MANDATORY INDEMNIFICATION IN CLAIMS TRADING: PRESERVING THE PURPOSES OF SECTIONS 502(D) AND 510(C) OF THE BANKRUPTCY CODE

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INTRODUCTION

The development of a market for bankruptcy claims has been one of the most significant events in corporate restructuring that has occurred in the past two decades.[1] The ability for investors to buy claims in a debtor's bankruptcy has made corporate restructuring a market-driven process[2] and has attracted big investment firms into the bankruptcy realm.[3] Indeed, some commentators estimate that the size of the market is in the hundreds of billions of dollars.[4] Although these numbers may be more speculative than concrete,[5] one thing is certain: claims trading is a booming business.[6]

Claims trading has a significant impact on the restructuring process, but whether that impact should be celebrated or condemned is an open question.[7] To be sure, the most obvious benefit of a liquid market for bankruptcy claims is that

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[1] *See* Adam J. Levitin, *Bankruptcy Markets: Making Sense of Claims Trading*, 4 BROOK. J. CORP. FIN. & COM. L. 67, 68 (2009) ("The creation of a market in bankruptcy claims is the single most important development in the bankruptcy world since the Bankruptcy Code's enactment in 1978."); *see also* Robert J. Keach & Albert Togut, *Commission to Explore Overhauling Chapter 11*, AM. BANKR. INST. L.J. at 36–37 (June 2011) ("The unparalleled expansion of distressed-debt markets and claims trading has made chapter 11 a financial and takeover play, minimizing the debtor's ability to control its own destiny."); Glenn E. Siegel, *Introduction: ABI Guide to Trading Claims in Bankruptcy Part 2*, 11 AM. BANKR. INST. L. REV. 177, 177 (2003) ("Perhaps nothing has changed the face of bankruptcy in the last decade as much as the newfound liquidity in claims.").

[2] Levitin, *supra* note 1, at 68 ("Claims trading has revolutionized bankruptcy by making it a much more market-driven process.").

[3] Hon. Robert D. Drain & Elizabeth J. Schwartz, *Are Bankruptcy Claims Subject to the Federal Securities Laws?*, 10 AM. BANKR. INST. L. REV. 569, 569 (2002) (stating between 1991 and 2002, "numerous distressed debt funds [were formed] with assets in excess of $1 billion"); *see also* CERBERUS CAPITAL, *Corporate Debt*, http://www.cerberuscapital.com/investment_strategies/distressed_securities_assets /corporate_debt_npls_structured_products ("Distressed corporate debt is one of Cerberus's core investment strategies and has been since the Firm's founding in 1992.").

[4] Frederick Tung, *Confirmation and Claims Trading*, 90 NW. U. L. REV. 1684, 1685 (1996) ("The size of the [claims trading] market was estimated to run as high as $300 billion.").

[5] Levitin, *supra* note 1, at 77 ("No one has a handle [on] . . . the size of the bankruptcy claims trading market, either in terms of face value of claims trading hands or the volume of transactions . . . . Moreover, it is unclear how anyone could arrive at any number. The data simply does not exist.").

[6] Drain & Schwartz, *supra* note 3, at 569 n.1 (stating it is reasonable to estimate size of claims trading market in multi-billion dollar range); *see also* SECONDMARKET INC., *Bankruptcy Claims Trading, March 2012*, *available at* https://www.secondmarket.com/discover/wp-content/uploads/2012/04/Claims-Trading-Monthly-March2.pdf (aggregating claims trading data from U.S. Bankruptcy Court and reporting that "[t]he aggregate dollar amount of transfers topped $6.2 billion" in March 2012).

[7] *Compare* Paul M. Goldschmid, *More Phoenix than Vulture: The Case for Distressed Debt Investor Presence in the Bankruptcy Restructuring Process*, 2005 COLUM. BUS. L. REV. 191, 193 (2005) (arguing distressed debt investors expedite business reorganizations), *with* Jonathan C. Lipson, *The Shadow Bankruptcy System*, 89 B.U. L. REV. 1609, 1615–19 (2009) (arguing distressed debt investors participate in chapter 11 to obtain privatized gains while socializing losses to the many).

it provides uneasy creditors with a quick exit option—if creditors dislike being involved in the debtor's bankruptcy, they can simply sell their claims and get out.[8] This exit option reduces creditors' risk of non-recovery on loans, and therefore should theoretically benefit society by lowering the cost of capital for all borrowers. Nevertheless, claims trading may cause problems in bankruptcy too. For example, the ability for an investor to buy into a debtor's bankruptcy may significantly delay the debtor's restructuring: A greenmail-minded creditor may buy enough claims to block the confirmation of any restructuring plan that treats him unfavorably. This creditor can then hold up the restructuring process—wasting time and money—until he receives better treatment.

The impact of claims trading on bankruptcy is not limited to its effects on the interactions between claim purchasers, creditors, and the debtor. In contrast, claims trading raises important and novel questions about how courts should interpret certain provisions of title 11 of the United States Code (the "Bankruptcy Code"). Specifically, several recent cases have considered how courts should apply sections 502(d) and 510(c) of the Bankruptcy Code to situations involving claims trading.[9]

This Article identifies certain problems that claims trading causes for these Bankruptcy Code provisions. When used properly, sections 502(d) and 510(c) create "defects" in a claimholder's claim. These provisions serve their respective purposes when the newly-created defects are enforced against the original claimholder. Interesting issues arise, however, when the original claimholder sells its defective claim to a buyer. Specifically, the question becomes: Should a court enforce the claim's defect against the buyer even when the buyer did not engage in the activity that created the defect?

This question presents a difficult policy choice. On the one hand, an observer may argue that it is unfair for a court to enforce a claim's defects against a buyer when that buyer did nothing to create the defect. On the other hand, if a court refuses to enforce these defects against claim buyers, the court risks creating perverse incentives for unscrupulous claimholders. Specifically, the risk is that a claimholder might view the claims trading market as a way to "wash" its claim of these defects. Additionally, "claims washing" is troubling

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[8] *See* Anne Marrs Huber & Thomas H. Young, *The Trading of Bank Debt In and Out of Chapter 11*, 15 J. BANKR. L. & PRAC. 15, 16 (2006) ("It is clear that a liquid market in claims benefits creditors who want to cut their losses, monazite their claims and may not have the resources or the desire to remain a party to the reorganization.").

[9] *See In re* KB Toys, 736 F.3d 247, 250–51 (3d Cir. 2013); *In re* Enron Corp., 379 B.R. 425, 427 (S.D.N.Y. 2007).

because, if allowed, it directly undermines the purposes of sections 502(d) and 510(c).[10]

This Article seeks to analyze this issue from a policy perspective, and concludes that it is more desirable to enforce a claim's defect against a claim buyer rather than to allow a claimholder to wash its claim. This Article explains, however, that this solution is not enough to solve all of the problems caused by claims washing. Specifically, if an unscrupulous claimholder can sell its claim and escape liability under sections 502(d) and 510(c) as a result, the claimholder will continue to thwart the purposes of sections 502(d) and 510(c). Accordingly, a more comprehensive solution is necessary to solve all of the problems caused by claims washing. This Article proposes such a solution: a mandatory indemnity in claims trading contracts.

