy estate? Understanding the state of the law on this critical question first requires a brief review of both the economics of bankruptcy claims trading and the existing case law interpreting the rules governing traded claims.

### Background

Bankruptcy claims trading carries risks not present in other types of financial transactions. Like any type of debt trading, there is repayment risk – in this context whether and to what extent the debtor will be able to pay its creditors via the bankruptcy process (*i.e.*, par, some discount to par or even zero). However, trading bankruptcy claims also involves impairment risk regarding the possibility that the debtor may use provisions of the Bankruptcy Code to reduce the face amount of the claim by “disallowing” all or a portion of the claim or alter the claim’s priority vis-à-vis other claims as a result of equitable subordination or recharacterization.

Parties’ assessment of repayment risk is typically reflected in the negotiated purchase price of a traded claim. Impairment risk is often mitigated through due diligence and carefully structured trade documentation. When impairment risk is present, buyers may insist that the trade be made pursuant to “recourse” documentation, which would allow the buyer recourse against the seller in the event the claim were disallowed or subordinated.

Because “recourse” trades involve ongoing post-trade obligations and counterparty risk, they are impractical in many contexts, especially the secondary market for bonds and syndicated loans. As a result, it is critically important for market participants to understand the extent that impairment risks pass from sellers to buyers in the absence of such documentation – particularly with regard to sections 502(d) and 510(c) of the Bankruptcy Code (disallowance due to failure to repay an avoidable transfer, including a preference or fraudulent conveyance, and equitable subordination, respectively).

The Southern District of New York addressed these issues in the context of the *Enron* bankruptcy case. At issue was whether purchasers of bank loans took the loans subject to the disallowance and equitable subordination risks that arose from preference and fraudulent conveyance suits lodged against the selling lender. Upsetting the market’s expectations, the bankruptcy court in *Enron I* held that buyers took the transferred loans subject to such risks. See *In re Enron Corp.*, 340 B.R. 180 (Bankr. S.D.N.Y. 2006). The District Court reversed in *Enron II* and held that if the trade was a “sale” (as opposed to an “assignment”), the buyer took the loan free of 502(d) and 510(c) risks. See *In re Enron Corp.*, 379 B.R. 425, 435 (S.D.N.Y. 2007). According to the District Court, impairment risks are personal disabilities and an assignee “stands

in the shoes of the assignor” but a purchaser does not and “can obtain more than the transferor...in certain circumstances.” *Id.* at 436. The result in *Enron II* eased market concerns, but its reliance on a distinction between “purchases” and “assignments” left many observers uneasy, as these terms are used interchangeably in the claims trading market and, even after close analysis, sales often cannot be distinguished from assignments.<sup>1</sup>

In the years after *Enron II*, the claims trading market settled on an expectation that disallowance risk could be mitigated when a claim was “purchased,” but buyers of claims with heightened impairment risk (e.g., certain derivatives claims against the estate of Lehman Brothers) continued to seek “recourse” rights against the seller in the event the claim was disallowed.

## **KB Toys**

In a somewhat surprising decision earlier this year, Judge Carey of the United States Bankruptcy Court for the District of Delaware revisited and rejected *Enron II*. See *In re KB Toys, Inc.*, 470 B.R. 331 (Bankr. D. Del. 2012). By directly attacking and rejecting the logical underpinnings of *Enron II*, this opinion may hint at the beginning of broader reconsideration of transferee liability in the Delaware courts.

The claims at issue in *KB Toys* were based on trade debts and each of the original claimants was listed on the debtors’ Statements of Financial Affairs as having received a payment within 90 days of the debtors’ bankruptcy petition. The debtors’ Residual Trustee successfully challenged each of those payments as a preference, and then sought to disallow the related trade claims to the extent the successful preference judgments had not been satisfied.

