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You Know About *Fisker*

But Do You Understand Fisker?

By Jonathan Brand and Jonathan Friedland

TRUE or FALSE: Lienholder buys a distressed loan from original lender. Lienholder acts appropriately and reasonably at all times and lien is valid and perfected. Lienholder has an increased risk of having its credit bid limited or capped because of In re Fisker Automotive Holdings, Inc., *2014 WL 210593 (Bankr. D.Del. Jan. 17, 2014).*

FALSE. Much has been written about *Fisker's* potential impact on credit bidding, including warnings of the sky falling. *Fisker* stands for something less dramatic, and already well known, to debt purchasers. Simply stated, the sky is not falling. And, in the midst of all the noise, *Fisker's* import has been exaggerated, as it really covers no new ground.

Footnote 14 Survives *RadLAX* in the Third Circuit

What is the major takeaway from *Fisker*? It simply serves as further confirmation that *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S.Ct. 2065 (2012) did not overturn all aspects of the Third Circuit's *Philadelphia Newspapers* opinion, and in particular, the Third Circuit's *dicta* discussion of § 363(k) was not undone by *RadLAX*.

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A Circuit Court Definitively Addresses Claims Trading

The Resurrection of Enron I?

By Yitzhak Greenberg

The United States Court of Appeals for the Third Circuit recently held that "a trade claim that is subject to disallowance under § 502(d) in the hands of the original claimant is similarly disallowable in the hands of a subsequent transferee." *In re KB Toys Inc.*, 736 F.3d 247 (3d Cir. 2013). Previously, the district court in *Enron* came to the opposite conclusion. *In re Enron Corp.*, 379 B.R. 425 (S.D.N.Y. 2007) (*Enron II*). Despite being the highest court to address this issue — one that implicates the trillion-dollar trade claims market — the Third Circuit did not generate the controversy and outpouring of commentary that the previous *Enron* decisions did in addressing the same issue. *See In re Enron Corp.*, 340 B.R. 180 (Bankr. S.D.N.Y. 2006) (disallowance of bankruptcy claims under § 502(d) travels with the claim) (122 citing references); *In re Enron Corp.*, 333 B.R. 205 (Bankr. S.D.N.Y. 2005) (concluding equitable subordination of bankruptcy claims under § 510 travels with the claim) (142 citing references) (collectively, *Enron I*); *Enron II* (reversing and remanding *Enron I*) (185 citing references); and *KB Toys* (23 citing references).

This disparity can be understood, as *Enron* and *KB Toys* addressed very different types of claims. *Enron* addressed bank loans, which together with bonds (collectively, Financial Claims) generally comprise the largest portion of pre-petition debt. In contrast, *KB Toys* addressed trade claims (Trade Claims), which generally comprise a much smaller portion of that debt. "Some purchasers [of Trade Claims] are simply arbitraging. … [O]ther purchasers [of Financial Claims] have more sophisticated motives. … [seeking] 'fulcrum securities.'" Tally M. Wiener & Nicholas B. Malito, On the Nature of the Transferred Bankruptcy Claim, 12 *U. Penn. J. Bus. Law* 35 (2009). The Third Circuit noted that the transferee belonged to the former

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category and its holding "only concerns trade claims." *KB Toys*, 736 at 247. This distinction provides a basis to limit *KB Toys* to Trade Claims and reconcile these cases.

In addition to being the highest court decision to address this issue, *KB Toys* provides bankruptcy courts in the Southern District of New York (SDNY) a basis for re-embracing *Enron I*. While bankruptcy courts in the SDNY may treat *Enron II*, a district court decision, as persuasive, "only decisions of the Second Circuit Court of Appeals are controlling." *See In re 400 Madison Avenue Ltd. Partnership*, 213 B.R. 888, 890 n.2 (Bankr. S.D.N.Y. 1997)). A decision by the Third Circuit may provide a basis for bankruptcy courts in the SDNY to re-embrace *Enron I*.

This article analyzes the *Enron* and *KB Toys* courts' treatment of the public policy issues associated with claims trading, and the implications of the *KB Toys* holding with respect to Financial Claims trading in the Third and other circuits. Based on the distinction between Trade Claims and Financial Claims, the article argues that *KB Toys* is limited to Trade Claims.