Part I describes the background information needed to understand the claims washing problem. Specifically, Part I describes the regulation and mechanics of the claims trading industry and also explains the purposes and functions of sections 502(d) and 510(c). Part II identifies the claims washing problem and explains how it undermines the purposes of sections 502(d) and 510(c). Part II then identifies the decisions in the District Court for the Southern District of New York and the Court of Appeals for the Third Circuit that have applied sections 502(d) and 510(c) to situations involving traded claims. Part II argues that, as a first step to solving the problems caused by claims washing, courts should adopt the Third Circuit's approach and enforce a claim's defect against a claim buyer. Part II explains, however, that widespread adoption—and expansion—of the Third Circuit's approach is only a first step to solving these problems, and that a comprehensive solution is needed to address the claims washing problems that remain. Part III suggests such a solution to the claims washing problem: a mandatory indemnity in claims trading contracts. Part III suggests that Congress should amend the Bankruptcy Rules to require a claim seller to indemnify a claim buyer against any loss under sections 502(d) or 510(c) caused by the seller's conduct. Part III explains that this solution should increase liquidity in the claims trading market and benefit all claim buyers and sellers for other reasons as well. Part IV introduces another comprehensive solution suggested by Professor Adam J. Levitin, and explains why this Article's mandatory indemnity is more desirable.

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[10] This Article assumes at the outset that a primary consideration in determining how to apply a statute is the policy underlying such statute, and, as such, preserving the purposes of such statute is a paramount concern. *See In re KB Toys*, 736 F.3d at 252 (citing Official Comm. of Unsecured Creditors of Cybergenics Corp. ex rel. Cybergenics Corp. v. Chinery, 330 F.3d 548, 559 (3d Cir. 2003) (en banc) for proposition that "courts must look to a law's 'object and policy' when interpreting the law.").

I. CLAIMS TRADING AND SECTIONS 502(d) AND 510(c)

To understand the problems caused by claims washing, it is important to have a working knowledge of two broad topics: (1) the mechanics of claims trading, and (2) sections 502(d) [11] and 510(c) [12] of the Bankruptcy Code. Accordingly, this Part provides the background necessary to understand these topics. Section 1 discusses the mechanics of claims trading and Section 2 discusses the purposes and functions of sections 502(d) and 510(c).

1. The Regulation and Mechanics of Claims Trading

Stated generally, "claims trading" is the buying and selling of claims against a debtor's bankruptcy estate.[13] This general statement, however, does not capture the complexity of the market. Rather, the market for bankruptcy claims is an intricate financial venue with trading mechanics that vary by asset class.[14] Sophisticated financial players dominate the market with investment strategies that can differ widely.[15] To complicate matters further, commentators have yet to reach a consensus on whether claims trading provides a net benefit, or a net detriment, to the restructuring process. While all of these topics are worthy of discussion, many of them are beyond the scope of this Article. In fact, a working knowledge of claims trading regulation and market mechanics is the only background necessary to understand the claims washing problem. Accordingly, this Section provides an overview of this topic.

A. The Different "Types" of Bankruptcy Claims

In order to understand the mechanics of claims trading, it is first important to understand the different *types* of claims that can be traded. Although the Bankruptcy Code treats all of the debtor's pre-petition obligations as "claims,"[16] the pre-petition debts on which these "claims" are based are not "claims" at all. Rather, before the debtor's bankruptcy, each claim was "a right to payment."[17] This expansive definition [18] includes many different types of pre-petition

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[11] *See* 11 U.S.C. § 502(d) (2012).
[12] *See* 11 U.S.C. § 510(c).
[13] *See generally* Levitin, *supra* note 1.
[14] *See id.* at 84–98.
[15] Drain & Schwartz, *supra* note 3, at 572 ("Effective entry into the [claims trading] market is difficult and generally limited to sophisticated institutions.").
[16] *See* 11 U.S.C. § 101(5)(A) (defining "claim").
[17] *Id.*
[18] In full, the definition of a claim is a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal,

obligations—obligations that may not have had similar characteristics before bankruptcy. Notwithstanding the pre-petition differences in these obligations, at the start of the debtor's bankruptcy "they are all transformed into claims that have similar rights in the debtor's estate."[19]

Claims to a corporate debtor's bankruptcy estate generally fall into one of four categories: (1) trade debt, (2) bank debt, (3) publicly traded debt securities ("bond debt" or "bonds"),[20] and (4) tort debt.[21] As discussed below, these different claim types may be regulated in different ways and may have differing trade mechanics. It should be noted at the outset, however, that the market for tort debt is "much smaller" than the markets for the other types of debt.[22] Accordingly, this Article limits its discussion of claims trading to the first three types of claims: trade debt, bank debt, and bond debt.[23]

B. Claims Trading Regulation

Despite the prevalence and money involved in claims trading, few individuals outside of the industry precisely understand its mechanics.[24] This is because claims trading is largely unregulated.[25] Although publicly traded securities remain subject to the securities laws even after a debtor has entered

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equitable, secured or unsecured; or [a] right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured." 11 U.S.C. § 101(5)(A) & (B).

[19] Drain & Schwartz, *supra* note 3, at 570.

[20] To simplify the discussion of publicly traded debt securities, this Article will refer to publicly traded debt securities as "bond debt" or "bonds."

[21] Levitin, *supra* note 1, at 86 ("Business debt claims fall into roughly four asset classes: bond debt, bank debt, trade debt, and tort debt."). The author acknowledges that this list of categories is not exclusive. Indeed, there may be claims to a debtor's estate that do not necessarily fall into one of these categories (for example, a debtor's obligation to pay a retired employee).

[22] *Id.* at 89–90 ("Most investors are not interested in tort claims, in part because of the issues of proof involved in disputed claims and because champerty issues are particularly salient in the personal injury context.").

[23] These three categories of debt appear to be the type of debt traded in greatest frequency. *See id.* at 86. Accordingly, it is these categories of debt on which this Article focuses its analysis. *See also* Drain & Schwartz, *supra* note 3, at 576 ("[T]he market in distressed debt [includes] bank and trade debt in addition to bonds.").

[24] Adam Levitin, *Bankruptcy Claims Trading: Part I*, CREDIT SLIPS, Sept. 20, 2007, http://www.creditslips.org/creditslips/2007/09/bankruptcy-clai.html ("The mechanics of the claims market are not well known outside of the trading community.").

[25] *Id.* ("Bankruptcy claims trading is virtually unregulated in the U.S.").

bankruptcy,[26] the trading of other types of debt may be unregulated outside of bankruptcy, and thus would be generally unregulated inside of bankruptcy.

Bankruptcy law regulation of claims trading is arguably nonexistent.[27] Federal Rule of Bankruptcy Procedure 3001(e) ("Rule 3001(e)") provides the only specific bankruptcy regulation for the claims trading market.[28] The current version of Rule 3001(e), which Congress adopted in 1991, simply requires claim transferees to file "evidence of the transfer" with the bankruptcy court.[29] It should be noted that Rule 3001(e) includes a carve out for "publicly traded note[s], bond[s], or debenture[s]."[30] Thus, Rule 3001(e) imposes no notice requirement on transferees of claims based on bond debt.[31]

C. Claims Trading Mechanics

Parties can trade bankruptcy claims in two different ways. First, not surprisingly, a claimholder can sell a claim through direct negotiations between claimholder and buyer. Second, a claimholder can sell a claim through a broker-dealer. This Section discusses both methods of trading bankruptcy claims and identifies the way in which each type of claim is typically traded.

i. Trading Claims Through Direct Negotiation

The first way a claim can be sold is through direct negotiations between buyer and seller. Generally, this is how trade creditors sell their trade debt.[32] When the bankruptcy court discloses the identities of the debtor's trade creditors, specialized investment firms may contact the listed trade creditors with offers to buy their claims.[33] Some buyers may make these offers on a "take it or leave it" basis.[34] Other buyers may be more amenable to negotiating for

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[26] Levitin, *supra* note 1, at 90 ("Bond debt and equity trade in bankruptcy just as it did outside of it . . . . The same securities laws will apply in bankruptcy as outside, which presents another variation in asset class.").