Rather than rely on *Enron II* (non-binding precedent in Delaware), Judge Carey rejected its framework *in toto* by highlighting the many criticisms of *Enron II* and stating that “the terms ‘assignment’ and ‘sale’ are not easily distinguishable...[and even if ] there exists a clear and principled way to distinguish between an assignment and a sale, the exercise, in this context, is unhelpful and unrevealing of the appropriate outcome.” *In re KB Toys, Inc.* 470 B.R. at 340-41. Instead Judge Carey relied on an extensive review of the legislative history of section 502(d) of the Bankruptcy Code and the early twentieth century case law applying 502(d)’s predecessor statute to conclude that liability for disallowance due to a preference passes into the hands of transferees of claims.<sup>2</sup>

Concerns regarding the impact of this decision on the claims trading market were dismissed by Judge Carey because “sophisticated entities” should be able to adequately assess the risks associated with a claim purchase. *Id.* at 342. Judge Carey gave some comfort to the public debt markets by stating that the issue of transferee liability may be construed differently in contexts where, “public markets may be impacted.” *Id.* at footnote 14. In support of this possible distinction, Judge Carey noted that Bankruptcy Rule 3001(e) (which governs the procedures for effectuating a claim transfer) distinguishes publicly traded debt transfers and excludes them from certain disclosure obligations, “presumably to facilitate trading of public securities”). *Id.*

*KB Toys* is now on appeal, with oral arguments at the Delaware District Court scheduled for January 2013. The impact of *KB Toys* on trading of syndicated bank loans and publicly traded debt will not be clear until that appeal is resolved and Judge Carey’s possible distinction for “public markets” is tested. Nevertheless, *KB Toys*’s direct attack on the logical underpinning of *Enron II* could be the opening salvo in a larger attack on *Enron II*, especially in the Delaware courts in the event that *KB Toys* is upheld on appeal.

## **Longacre Master Fund v. ATS Automation**

In a much less noticed unpublished summary order issued last month,<sup>3</sup> the Second Circuit entered the transferee liability fray. See *Longacre Master Fund, Ltd. v. ATS Automation Tooling Sys.*, 2012 U.S. App. LEXIS 19274 (2d Cir. Sept. 14, 2012). Interestingly, while the *Longacre* opinion was greeted with relief by market participants because it upholds “recourse” rights of claim buyers against claim sellers, *Longacre* also relies on and interprets the “assignment/sale” distinction in *Enron II* in ways that may prove troublesome for the claims trading community.

*Longacre* was an appeal from a non-bankruptcy lawsuit arising from a claims trade in the *Delphi* bankruptcy. ATS sold its claim against Delphi to Longacre on “recourse” documentation that allowed Longacre to seek a refund, with interest, of the original purchase price of the claim in the event that the claim was subject to “possible impairment” (i.e., objected to) and the possible impairment was not resolved within 180 days. Longacre sought to exercise this right when Delphi filed a placeholder objection to all claims related to ongoing preference litigation, including the claims sold by ATS to Longacre. The underlying preference action against ATS was ultimately resolved and dismissed, but not within the 180 day grace period in the

trade documentation. Soon after the 180 day deadline passed, Longacre sued ATS for reversion of the purchase price plus approximately \$800,000 in interest.

The District Court dismissed that portion of Longacre's complaint that construed the debtors' placeholder objection as a "possible impairment," because (according to the District Court) (i) the debtors only preserved their right to object to the claim and did not initiate an actual disallowance proceeding and also (ii) because the underlying preference action was dismissed with leave to replead at the time the 180 days lapsed. See *Longacre Master Fund v. ATS Automation Tooling Sys.*, 456 B.R. 633 (S.D.N.Y. 2011). The District Court further held that because the transfer was a "sale" and not an "assignment," no impairment was possible since under *Enron II* sold claims are cleansed of 502(d) disallowance risk. As a result, ATS did not breach its representation (at the time of the sale) that the claim was not subject to impairment – even though payments to ATS were made during the 90-day preference look back period. The District Court found that the transfer documents effectuated a "sale" rather than a "pure assignment" because the transfer agreement included language assigning ancillary documentation related to the claim "solely to the extent necessary to support or enforce the Claim" and because the documentation left certain claim defense rights with the seller. *Id.* at 640. A "pure assignment" would leave no retained rights with the seller.<sup>4</sup> *Id.*

The Second Circuit reversed on both fronts – it held that the "placeholder objection" filed by the Delphi debtors was sufficient to rise to a "possible impairment" because the plain language of the transfer documentation included "objection[s]...in whole or in part...for any reason whatsoever" as possible impairments, and because Delphi's retention of a right to replead the preference claims meant that such litigation had not concluded at the 180 day deadline. See *Longacre Master Fund, Ltd. v. ATS Automation Tooling Sys.*, 2012 U.S. App. LEXIS 19274 at \*6-\*7. This recognition of recourse rights will no doubt be greeted with relief by claims purchasers since it is in line with buyer expectations under claims trading documents.