Enron

Fleet National Bank (Fleet) loaned Enron money (the Bank Loans) before the latter's infamous collapse. After the bankruptcy filing and prior to the commencement of any action against Fleet, it transferred portions of the Bank Loans to third parties. Enron thereafter brought a complaint to clawback pre-petition transfers to Fleet — alleging that these transfers were preferential or fraudulent — and sought to disallow the claims of the third parties pursuant to § 502(d). Significantly, the debtors did not allege that the holders of the transferred claims themselves had acted inequitably in any manner or that the claims arose out of transactions challenged by Enron in its complaint. *Enron I*, 333 B.R. 211. *Enron I* found that the acquisition of claims in a bankruptcy proceeding "should not grant greater rights to their new holders than those claims … enjoyed by the transferring holders" and, as such, the transferees were subject to disallowance pursuant to § 502(d). 340 B.R, at 199. Previously, the bankruptcy court found that transferred claims were subject to subordination pursuant to § 510. *Enron I*, 333 B.R. 205.

Enron II reversed and remanded *Enron I*. *Enron II* concluded that, as a matter of law, "section 510(c) and disallowance under section 502(d) are personal disabilities … and do not inhere in the claim." 379 B.R. at 435-36. *Enron II* distinguished between a sale and an assignment. "[A] purchaser does not stand in the shoes of the seller and, as a result, can obtain more than the transferor had in certain circumstances." By contrast, "[a]n assignee of a claim takes with it whatever limitations it had in the hands of the assignor." *Enron II* was broadly criticized for its distinction between sale and assignment. *See KB Toys*, 470 B.R. 331, 340 (Bankr. D. Del. 2012).

KB Toys

In *KB Toys*, ASM Capital, LP and ASM Capital II, LLP (collectively, ASM) acquired nine trade claims (Claims) from trade claimants (Original Claimants). The trustee brought preference actions against, and obtained judgment against, the Original Claimants. These actions were uncollectable because the Original Claimants were no longer in business. One of the Claims was even purchased after the Trustee obtained a judgment against that claimant. The Trustee sought to disallow the Claims pursuant to § 502(d).

The *KB Toys* bankruptcy court disallowed the Claims, concluding under § 502(d) that "[d]isabilities attach to and travel with the claim." *KB Toys*, 736 F.3d at 251. Furthermore, the *KB Toys* bankruptcy court concluded that the

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Dealing with Stub Rent After *In re Oreck*

By John B. Spitzer

A bankruptcy judge recently held that lessors of a debtor's corporate headquarters were not entitled to administrative expense priority under 11 U.S.C. § 365(d)(3) for 25 days of unpaid "stub rent" for the period between the Chapter 11 petition and the first postpetition rent payment. *In re Oreck* (Bankr. D. Tenn., Mar. 10, 2014). The court held that the lessors' stub rent claim was a prepetition debt that was not within the scope of § 365(d)(3) and was not entitled to administrative expense priority under section 503(b)(1).

Does the Billing Date Method or Proration Approach Apply?

"Stub Rent" has been defined as the amount due a commercial landlord for a period of occupancy and use between the petition date and the first post-petition rent payment. *In re Goody's Family Clothing Inc.,* 610 F.3d 812, 815 (3d Cir. 2010). In *Goody's*, the court said that while the Bankruptcy Code does not address the landlord's remedy if a debtor-tenant fails to pay postpetition rent as § 365(d)(3) requires, most courts have held that the landlord may recover rent by filing an automatic administrative expense claim.

Bankruptcy attorneys and commentators have noted that courts have reached different conclusions about whether stub rent should be characterized as an administrative expense or a prepetition, unsecured debt for bankruptcy priority purposes.

The stub rent issue arose in Oreck's reorganization because Oreck's lease contained a typical provision that all rent was due and payable in advance on the first of each month. After Oreck filed a Chapter 11 petition on May 6, 2013, it continued to use its headquarters post-petition. Lessors asserted that the prorated stub rent of approximately $30,000 for the 25 post-petition days in May was an administrative expense under 11 U.S.C. § 365(d)(3).

Application of Billing Date Method

Quoting the applicable language from the that provision, the court focused on the requirement that the trustee "timely perform all the obligations of the debtor, … arising from and after the order for relief under any unexpired lease of nonresidential real property, until such lease is assumed or rejected, notwithstanding section 503(b)(1) of this title. …" 11 U.S.C. § 365(d)(3). The court said that in view of that section's use of the terms "obligations" and "arising," the clear and express intent of § 365(d)(3) required consideration of the terms of the lease to determine both the nature of the obligation and when it arises.