[27] Adam J. Levitin, *Finding Nemo: Rediscovering the Virtues of Negotiability in the Wake of Enron*, 2007 COLUM. BUS. L. REV. 83, 88 (2007) ("[T]he [claims trading] market is virtually unregulated.").

[28] Levitin, *supra* note 1, at 77.

[29] *See* FED. R. BANKR. P. 3001(e)(2) (2012).

[30] *See Id.*

[31] *See Id.*

[32] *See In re* KB Toys, 736 F.3d 247, 249 (3d Cir. 2013) ("A trade claim is usually transferred via contract.").

[33] Levitin, *supra* note 1, at 91.

[34] ARGO PARTNERS, *Bankruptcy*, http://www.argopartners.net/bankruptcy.php ("To accept our offer, simply complete the Assignment Agreement and return it via mail, email or fax. Payment for your claim will be made pursuant to the terms of the offer letter you received.").

different terms and provisions, such as representations, warranties, or indemnities.[35]

ii. Trading Claims Through Broker-Dealers

The second way in which a claimholder can sell a bankruptcy claim is through a broker-dealer in an electronic over-the-counter ("OTC") transaction.[36] Because OTC transactions take place through broker-dealers, buyers and sellers may not know each other's identity.

All three types of claims can be sold through broker dealers. Bond debt trades anonymously through OTC broker-dealer transactions before bankruptcy, and continues to trade in this manner during bankruptcy.[37] Bank debt also trades through OTC transactions,[38] but unlike bond debt, the trading of bank debt tends to be a much more involved process[39] where the buyer and seller may have direct contact.[40] Further, the market for bank debt differs from the bond market in another way: a group of syndicated loan broker-dealers have formed a trade association—the Loan Syndications and Trading Association (the "LSTA")—that has standardized, to some extent, the documents used for bank debt trading.[41] The LSTA standardized documentation contains numerous buyer

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[35] *See* Declaration of David Abrams in Support of the "Brief of *Amici Curiae* Abrams Capital, LLC, Blavin & Company, Inc., and Citadel Investment Group, L.L.C. in Support of Appellee and Affirmance of the Bankruptcy Court's Orders", at 7, *In re* Enron Corp, Adv. No. 05-01025 (AJG) [hereinafter "Abrams Decl."] (explaining that Abrams Capital, an investment fund "ordinarily will not purchase . . . trade debt . . . unless it receives warranties, representations and indemnities" from the seller); *see also In re KB Toys*, 736 F.3d at 250 (noting certain trade claim transfer contracts contained "restitution provisions" that "shift[ed] the risk of disallowance back to the [claim seller]").

[36] Levitin, *supra* note 1, at 90.

[37] *Id.*; *see* Abrams Decl., *supra* note 35, at 8 (stating that purchase of publicly traded bonds is typically anonymous).

[38] *See* Levitin, *supra* note 1, at 90–91.

[39] Huber & Young, *supra* note 8, at 24 ("A typical trade or sale of bank debt is much more involved than a standard bond trade and usually entails the execution of several documents.").

[40] *Id.* at 25 ("The trade itself invariably occurs over the phone with both buyer and seller noting the material terms of the trade on their respective trade tickets."); *see id.* at 26 ("The LSTA recommends that the seller send a confirmation to the buyer within one business day of the trade date unless otherwise agreed . . . . The trade confirmation sent by the seller to the buyer confirms the terms the parties agreed upon orally on the trade date[.]").

[41] *See id.* at 24 ("Distressed [bank debt] trades are consummated by the execution of two documents: (i) the assumption and assignment agreement . . . and (ii) a purchase and sale agreement[,] . . . a model of which the Loan Syndication and Trading Association (LSTA) has developed containing terms specifically applicable to trades of distressed debt."); *see also* Levitin, *supra* note 1, at 90 ("Bank debt trades OTC using standardized documentation from the Loan Syndication and Trading Association"); LSTA, *About LSTA*, http://www.lsta.org/content.aspx?id=198.

protections, such as representations, warranties, and indemnities.[42] Although the LSTA forms are used frequently when sellers trade bank debt, the LSTA guidelines are not universally employed.[43]

Trade debt can also be sold through broker-dealers.[44] As discussed above, however, trade creditors generally sell their trade debt to a buyer via direct negotiations. Thus, while trade debt *can* be traded through broker-dealers, this generally happens only after an initial sale directly between claimholder and buyer. Similar to bank debt, there has been movement towards standardizing the trading documentation used in trade debt sales.[45] In 2002, a number of professional trade claim buyers formed the Trade Claim Buyers Association (the "TCBA") for this very purpose.[46] This group, however, has not yet acquired industry acceptance comparable to the LSTA.

As a final point, it is important to note that there is a temporal element to the trading of bankruptcy claims. To be sure, much claims trading occurs after the debtor's bankruptcy.[47] Nevertheless, distressed debt investors need not wait until the debtor files for bankruptcy to begin investing. Rather, much distressed debt investment takes place before the debtor's bankruptcy.[48] Accordingly, it is not uncommon for professional distressed debt investors to begin to buy putative bankruptcy claims as soon as the debtor begins to show signs of insolvency.[49]

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[42] *See* Abrams Decl., *supra* note 35, at 6–7; *see also* Huber & Young, *supra* note 8, at 28 (describing LSTA confirmation as containing indemnification provisions, hold harmless clauses, and seller standstill provisions to protect buyer).

[43] *See* Levitin, *supra* note 1, at 90 ("Bank debt trades OTC using standardized documentation from the Loan Syndication and Trading Association (LSTA), a trade association of syndicated loan broker-dealers."); *see also* Siegel, *supra* note 1, at 567–68 ("The trading of bank debt increasingly standardized through the use of the LSTA form but has not yet reached the level of uniformity required for regulation."); Abrams Decl., *supra* note 35, at 7 ("Abrams Capital may not always use the precise LSTA Distressed Trade Agreement form in its trades.").

[44] Levitin, *supra* note 1, at 91.

[45] ARGO PARTNERS, *TCBA*, http://www.argopartners.net/tcba.php (asserting TCBA formed in 2002 to bring uniformity to all aspects of claims transfer process).

[46] *Id.* ("The TCBA was formed to promote good standards and practices within the business of purchasing and transferring trade claims of companies in general, and specifically companies in bankruptcy."); HAIN CAPITAL GROUP, *FAQ*, http://www.haincapital.com/html/faq.html ("Hain Capital is a member of Trade Claim Buyers Association").

[47] Drain & Schwartz, *supra* note 3, at 576.

[48] *See id.* ("The market in distressed debt, including bank and trade debt in addition to bonds, actually starts not with the filing of the bankruptcy case but when the debtor is perceived to be insolvent, which may occur months before the filing.").

[49] *Id.*

2. The Affected Provisions: Sections 502(d) and 510(c)

As discussed more fully in Part II, claims trading has dire implications for sections 502(d) and 510(c). Specifically, claims trading, in certain circumstances, may allow a claimholder to wash a claim of defects created by both of these provisions.[50] To understand the negative implications of claims washing, however, it is important to understand the purposes and functions of the affected provisions. Accordingly, this Section provides a brief overview of both sections 502(d) and 510(c).

