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Buyer Beware: Courts Put Claims Trades Under a Microscope

In a previous alert[1] we summarized decisions addressing the issue of vote designation in bankruptcy in the wake of the Second Circuit's decision in the seminal case *Dish Network Corp. v. DBSD North America, Inc.*[2] We noted that this line of cases indicates that if a court determines the primary motivation behind a secondary market purchase of bankruptcy claims is to obtain control of the underlying Chapter 11 process, that may constitute cause to "designate," or not count, the votes cast by the purchasers in connection with a Chapter 11 plan.[3]

These decisions and others issued in the last year should serve as a word of caution to participants in the claims trading market. Collectively, they suggest that courts determining claims disputes will not only examine facts and circumstances under which claims are bought and sold, but are increasingly willing to delve into the relationships between the parties and their respective motives and relative positions via-à-vis each other and the debtor.

In this alert, we provide a roundup of four more decisions issued in the last year that serve as additional examples of courts examining claims transfers under a microscope. We first review a recent ruling by the Third Circuit Court of Appeals which affirmed that the purchaser of trade claims is subject to the defenses that a debtor would have against the original creditor. Then we explore a case in which the bankruptcy court held that a debtor was permitted to treat a claim differently solely because that claim was assigned to a secondary market purchaser. We then discuss a decision in which an appellate panel held that insider status does not travel with a claim that is assigned. Finally, we turn to a

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1 http://www.cliffordchance.com/publicationviews/publications/2013/03/beyond_dish_networkfurtherdevelopmentsi.html

2 *Dish Network Corp. v. DBSD North America, Inc*. (*In re DBSD North America, Inc.*) 634 F.3d 79 (2d Cir. 2010).

3 Before a Chapter 11 plan of reorganization may be confirmed, each impaired class of claims must either accept the plan or be found to be afforded fair and equitable treatment under the plan. 11 U.S.C. § 1129(a)(8), (b). A class of claims is deemed to accept the plan if a majority in number of the voting claimholders in such class holding claims accounting for at least two-thirds of the total amount of all claims in such class, votes to accept the plan. 11 U.S.C. § 1126(c).
Section 1126(e) of the Bankruptcy Code allows the court to designate – meaning not to count – the vote of any creditor whose vote was not cast or procured in "good faith." See 11 U.S.C. § 1126(e) ("On request of a party in interest, and after notice and a hearing, the court may designate any entity whose acceptance or rejection of such plan was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of this title.").

case where a bankruptcy court scrutinized not only the ownership chain-of-title of a claim but also the authority of the entity filing such claim in determining whether to allow the claim. When read together, these decisions further suggest the willingness of bankruptcy courts to closely scrutinize secondary market claim transactions when determining questions of classification, treatment – and, ultimately, the value secondary market purchasers will realize on account of purchased claims.

Claim Purchasers Subject to the Same Disabilities as the Original Creditor

We previously highlighted the decision of the Delaware Bankruptcy Court in *In re KB Toys, Inc.*,[4] in which the court concluded that the purchaser of a bankruptcy claim is subject to the same disabilities as the original creditor – specifically preference liability. That decision has since been affirmed by the District Court and the Court of Appeals for the Third Circuit.

By way of background, secondary market purchaser ASM Capital ("ASM") purchased a number of claims originally held by trade creditors, each of whom had received payments within 90 days of the petition date, making them subject to avoidance as preferences. Indeed, the Trustee brought preference actions against the creditors and obtained judgments against each one. These judgments were not paid; they were uncollectable because all of the original trade creditors had gone out of business. The Trustee subsequently filed objections to the claims[5] alleging that the claims should be disallowed because each trade creditor received a preference before transferring its claim to ASM. The bankruptcy court agreed and disallowed the claims, a holding the district court affirmed.