The court in *Circuit City* explained the difference between the billing method and pro rata (or "accrual") approach: "Under the billing method, the obligation to pay arises at the time that payment is due under the terms of the lease contract. When the petition date falls in the middle of a month, the obligation to pay rent will be treated entirely as a prepetition obligation if the Lease is an Advance Lease, and the obligation to pay rent will be treated entirely as a postpetition obligation if the Lease is an Arrears Lease. Alternatively, under the accrual method, the obligation to pay rent is deemed to accrue on a daily basis following the Petition Date. The Petition Date separates the prepetition obligations (general unsecured claims for the portion of the month prior to the petition date) from postpetition obligations (administrative expense claims for the portion of the month after the petition date)." *In re Circuit City Stores Inc.*, 447 B.R. 475 (Bankr. E.D. Va. 2009).

Some courts have called for the uniform application of a pro rata approach to determining the priority status of stub rent. *See, e.g., In re Circuit City Stores Inc.*, 447 B.R. 475 (Bankr. E.D. Va. 2009) (noting that a minority of courts have adopted the billing method approach). Application of that approach would benefit landlords by giving administrative expense status to stub rent.

Arguing that a proration (or accrual) approach would discourage litigation and time-consuming word games involving the interpretation of lease terms, some courts support the uniform and simple application of pro rata division of obligations for stub rent and related tax debts that arise prepetition.

Some commentators have also disagreed with a focus on the lease payment date and have taken an accrual approach, arguing that bankruptcy courts should simply apply a pro rata formula to stub rent obligations. Those commentators have noted that the characterization of stub rent can have significant financial consequences for landlords because denial of administrative expense priority makes the stub rent an unsecured creditor claim. *See* Aaron H. Stulman, Stub Rent Under Section 365(d)(3): A Call for a Unified Approach, 36 *Del. J. Corp. L.* 655 (2011).

Rejecting the views of this commentator and those courts, looking to the explicit terms of the lease, and noting that Oreck's lease required payment of monthly rent in advance, due and payable on the first of each month, the *Oreck* court rejected the proration approach and held that Oreck's obligation to pay stub rent arose on the first of the month for bankruptcy priority purposes. In particular, the court found that Oreck's obligation for May 2013 stub rent arose on May 1, 2013.

No Administrative Expense Priority

The court also rejected the lessors' claim that the stub rent met the key prepetition requirement for administrative expense status under § 503(b)(1). Relying on an unpublished Sixth Circuit holding, the court focused on the prepetition lease payment due date. Rejecting an accrual approach, the Sixth Circuit

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said that the landlord's requirement that rent is due on the first of the month means that the debtor's obligation to pay rent for any given month arises on the first of the month. *In re Baby N' Kids Bedrooms, Inc.*, 2008 U.S. App. LEXIS 27720 (6th Cir. 2008).

In light of this holding, the court concluded that since the stub rent expense and the lessor's right to payment took place before the petition was filed, and since administrative expense status is available only for postpetition obligations, the lessor was not entitled to administrative expense priority under section 503(b)(1).

Drafting to Maximize Recovery of Stub Rent

Because stub rent in large bankruptcy cases has amounted to hundreds of thousands of dollars, and because unsecured creditors typically receive pennies on the dollar, landlords should draft leases to ensure that they receive administrative expense priority status and thereby recover all the stub rent to which their leases entitle them.

In view of the importance of stub rent in some bankruptcies and the holding in *Oreck*, a bankruptcy strategist could counsel a landlord to include the following provision in its leases: "Tenant's obligation to pay rent shall arise, accrue, and be due and payable, at Landlord's option, (1) in advance on the first day of the month for which rent is due under this Lease, or (2) in arrears on the last day of the month for which rent is due under this Lease, or (3) daily on a pro rata basis during the term of the Lease. Landlord shall retain sole discretion to determine, at any time, the payment method with which Tenant must comply. Landlord shall, from month to month, impose upon Tenant whichever option, (1), (2), or (3) above, will maximize Landlord's recovery of all rent due under the Lease during the term of the Lease."