A. The Function and Purpose of Section 502(d)

Section 502(d) requires a court to disallow a claimholder's claim if that claimholder is in possession of, and has not returned, an avoidable transfer.[51] In relevant part, section 502(d) provides, "the court shall disallow any claim of any entity from which property is recoverable under [the trustee's avoidance powers] unless such entity . . . has paid the amount, or turned over any such property, for which such entity . . . is liable[.]"[52]

Section 502(d) has two purposes. First, it promotes the Bankruptcy Code's policy of providing creditors with fair and equal distributions from the debtor's estate.[53] Section 502(d) accomplishes this goal by requiring a claimholder to pay money owed to the estate before the estate must pay money owed to the claimholder.[54]

Second, section 502(d) makes it easier for trustees to recover avoidable transfers.[55] Section 502(d) eases the trustee's recovery of these transfers by providing trustees with leverage over the claimholder: If a claimholder is in possession of an avoidable transfer and refuses to surrender the avoidable transfer to the trustee, the court will disallow the claimholder's claim.[56] Indeed,

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[50] *See In re* Enron Corp., 340 B.R. 180, 201 (Bankr. S.D.N.Y. 2006) ("Allowing a transferred claim in the hands of the transferees from the transferors who received avoidable transfers and did not pay or turn over the avoidable transfer would seriously undercut the purpose and policy of section 502(d)."); *see also In re* Enron Corp., 379 B.R. 425, 448 (S.D.N.Y. 2007) ("There can be no dispute that in limited circumstances, a bad faith transferor may be able to . . . effectively 'wash' its claim").

[51] 11 U.S.C. § 502(d) (2012).

[52] *See id.*

[53] *See In re Enron Corp.* 379 B.R. at 435.

[54] *See* 11 U.S.C. § 502(d); *see also In re* KB Toys, 736 F.3d 247, 251 (3d Cir. 2013) ("The language of section 502(d) states that 'any claim of any entity' who received an avoidable transfer shall be disallowed.")

[55] *See In re KB Toys*, 736 F.3d at 252 (stating that one "aim[]" of section 502(d) is to "coerc[e] compliance with judicial orders"); *In re Enron Corp.*, 379 B.R. at 443 ("[O]ne of the main purposes of section 502(d) [is] to coerce the return of assets obtained by preferential transfer.").

[56] *In re KB Toys*, 736 F.3d at 251–52.

if a claimholder in this position wants the court to allow its claim, the claimholder must succumb to the court's coercive power and surrender the avoidable transfer.[57] This coercive power allows trustees to recover avoidable transfers at a reduced cost, thus preserving estate assets that would have been otherwise wasted through costly avoidance action litigation or collection efforts.

To illustrate how the provision works, assume that debtor *D* transfers $100 to creditor *A* one day before *D* files for bankruptcy. Then, during *D*'s bankruptcy, *A* files a proof of claim and receives a claim against *D*'s bankruptcy estate. Subsequently, the trustee brings a preference action under section 547(b) and the court determines that *D*'s pre-petition $100 transfer to *A* was preferential. Under these facts, the court would use section 502(d) to disallow *A*'s claim until *A* surrenders the $100 transfer to the trustee.[58]

In this example, section 502(d) ensures the fair and equal distribution of the debtor's assets by preventing *A* from receiving a payment on its claim before *A* has returned the $100 owed to the estate. If *A* never returns the $100, *A* should not receive a distribution on its claim. Second, section 502(d) accomplishes its coercive purpose by requiring the court to disallow *A*'s claim until *A* has returned the $100—if *A* wants the court to allow its claim, *A* must yield to the court's coercive power and surrender the $100 preferential transfer. In this way, the trustee is able to save the estate funds that it would have otherwise spent on a potentially costly collection action.

It is important to note that section 502(d) applies to avoidable transfers received *before or after* the debtor files for bankruptcy.[59] Although trustees frequently use section 502(d) to ease the recovery of avoidable *pre-petition* transfers, the statute is not so limited. Rather, the statute expressly covers post-petition transfers as well.[60] Thus, if a claimholder receives an improper transfer from the debtor *during* the debtor's bankruptcy, the court must disallow the claimholder's claim until the claimholder surrenders the transferred property to the trustee.[61]

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[57] *See id.* at 252 ("Section 502(d) can be used to compel an original claimant to comply with a judgment and return the preferential payment as a condition of collecting on its claim. Failure to satisfy this condition provides a basis for the trustee to ask the bankruptcy court to disallow the claim.").

[58] *See* 4 COLLIER ON BANKRUPTCY, ¶ 502.05 (Alan N. Resnick& Henry J. Sommer eds., 16th ed. 2013).

[59] *See* 11 U.S.C. § 502(d).

[60] Section 502(d) provides, in relevant part, "[T]he court shall disallow any claim of any entity from which property is recoverable under section . . . 549 . . . of this title." *Id.* Section 549 covers post-petition transfers from the debtor's estate. *See* 11 U.S.C. § 549. Accordingly, section 502(d) requires a court to disallow a claimholder's claim if that claimholder has received an avoidable *post-petition* transfer.

[61] *See In re* Enron Corp., 379 B.R. 425, 438 (S.D.N.Y. 2007) ("[D]isallowance [under

B. The Function and Purpose of Section 510(c)

Section 510(c) allows a court to subordinate a claimholder's claim if the claimholder has engaged in inequitable conduct that injured other creditors.[62] Section 510(c) provides, in relevant part, that a court may, "under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim."[63] Section 510(c) does not provide any specific test for equitable subordination, and was enacted to codify pre-Code common law.[64]

The generally accepted test for equitable subordination was first articulated by the Court of Appeals for the Fifth Circuit in *In re Mobile Steel*.[65] In that case, the Fifth Circuit held that a court may equitably subordinate a claimant's claim if the following three conditions are met:

> (i) The claimant . . . engaged in some type of inequitable conduct.
> (ii) The misconduct . . . resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant.
> (iii) Equitable subordination of the claim [would not be] inconsistent with the provisions of the Bankruptcy Act.[66]

Section 510(c) has two important functions: a remedial function, and a deterrence function. The explicit purpose of section 510(c) is to provide relief to creditors injured by a claimant's inequitable conduct.[67] Thus, it is well accepted that the purpose of section 510(c) is remedial, not punitive, and, as a general rule, a court should subordinate a claim only to the extent necessary to

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section 502(d)] can be applied based solely on the post-petition receipt of (and failure to return) an avoidable transfer . . . .").

[62] *See id*. at 432–33. ("Under the doctrine of equitable subordination . . . a bankruptcy court may subordinate a particular claim if it finds that the creditor's claim . . . results from inequitable behavior on the part of that creditor.") (internal quotation marks omitted) (citation omitted).

[63] 11 U.S.C. § 510(c)(1).

[64] *In re* Fabricators, Inc., 926 F.2d 1458, 1464 (5th Cir. 1991) ("The legislative history [of section 510(c)] indicates that equitable subordination is to be invoked according to case law existing at the time of codification, with development of the concept being left to the courts."); *see also* Andrew DeNatale & Prudence B. Abram, *The Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors*, 40 BUS. LAW. 417, 421 (1985) ("The drafters of the Code saw fit to codify the principle of equitable subordination, yet left the delineation and development of the doctrine to the courts.").