The Court of Appeals for the Third Circuit agreed that the claims should be disallowed "[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."[6] According to the Court, any other interpretation would enable and incentivize a creditor that received an avoidable transfer "to sell its claim and 'wash' the claim of any disability."[7] In terms of the impact of its decision on secondary market purchasers, the Court observed that they are "typically sophisticated entities" and "[b]ecause they choose to voluntarily take part in this risky process, it is only fair to require them to bear the risk the original claimant will not return an avoidable transfer."[8] According to the Court, these sophisticated parties can mitigate risk by performing due diligence and can account for risk in the transfer documents and the price of the claim.[9]

The holding of *KB Toys* stands in stark contrast to the widely criticized *Enron* decision issued by the District Court for the Southern District of New York which "focused on the claimant as opposed to the claim" finding that "disallowance is a personal disability of a claimant, not an attribute of the claim."[10] Creating confusion, the *Enron* court held that whether the claim is subject to disallowance in the hands of a subsequent transferee depends on whether the claim was acquired pursuant to an "assignment" or a "sale"; while assigned claims are subject to the disability of the original claimant, claims that are sold are not. Unfortunately, the court failed to provide any guidance as to what constitutes an assignment or a sale, creating uncertainty regarding how to differentiate one from the other. Ultimately, when these decisions are read together, a claim that is likely to be disallowed in the Third Circuit may be allowed in the Second Circuit.

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4 http://www.cliffordchance.com/publicationviews/publications/2012/08/delaware_bankruptcycourtholdsclaimpurchaser.html

5 Section 502(d) of the Bankruptcy Code states that "the court shall disallow any claim of any entity" that received an avoidable transfer, "unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable." 11 U.S.C. § 502(d).

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

7 *Id.* at *10-11.

8 *Id.* at *11, n.8.

9 *Id.*

10 *Enron Corp. v. Springfield Assocs., L.L.C.* (*In re Enron Corp.*), 379 B.R. 425, 443 (S.D.N.Y. 2007).

Transfer of a Claim Justifies Reclassification

Secondary market purchasers will likely find it worrisome that one bankruptcy court determined that the mere assignment of a claim to a secondary market purchaser is sufficient grounds for a debtor to change the classification and ultimate treatment of such claim in its Chapter 11 plan.

In that case,[11] the debtor owned a commercial development which had one secured creditor ("CWCapital") in addition to numerous unsecured creditors. The debtor's original Chapter 11 plan proposed to pay creditors in full, and placed unsecured creditors into two classes. Class 5 consisted of general unsecured claims, and Class 6 was a convenience class of small unsecured claims.

In an effort to block confirmation of the original plan, CWCapital filed rejecting ballots for its secured claims. It also purchased sixteen unsecured claims and filed rejecting ballots for them. After receiving the ballots, but before the confirmation hearing, the debtor filed a modified plan and supplemented its disclosure statement. The modified plan provided for a third class of unsecured claims – Class 4A – which was solely comprised of unsecured claims purchased by CWCapital. This class would receive treatment under the modified plan that was different from the other classes of unsecured claims. The debtor proposed to convert CWCapital's unsecured claims to secured claims and to pay those claims at a secured interest rate of 3.75% over ten years.

CWCapital objected to both plans and moved to dismiss the case based on the debtor's inability to confirm a Chapter 11 plan. After a hearing, the court upheld the debtor's modified classification scheme finding that the debtor had articulated a legitimate business justification beyond plan confirmation for separately classifying CWCapital's claims.[12] According to the debtor, this classification scheme was based on its desire to maintain trade and professional relationships with its other unsecured creditors. The court agreed finding that paying these "creditors quickly fosters relationships for future business," and this "rationale simply does not apply to the claims which were purchased by CWCapital."[13]

A finding that the identity of the holder of a claim warrants separate classification and separate treatment under a Chapter 11 plan should make secondary market purchasers take caution. CWCapital appealed the bankruptcy court's decision and obtained a stay of the bankruptcy proceedings pending appeal from the District Court.[14] In its decision granting the stay, the District Court stated that it is "highly likely that Burcam proposed this classification scheme for the sole purpose of manipulating the vote to confirm the plan, "rather than for a legitimate business reason.[15] While the appeal is briefed it has not been set for hearing. We will continue to monitor this case.