Conclusion

The court's conclusion contains a clear lesson for landlords. Lessors should assume that some courts may apply a bright line rule that makes stub rent an unsecured debt unless the lease specifies that the monthly rent obligation arises — or could arise — after the day in the month when the debtor files the bankruptcy petition. Including the type of provision described in the preceding paragraph could help landlords collect rent that was due during the month in which the bankruptcy petition was filed. Carefully crafted provisions could help landlords recover rent due after the petition was filed and before the debtor assumes or rejects the lease.

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Philadelphia Newspapers' famous footnote 14 states:

> A court may deny a lender the right to credit bid in the interest of any policy advanced by the Code, such as to ensure the success of the reorganization or to foster a competitive bidding environment.
> (citation omitted).

If footnote 14 was a wakeup call, *Fisker* is akin to the optional second wakeup call a hotel sometimes makes five minutes after the first, to ensure the guest is truly awake.

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RadLAX Revisited

In *RadLAX*, the debtors owned a hotel and an adjacent parking deck. After attempts to solicit new equity for a traditional reorganization proved unsuccessful, the debtors proposed a Chapter 11 plan to sell the hotel and parking deck at an auction, free of liens, and to use the proceeds to fund a liquidating plan.

The debtors filed a motion to approve bid procedures and because of the enormous discrepancy between the secured creditor's claim ($120 million) and the approximate value of the assets to be sold ($55 million), the debtors proposed to prohibit the secured creditor from credit-bidding at the auction.

The debtors took the position that, under *Philadelphia Newspapers*, a cram down plan could be confirmed by providing the secured creditor with essentially all of the proceeds from the sale as the "indubitable equivalent" of its secured claim under § 1129(b)(2)(A)(iii).

The bankruptcy court, and then the Seventh Circuit, rejected the debtors' argument. This created a split in the circuits (as the decision was at odds with the Third Circuit's *Philadelphia Newspapers* decision and Fifth Circuit's *Pacific Lumber* decision).

The Supreme Court ultimately affirmed the Seventh Circuit decision to deny confirmation of the debtors' Chapter 11 plan because the plan sought to sell encumbered assets free and clear of liens without allowing the secured lender to credit bid its debt in the sale. While *RadLAX* concerned § 363(k) and confronted a secured creditor's right to credit bid in an auction proposed in a plan, it simply did not directly address the "for cause" exception found in § 363(k).

Fisker Understood

In *Fisker*, the debtor filed a motion seeking authority to sell, without an auction and on a very fast timeline, substantially all of its assets to a third party (we'll call this party "LTO" (as in loan to own) in exchange for LTO's credit bid of a portion of the secured debt that LTO had bought at a steep discount. Another potential cash bidder wanted an auction, and so did the Committee; the latter objected to the motion.

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The debtor and committee subsequently agreed to a set of stipulations providing, among other things, that: 1) the validity of a material portion of the secured creditor's lien was in dispute; 2) if the secured creditor's credit bid was not capped, there would be no realistic possibility of an auction; 3) capping the credit bid would likely foster a "competitive bidding environment" (as those words were used by the Third Circuit in *Philadelphia Newspapers*); and 4) this would likely result in a material benefit to the estate. These stipulations guided the court's decision. In reaching his decision, Judge Kevin Gross noted:

> The cases, I think, are fairly clear that the cause in this situation is that we have undetermined perfected liens on a group of assets. … I do not know, at the moment, the value of those liens — I should say value of those assets. … And I think that certainly has to provide for cause [under § 363(k)]. Courts can place conditions upon the right to credit bid, without denying the right completely. I'm not denying the right completely; I'm simply saying that it should be capped. … [I]n the absence of evidence on the perfection of the liens, which would take time and would unduly delay this case, the Court will cap the credit-bid [of the debt purchaser] …

Fisker, Jan. 10, 2014 Hearing Transcript at 136-38.

The LTO appealed, and the district court denied the appeal. The district court determined, among other reasons, that the appeal was interlocutory and the LTO failed to meet the factors for an interlocutory appeal.

Did *Fisker* concern capping the credit-bid of a loan-to-own debt buyer at the amount the debt buyer paid for its claim and lien? Yes. But would the decision have been similar if the secured creditor who originated the loan had still been holding it? Yes. Sure, the court would not have had the convenience of an amount paid by the debt purchaser to use as the compromise amount it permitted for the credit bid but, under the court's logic, it would have arrived at some capped amount.