[65] Benjamin v. Diamond (*In re* Mobile Steel Co.), 563 F.2d 692 (5th Cir. 1977).

[66] *Id.* at 700 (citations omitted). Although the Supreme Court has not expressly adopted this test, it did implicitly bless the *Mobile Steel* framework in *United States v. Noland*, by citing *In re Mobile Steel* for the three prong equitable subordination test. 517 U.S. 535, 538–39 (1996).

[67] *See* COLLIER ON BANKRUPTCY, *supra* note 58, ¶ 510.05 ("Section 510(c) permits the court to subordinate claims under principles of equitable subordination.").

remedy the claimholder's inequitable conduct.[68]

However, in addition to section 510(c)'s explicit purpose, section 510(c) serves another, implicit purpose: the deterrence of inequitable conduct.[69] The provision deters inequitable conduct by ensuring that the bad actor pays for its misconduct. Indeed, if a claimholder is aware that its inequitable conduct will lead to the subordination of its claim, the claimholder will be deterred from engaging in such conduct in the first place.

An example is helpful to illustrate section 510(c). Assume that before debtor *D*'s bankruptcy, creditor *A* engaged in inequitable conduct that harmed creditor *B*. *A* and *B* are *D*'s only creditors, and the claims of *A* and *B* are *pari passu*. Both *A* and *B* have claims of $1,000, and *D* has total assets of $500. Under these facts, the court will subordinate *A*'s claim to the claim of *B*. This subordination results in *B* receiving an extra $250 on its claim. This extra $250 distribution to *B* is the remedy that section 510(c) provides to cure the injury that *A* caused to *B*. Moreover, the fact the subordination results in a $250 loss to *A* serves a deterrence function. *A* had to pay for its misconduct and is therefore less likely to engage in this misconduct in the future.[70]

It should be noted that a claimholder's conduct need not be illegal in order to qualify as "inequitable." Nevertheless, this does not mean that courts use section 510(c) to subordinate claims rampantly. Rather, a court will typically not subordinate a non-management claimholder's claim based on *legal* conduct unless the failure to subordinate results in circumstances that shock the conscience of the court.[71] Thus, although courts possess awesome power under section 510(c), they use the provision sparingly.[72] As explained by the Court of Appeals for the Fifth Circuit, "equitable subordination is an unusual remedy which should be applied only in limited circumstances."[73]

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[68] *See id.*, ¶ 510.05[2] ("The concept of equitable subordination, as developed by case law, is that a claim may normally be subordinated only if its holder is guilty of some misconduct. It is a remedial, not a penal, measure that is used only sparingly.").

[69] Leonard J. Long, *Automatic Subordination as Incentive for Insider Creditors' Prudential Investing*, 13 J.L. & COM. 97, 141 (1993) ("Ideally the conduct which dislodges the parties from their rightful position should not occur at all, but it does and therefore a second goal of equitable subordination is the prevention of such inequitable conduct by deterrence.").

[70] Similarly, other potential bad actors will have seen that *A* had to pay for its misdeeds. These potential bad actors will also be deterred from engaging in the bad conduct in which they may have engaged otherwise.

[71] *In re* Sunbeam Corp., 284 B.R. 355, 363 (Bankr. S.D.N.Y. 2002) ("[E]ven lawful conduct may be considered inequitable if it 'shocks one's good conscience.'") (citation omitted).

[72] *See* US Abatement Corp. v. Mobil Exploration & Producing US, Inc. (*In re* U.S. Abatement Corp.), 39 F.3d 556, 561 (5th Cir. 1994) ("[It] is a remedial, not a penal, measure that is only used sparingly."); *see also* COLLIER ON BANKRUPTCY, *supra* note 58, ¶ 510.05[2].

[73] Fabricators, Inc. v. Technical Fabricators, Inc. (*In re* Fabricators, Inc.), 926 F.2d 1458, 1464 (5th Cir. 1991).

Finally, it is worth noting that section 510(c), like section 502(d), applies to *post-petition* conduct as well as pre-petition conduct.[74] Thus, a court may use section 510(c) to equitably subordinate a claimholder's claim based on the claimholder's inequitable conduct that occurs *after* the debtor files for bankruptcy.[75]

II. PROBLEMS THAT ARISE WHEN CLAIMS TRADING INTERSECTS WITH SECTIONS 502(d) AND 510(c): CLAIMS WASHING

As mentioned above, claims trading can undermine the purposes of sections 502(d) and 510(c). This Part explores these problems in greater detail. Section 1 identifies "claims washing" and the problems that it can cause. After these problems are identified, Section 2 explains the two approaches that have been configured by the Southern District of New York and the Third Circuit when considering claims washing. Section 3 argues that the Third Circuit's approach should be adopted and extended to stem some of the problems caused by claims washing. Section 4, however, explains that while the Third Circuit's approach is a good first step, it does not solve all of the problems caused by claims washing. Rather, problems still remain if bad actors can shield themselves from liability under sections 502(d) or 510(c) merely by selling their claims. If other steps are not taken to prevent these remaining problems, claims trading may continue to undermine section 502(d) and 510(c).

1. The Costs of Allowing Creditors to Wash Claims

Many courts and commentators that have considered the intersection of claims trading and sections 502(d) and 510(c) have identified "claims washing" as a potential problem.[76] In a general sense, claims washing occurs when a creditor is able to take a claim that is tainted by a defect and remove that defect from the claim.[77] The creditor is said to have "washed" the claim because the

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[74] *See In re* Enron Corp., 379 B.R. 425, 438 (S.D.N.Y. 2007) ("[E]quitable subordination can be based on post-petition inequitable conduct . . . .").

[75] *See e.g.*, *In re* Clamp-All Corp., 233 B.R. 198, 210–11 (Bankr. D. Mass. 1999) (subordinating claimholder's claim when, during debtor's exclusivity period, claimholder improperly promoted its own proposed reorganization plan).

[76] *See generally In re* KB Toys, 736 F.3d 247, 252 (3d Cir. 2013); *In re* Enron Corp., 379 B.R. at 447; *In re* Enron Corp., 340 B.R. 180, 199 (Bankr. S.D.N.Y. 2006), *rev'd*, 379 B.R. at 448–49; *In re* Enron Corp., 333 B.R. 205, 225 (Bankr. S.D.N.Y. 2005), *rev'd*, 379 B.R. at 448–49.

[77] *See, e.g.*, *In re Enron Corp.*, 340 B.R. at 188, *rev'd*, 379 B.R. at 448–49 ("Enron argues that . . . the court should not permit 'claims washing'—a practice by which creditors sell their claims to avoid the threat of claim disallowance.").

creditor is essentially taking a "dirty" claim and making it "clean."[78] Under certain circumstances, a creditor may be able to wash a claim by selling it.[79]

The potential costs associated with claims washing are substantial. Specifically, if a court allows a creditor to wash a claim of its defects, the court will undermine the purposes of sections 502(d) and 510(c).

A. Claims Washing Effects on Section 502(d)

If a court allows a creditor to wash a claim of a section 502(d) defect, the court directly undermines the purposes of section 502(d). As discussed above, section 502(d) has two purposes: (1) to promote the Bankruptcy Code's policy of providing creditors with fair and equal distributions from the debtor's estate, and (2) to coerce the return of avoidable transfers.[80]

If the court allows a claimholder to wash a section 502(d) defect from a claim merely by selling it, the court undermines section 502(d)'s purposes. First, the claim buyer would be able to receive a distribution on the claim regardless of whether the original claimholder ever returned the avoidable transfer. Second, section 502(d)'s coercive power disappears, potentially wasting estate assets.