Acquisition of a Claim from an Insider Does Not Result in a Purchaser Being Deemed an Insider

A decision by the Ninth Circuit Bankruptcy Appellate Panel provides another example of a court considering the identity of the purchaser and the circumstances under which a claim was purchased to determine how the claim should be treated for voting

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11 *In re Burcam Capital II, LLC,* 2013 Bankr. LEXIS 604 (Bankr. E.D.N.C. Feb. 15, 2013).

12 Section 1122(a) of the Bankruptcy Code provides that a plan may place a claim in a particular class only if such claim is "substantially similar to the other claims in that class." 11 U.S.C. § 1122(a). However, the Bankruptcy Code does not require that all similar claims be in the same class.

13 *Id.* at 7.

14 *CWCapital Asset Mgmt., LLC v. Burcam Capital II, LLC*, 2013 U.S. Dist. LEXIS 91488 (E.D.N.C. June 26, 2013).

15 *Id.* at *16.

purposes. This decision should give claim purchasers comfort as the panel decided that insider status does not travel with the claim.

In *Village at Lakeridge*,[16] Lakeridge was an owner-operator of commercial real estate. The sole member of Lakeridge was MBP Equity Partners 1, LLC ("MBP"). A member of the board of managers of MBP named Kathie Bartlett signed the bankruptcy petition and all related documents on behalf of Lakeridge. Lakeridge's Chapter 11 plan and related disclosure statement addressed just two claims: a secured claim in the amount of $10 million filed by U.S. Bank and an unsecured claim in the amount of $2,761,000 asserted by MBP (the "MBP Claim"). Shortly after the plan and the disclosure statement were filed, an individual named Robert Rabkin purchased the MBP Claim for $5,000.

During the proceedings U.S. Bank deposed Rabkin. At his deposition, Rabkin stated that he had purchased the MBP Claim as a business investment expecting to be paid a dividend of $30,000 under the Lakeridge Chapter 11 plan. He also revealed that he had a business and a close personal relationship with Bartlett. During the deposition, U.S. Bank offered to purchase the MBP claim for $60,000, an offer Rabkin declined. U.S. Bank subsequently filed a motion arguing, among other things, that Rabkin's vote should not be counted because he was both a statutory insider (by virtue of his purchase of the MBP Claim – an insider claim) and a non-statutory insider (due to his relationship with Bartlett).[17]

The bankruptcy court concluded that as a matter of law, a non-insider becomes a statutory insider by acquiring an insider claim.[18] Based on this decision, Rabkin's claim could not be considered for voting purposes. This decision left the debtor without an impaired, assenting class of claims necessary to confirm its Chapter 11 plan.

Significantly for those who purchase claims in the secondary market, on appeal the Panel found that insider status does not travel with the claim. Therefore, Rabkin did not automatically become a statutory insider when he acquired MBP's claim; one must fall into one of the categories specifically enumerated in the statute to be considered a statutory insider.[19]

The Importance of Properly Documenting Chain-of-Title and Authority

Finally, secondary market claims purchasers should perform careful due diligence as to the purported authority to file a claim as well as with respect to the chain-of-title and the documentation supporting the claim itself.[20] One bankruptcy court disallowed a claim because the claimant (a secondary market purchaser) failed to provide sufficient evidence of the chain-of-title ownership of the claim[21] and the authority of a third party to act on behalf of the assignee when it filed the proof of claim.[22]

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16 *Vill. at Lakeridge, LLC v. U.S. Bank N.A. (In re Vill. at Lakeridge, LLC)*, 2013 Bankr. LEXIS 2329 (B.A.P. 9th Cir. Apr. 5, 2013).