Judge Gross did not discuss why the credit bid was capped at the $25 million purchase price, as opposed to some other amount, in his memorandum opinion of Jan. 17, 2014; the stipulations were the only evidence the Judge had to consider. And through the stipulations, the court was advised that no qualified bidder would participate in an auction if the credit bid was over $25 million.

We note also the court's analysis that "absence of evidence on the perfection of the liens" constitutes "cause" under § 363(k). While the Code section does not explicitly refer to a "valid and perfected" lien, it simply belies logic that anything else could be intended. Judge Gross himself pointed out that where the validity of a secured creditor's lien is at issue, it may be denied the right to credit bid altogether. *See Fisker*, 2014 WL 210593 at *5 (citing *In re Danfuskie Isl. Props., LLC*, 441 B.R. 60 (Bankr. D.S.C. 2010)). Giving credit where credit may be due, however, our guess is that Judge Gross analyzed it the way he did so that he could split the proverbial baby.

In other words, the court did not need to reach the question of cause because the secured creditor did not satisfy its initial evidentiary burden. *Fisker* was not about "cause" under § 363(k). *Fisker* and the "cause" to limit the credit bid was more fundamentally about lien validity.

But would the court have capped the credit bid if the liens were not in dispute? Well, maybe, and this is where much of the commentary to-date has focused. Taking a step back, *Fisker* concerned a non-operating company seeking approval of a private sale to a group led by one of Fisker's original investors within 24 business days after the petition date. Maybe the court would have found cause under these facts alone, but it simply didn't get that far. The lien validity issue sculpted the court's decision first and foremost.

Keep Your Eye on the Ball

Farah Fawcett was a big star. When she passed away, her death was the headline. That is, until Michael Jackson died later the same day; big news can be overshadowed by bigger news.

About two months after *Fisker*, Judge Kevin R. Huennekens issued an oral ruling and thereafter issued a memorandum opinion in *The Free Lance-Star Publishing Co. of Fredericksburg, VA*, Case No.14-30315-KRH (Bankr. E.D.Va. April 14, 2014). If *Fisker* is our Michael Jackson (because it was issued by the Chief Judge for the Delaware Bankruptcy Court), *Free Lance-Star* is our Farrah Fawcett, yet is arguably a more important decision for the reasons explained below.

The debtor in *Free Lance-Star* was a family-owned media company. The company borrowed $50 million from Branch Banking and Trust secured by some, but not all, of the company's assets. The company subsequently fell on hard times.

BB&T sold its loan to Sandton Capital Partners in June 2013. Sandton wanted to push the debtor through a Chapter 11 case and sell substantially all the assets to one of its affiliates, DSP Acquisition LLC. DSP took certain actions pre-petition in an effort to expand the scope of its security interest.

The debtor in *Free Lance-Star*, like the committee in *Fisker*, sought to limit DSP's credit bid, arguing that: 1) the validity and scope of DSP's lien was at issue; 2) DSP engaged in inequitable conduct; and 3) limiting the credit bid would foster a robust bidding process. DSP counterpunched with an adversary complaint and motion for summary judgment. The matter was briefed on an expedited basis and the court held a combined hearing on DSP's summary judgment motion and the debtor's motion to limit DSP's credit bid.

At a combined evidentiary hearing, the court determined that DSP did not have a valid lien on, among

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statement of financial affairs (the SOFA) filed in the bankruptcy proceedings put ASM on "constructive notice" of the potential preference actions and, accordingly, that ASM was "not entitled to protection as a 'good faith' purchaser." *Id*. at 250-51. "The *KB Toys* District Court noted that it believed the plain language of § 502(d) was ambiguous but it otherwise adopted the reasoning of the Bankruptcy Court." *Id*. at 251.

The Third Circuit explained that the "issue here is whether a trade claim that is subject to disallowance under § 502(d) in the hands of the original claimant is similarly disallowable in the hands of a subsequent transferee," and answered

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others, the "tower assets" associated with the debtors' radio operations. The court determined that DSP acted in an improper manner, among other reasons, by recording financing statements covering the tower assets pre-petition, and not disclosing its actions to the debtors or the court when seeking post-petition replacement liens in those assets.

Once the court determined that DSP did not have a lien on the tower assets and found cause to limit DSP's credit bid, it turned its attention to how DSP's credit bid should be limited. DSP, apparently in a strategic move, did not take the court's invitation to present testimony as to the amount paid for the BB&T loan.