To illustrate, assume that Creditor *A* received a pre-petition preferential transfer from Debtor *D* and that *A* has a claim against *D*'s estate. If *A* remains in possession of its claim, the court will disallow the claim. The court's disallowance of *A*'s claim prevents *A* from sharing in an estate distribution until *A* has returned the preferential transfer to the trustee. Further, through the disallowance of *A*'s claim, the court is able to coerce *A* into returning the preferential transfer directly.

To put this scenario in the claims trading context, further assume that *A* sold its claim to Buyer *B*. This sale should not change the result. If the court allows the *A*'s sale to *B* to remove the section 502(d) defect from the claim, the court would effectively write section 502(d) out of the Bankruptcy Code any time a claim is transferred. This would undermine the purposes of section 502(d) and injure the debtor's other creditors in several ways. First, the court would allow *B*—the claim buyer—to receive a distribution on the claim even if *A* never returned the avoidable transfer. This would inequitably reduce the distributions to the debtor's other creditors because (1) the estate would not contain *A*'s avoidable transfer, and (2) the other creditors would need to share their estate

[78] *See In re Enron Corp.*, 379 B.R. at 448 (describing how bad faith transferor may be able to sell its claim to bona fide purchaser to "wash" claim to detriment of other creditors).
[79] *See id.*
[80] *See id.* at 435.

distributions with *B*'s claim—a claim that should have been otherwise disallowed.[81] Second, the court would effectively remove the coercive power that Congress designed section 502(d) to provide.[82] This would likely result in trustees wasting estate assets to prosecute avoidance and collection actions.

B. Claims Washing Effects on Section 510(c)

Claims washing similarly undermines the purposes of section 510(c). As explained above, section 510(c) serves two purposes: a remedial purpose and a deterrence purpose. If a court allows a claimholder to wash its claim of a section 510(c) defect by selling it, section 510(c) will fail to serve these two purposes.

To illustrate, recall the example used in Part I.2.B. Before Debtor *D*'s bankruptcy, Creditor *A* engaged in inequitable conduct that harmed Creditor *B*. *A* and *B* are *D*'s only creditors, both *A* and *B* have claims of $1,000 that are *pari passu*, and *D* has total assets of $500. If *A* keeps its claim, the court will subordinate *A*'s claim to the claim of *B*, resulting in an extra $250 distribution to *B*. This extra $250 distribution is the remedy that section 510(c) provides to cure the injury that *A* caused to *B*.

To put the example in the claims trading context, further assume that *A* sells its claim to Purchaser *P*. This sale should not change the result. If it does, both purposes of section 510(c) will be washed away.

First, if the court allows Creditor *A* to wash its claim of a section 510(c) defect, section 510(c) no longer serves its remedial purpose. This is because if the court fails to subordinate *P*'s new claim, both *P* and *B* will remain *pari passu*. And if the court allows *P*'s claim to remain *pari passu* with *B*'s claim, both *P* and *B* will be paid $250 from the estate. This has the effect of removing $250 from *B*'s pocket merely because *A* sold the claim to *P*. Without any other redress, *B* is forced to live with its injury and bear the $250 cost of *A*'s inequitable conduct. This is precisely the result that section 510(c) was enacted to avoid.

Second, if the court refuses to subordinate *P*'s claim, the court undermines section 510(c)'s deterrence function. As explained above, section 510(c) serves as a powerful disincentive to creditors considering whether to engage in inequitable conduct. The provision deters creditor inequitable conduct by

[81] *See In re KB Toys*, 736 F.3d at 252.

[82] *See In re Enron Corp.*, 379 B.R. at 443 ("[O]ne of the main purposes of section 502(d) [is] to coerce the return of assets obtained by preferential transfer.").

holding the bad actor responsible for its bad acts.[83] Again consider the above example. As long as *A* is aware that it will be held accountable for misconduct, *A* will be unlikely to engage in such misconduct. If, on the other hand, the court allows *A* to wash its claim of a section 510(c) defect by merely selling the claim to *P*, claimholders in general will soon realize that they can engage in inequitable conduct to their advantage, escape liability by selling their claims, and pocket the value received from the claim buyer. This realization would likely lead to an increase in inequitable conduct, which would increase the estate's costs of litigating section 510(c) actions. This increased cost would deplete estate assets and lead to lower returns for all creditors.

2. Current Approaches to Addressing the Interaction Between Claims Trading and Sections 502(d) and 510(c): The Divergent Law in the Southern District of New York and the Third Circuit

As explained above, if a court allows a creditor to wash a claim of its susceptibility to sections 502(d) and 510(c), the court will render the provisions ineffectual. Not all courts, however, have recognized this problem.[84] Rather, courts have devised two distinct methods for applying sections 502(d) and 510(c) to traded claims. Specifically, the District Court for the Southern District of New York and the Court of Appeals for the Third Circuit have come to different conclusions as to the proper result in these cases.[85] This Section describes each approach.

A. The Law in the Southern District of New York

In 2007, New York District Court Judge Shira Scheindlin issued a decision in the Enron bankruptcy that established the Southern District of New York's approach to applying sections 502(d) and 510(c) to traded claims. In that case,

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[83] *See* Long, *supra* note 69, at 141 ("[A] second goal of equitable subordination is the prevention of such inequitable conduct by deterrence.").

[84] *Compare In re* Enron Corp., 340 B.R. 180, 201 (Bankr. S.D.N.Y. 2006) ("[A]llowing a transferred claim in the hands of the transferees from the transferors who received avoidable transfers and did not pay or turn over the avoidable transfers would *seriously undercut* the purpose and policy of section 502(d)") (emphasis added), *rev'd*, 379 B.R. 425 (S.D.N.Y. 2007) *with In re Enron Corp.*, 379 B.R. at 448 ("[T]here can be no dispute that in limited circumstances, a bad faith transferor may be able to . . . effectively "wash" its claim . . . . However, the risk of that scenario is outweighed by the countervailing policy at issue, namely the law's consistent protection of bona fide purchasers for value.").

[85] *Compare In re Enron Corp.*, 379 B.R. at 443 (holding section 502(d) defect did not pass with transferred claim) *with In re KB Toys*, 736 F.3d at 254 (holding section 502(d) defect passed with transferred claim).

Fleet National Bank held over $1 billion in bank debt claims against Enron.[86] During Enron's bankruptcy, Fleet sold some of its claims, which were later resold to various claim purchasers.[87] As a result, many different entities eventually acquired the claims Fleet originally possessed.[88] Subsequently, the trustee brought actions against the claims purchasers under sections 502(d) and 510(c), alleging that Fleet (1) was in possession of pre-petition preferential transfers, and (2) had engaged in inequitable conduct.[89] Accordingly, the trustee sought to have the purchasers' claims disallowed pursuant to section 502(d) and subordinated pursuant to section 510(c).[90] Thus, the case presented the following issue: Can a court use section 502(d) to disallow, and section 510(c) to subordinate, a claim in a purchaser's hands based on the seller's bad conduct?[91]

Judge Scheindlin determined that the issue turned on whether sections 502(d) and 510(c) create defects that vest in the *claim* itself, or rather defects that are personal to the *claimant*.[92] According to Judge Scheindlin, if a defect were to vest in the claim, it would pass with the claim in all circumstances.[93] If, however, a defect were personal to the claimant, whether the defect would pass with the claim depends on the type of claim transfer.[94] After considering the statutory language, Judge Scheindlin determined that sections 502(d) and 510(c) create defects personal to a claimant, and not a claim.[95]