17 The term, "insider" is defined in the Bankruptcy Code, which sets forth eighteen examples of what constitutes a statutory insider, including the following: (i) a director of the debtor corporation; (ii) an officer of the debtor corporation; (iii) a person in control of the debtor; (iv) a partnership in which the debtor is a general partner; (v) a general partner of the debtor; or (vi) a relative of a general partner, director, officer, or person in control of the debtor, among others. 11 U.S.C. § 101(31).

Courts have concluded that the list of insiders is not exhaustive. Based on the facts and circumstances, an individual may be deemed to be an insider even if he or she did not fall into one of the categories enumerated in the statute – what is known as a "non-statutory insider." Insider status is important because if any class of claims is impaired under a Chapter 11 plan, section 1129(a)(10) of the Bankruptcy Code requires that at least one impaired class vote to accept the plan without regard to the vote of insiders. 11 U.S.C. § 1129(a)(10)

18 The bankruptcy court also found that Rabkin was not a non-statutory insider.

19 The Panel also upheld the bankruptcy court's determination that Rabkin was not a non-statutory insider of Lakeridge.

20 *In re Halstead*, Ch. 13 Case No. 12-66833-WSD, Doc. No. 80 slip op. (E.D.Mi. Sept. 13, 2013).

21 Rule 3001(c) provides, in relevant party that "when a claim...is based on a writing, a copy of the writing shall be filed with the proof of claim [and] [i]f the writing has been lost or destroyed, a statement of the circumstances of the loss or destruction shall be filed with the claim."

22 Rule 3001(e) provides that where the claim "has been transferred...before the proof of claim has been filed, the proof of claim may be filed only by the transferee."

Quantum 3 Group, LLC ("Quantum 3"), as agent for CF Medical LLC ("CF Medical"), filed claims which referred to certain debt owed to a hospital. Attached to each claim was a document entitled "Bankruptcy Rule 3001(c) Account Information," which contained information describing the services rendered by the hospital and the amount of the claim. The claims forms were signed by an "Authorized Agent" of Quantum 3.

The debtors objected to these claims and urged the court to disallow the claims for failure to provide documentation sufficient to meet the mandatory requirements of Rule 3001(c). In response, Quantum 3 amended the claims to include an affidavit of a hospital employee attesting to the amount of the claim and that the accounts were sold and assigned by it to CF Medical. The debtors maintained their objection. [23]

The court questioned whether Quantum 3 was the proper party to assert a right to payment on the claim, and required Quantum 3 to provide evidence of (i) the assignment of the claim by the hospital to CF Medical LLC and (ii) the agency agreement between Quantum 3 and CF Medical authorizing the former to sign the claim documentation on behalf of the latter. According to the court, "ownership of the claim and the legal right to assert it are as much a part of the claim as the substance of the goods, services, or other considerations that give rise to the claim, at least for the purposes of its payment to the correct party in the bankruptcy context."[24]

Quantum 3 failed to produce either document. Based on this failure, the court observed that "one can infer that neither of such documents exist."[25] This finding was fatal to Quantum 3's claims, and accordingly, its claims were disallowed.

Conclusion

Claims traders should take notice of the foregoing decisions as signals of a potential emerging trend in which bankruptcy courts increasingly scrutinize claims trading transactions and the parties who enter into them. Courts seem keen to delve into the relationships between the parties and their respective strategic motives and positions.

Every hedge fund and investment bank that purchases claims in the secondary market should carefully consider the holding in *Burcam Capital*. Much like the decisions we discussed previously where courts designated the votes cast by secondary market claim purchasers, the *Burcam Capital* court held that a debtor can modify its plan to change the treatment of claims purchased on the secondary market and treat such claims differently on the basis that they were purchased on the secondary market.

[23] Rule 3001(f) states, “A proof of claim executed and filed in accordance with these rules shall constitute prima facie evidence of the validity and amount of the claim." Fed. R. Bankr. P. 3001(f).
[24] *In re Halstead*, Ch. 13 Case No. 12-66833-WSD, Doc. No. 80 slip op. at 3 (E.D.Mi. Sept. 13, 2013).
[25] *Id.* at 4.