Therefore, the court, interestingly, accepted a methodology proposed by the debtor's expert, which "eliminated the unencumbered assets of the Debtors [based on the court's determination] from the potential credit bid and applied a market analysis to develop an appropriate cap for a credit bid that would foster a competitive auction process" to develop an appropriate cap for a credit bid that would foster a competitive auction process. The result was that DSP was limited to credit bidding $13.9 million rather than the $38 million it sought to credit bid. DSP appealed. Similar to and adopting portions of the district court's determination and denial of Hybrid's appeal in *Fisker*, the district court found that the bankruptcy court's order was interlocutory, DSP failed to establish the factors necessary to entertain an interlocutory appeal, and there is no reason why the underlying auction should not proceed.

Free Lance-Star Is More Important Than *Fisker*

Free Lance-Star, like *Fisker*, does not create a new basis for "cause" under § 363(k). Each decision was grounded on the questionable validity or extent of the debt buyers' liens. The other allegations of wrongdoing and bid chilling are interesting and while they likely colored the courts' respective views on a general level, there should be no doubt that these acts, in and of themselves, were not the primary basis of either court's decision to find cause to limit the debt purchasers' credit bids.

Free Lance-Star goes a step further than *Fisker* in one respect: *Fisker* relied on stipulations and did not reach a determination of the disputed validity of the debt buyer's lien. *Free Lance-Star* addressed this issue directly through issuing an expedited briefing schedule and holding a combined evidentiary hearing. After conducting the evidentiary hearing, the court found that the debt purchaser did not have a proper lien on all the assets it claimed was covered by its lien.

As stated above, the amount DSP was allowed to credit bid was significantly reduced because the court determined that DSP did not have a lien on many of the assets over which asserted an interest, and conducted a market analysis in the absence of evidence as to the value paid for the debt. This, more than any reason, is why *Free Lance-Star* should be our Michael and not our Farrah: 1) If a pizza is worth $20, and you scrape off all the cheese, what is the value of the cheeseless pizza? 2) If you take a lien on all of the assets of a newspaper empire consisting of 25 regional and one national newspaper and it turns out you messed up and you don't have a lien on the one national newspaper, what does that do to your collateral position? What if it was one of the regionals? What if it was 10 of the regionals? 3) If hedge fund X loans an ice cream manufacturer $50 million secured by liens on all its assets, but it turns out that the secret recipe upon which the entire company is built is not owned by the company, what does that do to the company's value (and to the career of people at the fund who did the underwriting)? But wait, the brand is huge and other, newer recipes may be better than the original?

Get our point? Once a court has to look at the value of pieces rather than the value of a whole, there is a lot of room for argument.

The Practical Take-Away

Fisker is not going to decimate loan-to-own tactics or destroy the broader credit markets any more than the worries about GGP dooming collateralized loan originations came to pass. Do secured creditors need to conduct themselves in a manner that will withstand attacks suggesting they have engaged in inequitable or bid chilling conduct? Sure, but that is not news. And do they need to conduct stellar legal diligence on liens before they buy related claims? Of course but, again, this is not new ground.

There are three key take-aways from *Fisker* and *Free Lance-Star*. First, we expect committees and debtors to be more vigilant than ever in putting a secured creditor's liens through figurative proctology exams before the holders of those liens are permitted to credit bid. Second, as discussed above, a creditor that has a lien on some but not all assets of a going concern should be aware of the issues that may cause down the road. And third, one tactic such a creditor should consider is to try to force separate auctions.

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affirmatively based on the language, the objectives, and the legislative history of § 502(d). *Id*. at 249. The Third Circuit reasoned that "[b]ecause the statute focuses on claims — and not claimants — claims that are disallowable under § 502(d) must be disallowed no matter who holds them." *Id*. at 252 (citation omitted).

Crucially, the Third Circuit held that to allow a transferee/purchaser greater rights would provide an incentive to "wash the claim of any disability … to receive some value for an otherwise valueless claim." *Id*. This result would contravene the aims of § 502(d): 1) ensuring equality of distribution — "the estate has less money and the other creditors would receive smaller amounts"; and 2) coercing compliance with judicial orders — "the original claimant no longer has a claim that the trustee can leverage." *Id*. The Third Circuit noted that ASM could have easily protected itself "by reviewing the Debtors' publicly available SOFAs." *Id*.