However, in part two of its decision, the Second Circuit also reversed dismissal of indemnifications claim arising from a seller representation in the claim trading documents that "to the best of [seller's] knowledge the claim is not subject to any...impairment...or preference action..." *Id.* at \*8-\*10. Importantly for participants in the claims trading market, the Second Circuit *rejected* the District Court's analysis of the claim trading documents and held that the agreement "strongly suggests that it was an assignment" because it was (i) titled an "Assignment of Claim"; (ii) included language stating that the agreement "unconditionally sells, transfers and assigns"; and (iii) the agreement says the parties recognize "this assignment of claim as *unconditional assignment*" (emphasis added by the Second Circuit). *Id.* at \*10. While not deciding that this language necessarily creates an assignment, the Second Circuit said that there was a material issue of fact as to whether the agreement was a sale or an assignment. *Id.*

*Longacre* has been remanded to the District Court, which will have to parse through the complicated question of whether the trade at issue is a "sale" or an "assignment."

## Conclusion

*Longacre* and *KB Toys* show how unsettled the law of transferee liability with respect to bankruptcy claims still is, five years after *Enron II*. Neither case will have an immediate impact on claims trading with respect to bank loans and bonds (one aspect of the market that has arguably taken the most comfort from *Enron II*), because (i) *Longacre* is an unpublished summary order and (ii) the precedential value of both cases could be limited to the "special case" of trade claims purchased from original claimants. But, *KB Toys*' direct attack on *Enron II*'s "sale versus assignment" logic and the fact that the District Court and the Second Circuit in *Longacre* came to radically different readings of whether a "plain vanilla" claim transfer agreement was a "sale" or an "assignment," indicate how insufficient the present state of the case law on these points is.

Specifically, the contrasting uses of *Enron II* by the District Court and Second Circuit in *Longacre* indicate the problems with the fundamentally untenable distinction between "sales" and "assignments." *Enron II* focused on the economic consequences of a transfer transaction, finding that a complete sale freed the buyer of the "personal disability" that *Enron II* read in Section 502(d). But, by contrasting such a sale with "pure" assignments that put buyers "in the shoes" of sellers (and thus susceptible to transferred "personal disabilities"), *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.

In the meantime, in addition to standard due diligence, market participants should carefully analyze their transfer documentation to ensure that the intent to create a “sale” is clear on the face of such documentation. The transfer agreement at issue in *Longacre* was executed in December 2006, before *Enron II*. Many market participants have, since then, updated their forms to more expressly create a “sale.” These changes can be superficial, but they also present complicated questions when “assignment indicating” statements may be necessary or market-standard. For example, sellers often agree to “sell, transfer *and assign*” their interest in the claim and its supporting documentation because such supporting documentation often cannot be “sold” and must be “assigned.” 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.

#### Endnotes

<sup>1</sup> For a list of several articles criticizing *Enron II*, see *In re KB Toys, Inc.*, 470 B.R. 331 at footnote 12. A year after *Enron II*, the Seventh Circuit further eased concerns with regard to equitable subordination when it held that a creditor that acquired a secured claim by assignment would not be subject to having its claim equitably subordinated to those of other creditors in the bankruptcy case, despite arguably inequitable conduct engaged in by the original holder/assignor of the claim, unless evidence of actual harm to other creditors arising from inequitable conduct was established. *In re Kreisler*, 546 F.3d 863 (7th Cir. 2008).

<sup>2</sup> *KB Toys* did not deal with section 510(c) equitable subordination.

<sup>3</sup> Under Second Circuit rules, unpublished summary orders are *not* binding precedent on lower courts.

<sup>4</sup> This interpretation of the “sale/assignment” distinction is particularly troublesome because it appears to imply that an “assignment” is a more complete transfer than a “sale.” This is not how the concepts are used in real world practice.

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