With respect to section 502(d), Judge Scheindlin arrived at this conclusion by examining the provision’s language.[96] Section 502(d) provides, in relevant part: "[T]he court shall disallow *any claim of any entity* from which property is recoverable under [the trustee's avoidance powers] unless *such entity* . . . has paid the amount, or turned over any such property for which such entity . . . is liable[.]"[97] Judge Scheindlin concluded that "[t]he language and structure [of section 502(d)] is plain, and requires the entity that is asserting the claim be the

[86] *In re* Enron Corp., 333 B.R. 205, 211–12 (Bankr. S.D.N.Y. 2005), *rev'd*, 379 B.R. 425 (S.D.N.Y. 2007).
[87] *Id.* at 212
[88] *Id.*
[89] *Id.*
[90] *Id.* at 213.
[91] *Id.*; *see In re* Enron Corp., 340 B.R. 180, 190 (Bankr. S.D.N.Y. 2006), *rev'd*, 379 B.R. 425 (S.D.N.Y. 2007).
[92] *In re* Enron Corp., 379 B.R. 425, 439 (S.D.N.Y. 2007).
[93] *Id.*
[94] *Id.*
[95] *Id.*
[96] *Id.* at 443.
[97] 11 U.S.C. § 502(d) (emphasis added).

same entity (*i.e.*, 'such entity') that is liable for the receipt of and failure to return property."[98] Thus, Judge Scheindlin held that section 502(d) creates a defect personal to a *claimant* that does not vest in the claim itself.[99]

Judge Scheindlin arrived at a similar conclusion with respect to section 510(c).[100] Again, Judge Scheindlin began with the statutory text.[101] Section 510(c) provides, in relevant part, that a court may, "under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim[.]"[102] However, because this statutory language is unrevealing as to whether section 510(c) creates a defect in the claimant or the claim, Judge Scheindlin turned to the statute's legislative history.[103] In analyzing the provision's legislative history, Judge Scheindlin found it particularly significant that, in the congressional discussion of section 510(c), congressional representatives consistently mentioned the requirement of misconduct on the part of the "holder" of the claim.[104] This congressional phrasing, Judge Scheindlin determined, "demonstrate[s] that Congress intended equitable subordination under section 510(c) to be specific to the individual who acted inequitably."[105]

Based on her conclusions that sections 502(d) and 510(c) create defects personal to the claimant, Judge Scheindlin determined that these defects pass with a traded claim only in certain circumstances. Specifically, Judge Scheindlin drew a sharp line between claim *assignments* and claim *sales*.[106] Under Judge Scheindlin's rule, if a claimholder transfers a claim by a *pure assignment*, the assignee will "step into the shoes" of the claimholder and will be subject to all defenses that the debtor could have asserted against the claimholder.[107] In contrast, if a claimholder transfers a claim by *sale*, the purchaser will take the claim free of any section 502(d) or section 510(c) defect as long as the purchaser bought the claim "in good faith."[108]

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[98] *In re Enron Corp.*, 379 B.R. at 443.
[99] *Id.* at 448–49.
[100] *Id.*
[101] *Id.* at 439–40.
[102] 11 U.S.C. § 510(c)(1).
[103] *In re Enron Corp.*, 379 B.R. at 440 ("The [statute's language], however, cannot be read in a vacuum . . . . Thus, I turn to the legislative history and case law to determine whether the legislative intent was to create a characteristic of a claim or rather a personal disability of claimants.").
[104] *Id.*
[105] *Id.*
[106] *Id.* at 439.
[107] *Id.*
[108] *Id.* at 445 ("[I]t bears noting that this Court's analysis does not apply to bad faith purchasers."). Thus, it appears that Judge Scheindlin's analysis essentially applies the concept of negotiability to bankruptcy claims. It should be noted that nothing in the Bankruptcy Code requires bankruptcy claims to be treated as negotiable instruments.

B. The Law in the Third Circuit

Like the District Court for the Southern District of New York, the Court of Appeals for the Third Circuit has also weighed in on the interaction between claims trading and section 502(d). In a 2013 decision in the KB Toys bankruptcy case, Third Circuit Judges Michael Chagares, Thomas Vanaskie, and Patty Shwartz considered the application of section 502(d) to a traded claim.[109] Despite considering an issue similar to Judge Scheindlin, however, the three Circuit Judges did not adopt the *Enron* analysis.[110] Rather, in an opinion authored by Judge Shwartz, the Third Circuit analyzed the same statutory provision as Judge Scheindlin, but came to a different conclusion.[111]

The facts of *KB Toys* are similar to the facts *Enron*, but with key differences. In *KB Toys*, the debtor made pre-petition transfers to certain trade creditors.[112] After the debtor filed for bankruptcy protection, the trade creditors filed proofs of claim and received claims against the debtor's estate.[113] Several of these trade creditors then sold their trade debt claims to two ASM Capital entities (collectively, "ASM").[114] After ASM acquired a majority of the claims,[115] the trustee brought section 547 preference actions against the trade creditors, alleging that the creditors were in possession of preferential transfers.[116] The trustee obtained judgments against the trade creditors, but could not collect on these judgments because all of the trade creditors had gone out of business.[117] In addition to the preference actions, the trustee moved to disallow ASM's claims, pursuant to section 502(d), because the trade creditors—as the original owners of the claims—had not surrendered the preferential transfers to the trustee.[118] Accordingly, in determining whether to disallow ASM's claims, the Third Circuit needed to analyze "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."[119]

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[109] *In re* KB Toys, 736 F.3d 247 (3d Cir. 2013).
[110] *Id.* at 252.
[111] *Id.*
[112] *See id.* at 250.
[113] *See id.*
[114] *See id.* at 249–50.
[115] There were nine trade claims at issue in *KB Toys*. *Id.* at 250. ASM purchased eight of the nine claims before the trustee commenced the preference actions and purchased the final trade claim after the trustee had already obtained a judgment against the trade creditor. *Id.*
[116] *See id.* at 250 & n.5.
[117] *See id.* at 250.
[118] *See id.*
[119] *Id.* at 249.

In answering this question, the Third Circuit began by interpreting the statutory language of section 502(d).[120] As noted above, section 502(d) provides: "[T]he court shall disallow any claim of any entity from which property is recoverable under [the trustee's avoidance powers]."[121] Thus, much like Judge Scheindlin in *Enron*, the Third Circuit had to decide whether the language "any claim of any entity" refers to a *claim* or a *claimant*.[122] Unlike Judge Scheindlin, however, the Third Circuit determined that the provision unambiguously referred to *claims*.[123]

As explained by the Third Circuit, "[t]he language of § 502(d) states that 'any claim of any entity' who received an avoidable transfer shall be disallowed."[124] Accordingly, "the statute operates to render *a category* of claims disallowable," and that category includes the claims "that belonged to an entity who had received an avoidable transfer."[125] By the terms of section 502(d), claims falling within that category "cannot be allowed until the entity who received the avoidable transfer, or the transferee, returns [the avoidable transfer] to the estate."[126] "Accordingly, 'any claim' falling into this category of claims is disallowable until the avoidable transfer is returned . . . no matter who holds them."[127]

The Third Circuit bolstered its conclusion by considering the policy ramifications of holding otherwise, which would allow claims washing and "contravene the aims of § 502(d)."[128] As an initial matter, the Third Circuit explained that allowing claims washing would undermine section 502(d)'s purpose of "ensur[ing] equality of distribution of estate assets," which would injure other creditors in two ways.[129] First, because the original trade creditors had gone out of business, the trustee would never be able to recover the preferential transfers from the trade creditors, and, as a result, the estate would have less money to distribute to other, innocent creditors.[130] Second, if the court allowed the trade claims to be washed of their section 502(d) defects, "the estate

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[120] *Id.* at 251 ("The Court's analysis begins with the text of the statute.").