KB Toys' Broad Rationale Appears to Envelope Financial Claims

Section 502(d) does not distinguish between different types of claims, and should be equally applicable to all types of transferred claims. Furthermore, the Third Circuit's broad policy arguments — 1) "claims washing"; and 2) "sophisticated traders bearing the risk" — appear to be applicable to all traded claims. Moreover, the Third Circuit criticism of *Enron II* — "reliance on this supposed state law distinction may also be problematic for several reasons" — is likewise applicable to all traded claims. *KB Toys*, 736 F.3d at 254.

The Application of *KB Toys* To Equitable Subordination

KB Toys did not address whether claims can be equitably subordinated in the hands of transferees pursuant to § 510. However, the Third Circuit's rationale of claims washing and criticism of *Enron II* would support an adoption of *Enron I's* rationale regarding § 510.

The subordination of traded claims in the hands of transferees may well have a more significant impact than disallowance pursuant to § 502(b). The *amici curiae* (*Enron* amici) argued that subordination of transferred claims would have a disastrous effect on the claims trading market. For example, in the Refco bankruptcy, the debtor borrowed from one bank, Bawag P.S.K. Group. If the transferred claims would be tainted by Bawag's alleged bad acts, all claims trading would essentially be halted. Moreover, allegations of § 510 can be far more difficult for a claims purchaser to uncover or indentify than clawback actions (the basis for such actions will certainly not appear on bankruptcy schedules or even publicly available books and records). (*See, e.g. Enron I*, 333 B.R. at 229: "Banks are involved in hundreds of transactions with a debtor, therefore, as a practical matter, it would be impossible for them to conduct due diligence on all transactions in which they purchase claims.")

Many of the key rationales of *KB Toys* are applicable to the equitable subordination of transferred claims. However, importantly, the rationale of the SOFA providing notice is not applicable to equitable subordination. The Third Circuit's "claims washing rationale" is as applicable to § 510 as it is to § 502(b). Furthermore, the Third Circuit found *Enron II* problematic for several reasons, including that "the state law on which it relies does not provide a distinction between assignments and sales." *KB Toys*, 736 F.3d at 254. Thus, *KB Toys* places claims traders on notice that transferred claims may well be subject to subordination pursuant to § 510.

Taking the Third Circuit at Face Value

The Third Circuit appears to have dealt a significant blow to the claims trading market. However, in *Enron*, the amici, including the Securities Industry and Financial Markets Association, the International Swaps and Derivatives Association, the Loan Syndications and Trading Association and the Commercial Law League of America, argued that the stability of the trade claims market was at stake. In contrast, there was a noticeable absence of any *amici curiae* in *KB Toys*. This supports the notion that *KB Toys* can be limited to Trade Claims. Thus, courts, even a court in the Third Circuit, may follow *Enron II* when addressing Financial Claims.

The Distinction between Financial Claims and Trade Claims

The distinction between Financial Claims and Trade Claims is readily apparent in these cases. *Enron* addressed billions of dollars of bank claims, and *KB Toys* addressed hundreds of thousands of dollars of trade claims. As discussed, *Enron* amici appeared unconcerned with the outcome of *KB Toys*.

The crucial distinctions between Financial and Trade Claims provide a basis for understanding the Third Circuit's profession that the "issue in this case … only concerns trade claims." *KB Toys*, 736 at 247. These distinctions include: 1) Public Policy: Trade Claims are of limited significance to the claims trading market; 2) "Claims washing": This rationale has limited relevance to Financial Claims; and 3) Diligence: Examination of the SOFA has limited value in regard to Financial Claims.

Public Policy

Enron I and *Enron II* both contained a detailed analysis of the effect of their decisions on the claims trading market and the associated public policy. In contrast, *KB Toys* lacked this analysis. In *Enron I*, after the court's extensive public policy analysis, the court concluded that its decision would not impair the claims trading market because the efficient marketplace would properly take into account and price all of the risks. In fact, *Enron I* posited that "immunizing a transferred claim from disallowance under section 502(d) would alter the risk factors associated with a claim and would

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Claims Trading

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interfere with the efficient market by artificially enhancing the claim's value in the claims-transfer market." *Enron I*, 340 B.R. at 209.

Enron II began its decision noting "the outcry from commentators and *amici curiae*, who have expressed great concern that the effect of these opinions will wreak havoc in the markets for distressed debt." *Enron II*, 379 B.R. at 428. *Enron II* concluded that "[a]ccordingly, the concerns raised by Industry Amici with respect to the effects of the Bankruptcy Court's rulings on the markets for distressed debt are no longer present." *Id*. at 448, fn. 114.

Importantly, *Enron II* noted that a court may depart from the plain language of a statute to avoid a result "demonstrably at odds with the intentions of [the statute's] drafters" and, as such, it is "proper to consider the effect that the court's interpretation would have on the markets." *Id*. at 432. Thus, a court's position regarding the importance of claims trading may well be an integral element to its treatment of transferred claims.

Opponents argue that claims trading is destructive. (*See, e.g.*, Harvey R. Miller, Chapter 11, Reorganization Cases and the Delaware Myth, 55 *Vand. L. Rev*. 1987, 2014-2015 (2002): "Distressed debt trading … [has] destroyed the symbiotic relationship of debtor and creditor. ... Chapter 11 is premised upon a symbiotic relationship between debtor and creditor. …") In contrast, many commentators find that the claims trading market is beneficial to the reorganization process. These benefits include: 1) "increased market liquidity/enhancement of sellers' recovery[,] resulting in lower cost of borrowing"; and 2) "consolidation of diverse interests in the hands of a few sophisticated investors, leading to more vigorous negotiations, rapid reorganizations and maximization of value for remaining creditors." Robert D. Drain & Elizabeth J. Schwartz, Are Bankruptcy Claims Subject to the Federal Securities Laws?, 10 *A.M. Bankr. Inst. L. Rev*. 569, 575-576 (2002). (*See also Enron I*, 340 B.R. at 200 "the existence of a market to transfer claims is commonly viewed to provide a source of liquidity to the original or subsequent holders of the claims, including financial institutions that provide pre-petition loans to debtors.") In fact, bankruptcy courts in the SDNY routinely enter orders to help facilitate the efficient negotiations amongst claims traders protecting claims traders from allegations of insider trading.

'Claims Washing'

In *KB Toys*, "claims washing" was not an abstract issue. The preferences were not collectable from the original claimants. If the claims were not sold subject to their § 502(d) infirmity, the original claimants would have successfully washed their claims at the expense of the estate.

However *Enron I* and *Enron II* expressed little concern over "claims washing." *Enron I* did "not speculate" whether the absence of disallowance would provide an "incentive to engage in "claim washing." "[T]here is no evidence in the body of jurisprudence dealing with claims-transfers, in any study, nor in any law review that suggests that "claim washing" [for Financial Claims] is an actual 'real world' problem." *Enron I*, 340 B.R. 180.

Likewise, *Enron II* found that claims washing "cut both ways" and "would not be "washed" because the transferor remains subject to direct actions." 379 B.R. 425, 447. Claims washing was not viewed as a motivation for large financial institutions by the *Enron* courts because they would still be subject to the avoidance actions/subordination. In contrast, with respect to Trade Claims, there can no longer be any doubt that claims washing is an actual real-world problem. Thus, claims washing, a key rationale of the *KB Toys* holding, is not applicable to Financial Claims.

SOFA and Diligence

In *KB Toys*, ASM could have easily protected itself by reviewing the publicly available SOFAs. Indeed, perhaps ASM did review the SOFAs and took a calculated risk. *KB Toys*, 736 F.3d at 255. In contrast, in *Enron*, diligence would have not necessarily uncovered a potential suit. "[B]anks are involved in hundreds of transactions with a debtor, therefore, as a practical matter, it would be impossible for them to conduct due diligence on all transactions in which they purchase claims." *Enron I,* 340 B.R. at 202. Thus, another key rationale of the *KB Toys* holding is not applicable to Financial Claims.

The Uncertainty

This *KB Toys* decision — finding that § 502(d) disabilities attach to and travel with the traded claim — appears to definitively address all traded claims, and appears to support the application of equitable subordination pursuant to § 510 to traded claims. The effect of this decision should have negatively impacted the claims trading market in not only the Third Circuit, but also other circuits and even the Southern District of New York. However, this article has demonstrated why the *KB Toys* holding may be limited to Trade Claims and, as such, *Enron II* remains the highest court to address Financial Claims. Further, this discussion highlights the critical role the stability of the claims trading market may play in further court decisions.