[121] 11 U.S.C. § 502(d).

[122] *See In re KB Toys*, 736 F.3d at 251 ("The issue in this case . . . turns on the interpretation of the phrase 'any claim of any entity.'").

[123] *Id.* at 252 ("[T]he statute focuses on claims—and not claimants . . . .").

[124] *Id.* at 251.

[125] *Id.* at 252 (emphasis added).

[126] *Id.*

[127] *Id.*

[128] *Id.*

[129] *Id.*

[130] *See id.*

would [end up paying] on [claims] that would have been otherwise disallowed," thus further reducing distributions to other creditors.[131]

Additionally, the Third Circuit explained that allowing a claimholder to wash its claim of a section 502(d) defect would undermine section 502(d)'s aim of "coercing compliance with judicial orders."[132] As explained by the court, "[t]o allow the sale [of the claim] to wash the claim entirely of the [section 502(d) defect] would deprive the trustee of one of the tools the Bankruptcy Code gives trustees to collect assets—asking the bankruptcy court to disallow problematic claims."[133]

The Third Circuit further supported its holding with an analysis of legislative history.[134] The Third Circuit noted that the statutory precursor to section 502(d) was section 57(g) of the 1898 Bankruptcy Act.[135] Prior to the Bankruptcy Code, courts used section 57(g) to disallow a claim in a claim buyer's hands if the claim seller was in possession of an avoidable transfer.[136] Thus, concluded the Third Circuit, "the case law interpreting section 57(g) is consistent with our interpretation of § 502(d)."[137] In conclusion, the Third Circuit stated, "because § 502(d) permits the disallowance of a claim that was originally owned by [an entity that] received a voidable preference that remains unreturned, the [section 502(d)] cloud on the claim continues until the preference payment is returned, regardless of whether the [entity] holding the claim received the preference payment."[138]

3. A Policy Analysis of the Two Different Approaches: Courts Should Adopt and Extend the *KB Toys* Holding

As a matter of policy, the *KB Toys* approach is more desirable than the *Enron* approach. As discussed above, if a court allows a creditor to wash a claim, the court directly undermines the purposes of sections 502(d) and 510(c). *KB Toys* prevents claims washing by requiring, in limited circumstances, that the defect pass with the claim.[139] In contrast, *Enron* allows claims washing as

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[131] *See id.*
[132] *Id.*
[133] *Id.*
[134] *See id.* at 253.
[135] *See id.*
[136] *See id.*; *see also* Swarts v. Siegel, 117 F. 13, 15 (8th Cir. 1902) (disallowing buyer's claim when claim seller had not surrendered preferential transfer to trustee).
[137] *In re KB Toys*, 736 F.3d at 253.
[138] *Id.* at 254.
[139] *See id.* at 252.

long as the seller can find a "good faith" purchaser.[140] Indeed, Judge Scheindlin even admitted that her decision will create an opportunity for creditors to wash claims: "[T]here can be no dispute that in limited circumstances, a bad faith transferor may be able to sell its claim to a bona fide purchaser for value, effectively 'wash' its claim in the hands of the purchaser, take the proceeds and run, to the detriment of other creditors."[141] Accordingly, to prevent claims washing, courts should adopt the *KB Toys* approach.[142]

Nevertheless, courts that merely *adopt* the *KB Toys* holding may allow claims washing to continue in other contexts. Technically speaking, *KB Toys* had a very limited holding: it simply addressed the application of *section 502(d)* to transferred *trade claims*.[143] Thus, the opinion does not apply to section 510(c), and does not apply to bank debt or bond debt.[144] Accordingly, if a court reads *KB Toys* narrowly, it may allow claims washing to occur in situations not addressed in *KB Toys* itself. To avoid this potential problem and prevent claims washing in all contexts, courts should extend the *KB Toys* holding to apply to both sections 502(d) and 510(c), and to all types of claims—trade debt, bank debt, and bond debt.

A. Courts Should Apply KB Toys *to Section 510(c)*

Although *KB Toys* did not analyze the applicability of section 510(c) to a traded claim, courts should apply *KB Toys* to section 510(c). From a statutory interpretation standpoint, section 510(c)—like section 502(d)—refers to "claim[s]" and not "claimants."[145] Indeed, section 510(c) allows a court to subordinate "all or part of any allowed *claim*."[146] Thus, while the statutory language of section 510(c) is not identical to the language of section 502(d), it is similar. Accordingly, section 510(c)'s language should be interpreted in a similar manner.

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[140] *See In re* Enron Corp., 379 B.R. 425, 440 (S.D.N.Y. 2007) ("Congress did not intend section 510(c) to be applied to a transferee of a claim—who has not acted inequitably.").

[141] *Id.* at 448.

[142] There is a competing policy interest to be considered. Specifically, some commentators worry that adhering to a *KB Toys*-like rule would significantly decrease the liquidity in the market for bankruptcy claims. This argument is addressed further below.

[143] *In re KB Toys Inc.*, 736 F.3d at 251 ("The issue in this case . . . only concerns trade claims . . . .").

[144] *See id.* In fact, at the bankruptcy court level, Bankruptcy Judge Kevin Carey took pains to make it clear that the holding was so limited. *In re KB Toys*, 470 B.R. 331, 342 n.14 (Bankr. D. Del. 2012) ("The claims before me in this matter are trade claims purchased from the original holders of such claims. I make no determination about whether the same result should ensue in circumstances involving other types of transferred claims."), *aff'd*, 736 F.3d 247 (3d Cir. 2013).

[145] 11 U.S.C § 510(c).

[146] *Id.* (emphasis added).

Moreover, from a policy standpoint, a court's subordination of a claim in a buyer's hands is more desirable than the court's failure to subordinate. As explained above in Part II.1.B, a court's failure to subordinate a buyer's claim allows the seller to wash his claim of its section 510(c) defect. And if a seller can wash his claim of a section 510(c) defect, the seller can directly undermine the purposes of section 510(c). Accordingly, a court should subordinate the buyer's claim to prevent the seller from undermining the purpose of section 510(c).[147]

B. Courts Should Apply KB Toys *to Bank Debt and Bond Debt*

Although *KB Toys* was limited to trade debt, courts should apply *KB Toys* to bankruptcy claims derived from both bank debt and bond debt. This would prevent claimholders from washing bank and bond debt claims of section 502(d) and section 510(c) defects.

There are counterarguments against extending *KB Toys* to cover bond debt.[148] One such argument concerns the pre-bankruptcy "negotiable instrument" status typically given to a debtor's bonds.[149] Before a debtor's bankruptcy, a debtor's publicly traded debt securities are generally considered to be negotiable instruments.[150] Along with this "negotiable" status, comes a good faith purchaser defense.[151] This good faith purchaser defense functions as follows: If a good faith purchaser buys a debtor's bond from a seller, the purchaser will take that bond free of most defenses that the debtor could have asserted against the seller, as long as the purchaser did not know of these defenses at the time of sale.[152]

A uniform *KB Toys*-like rule would require a determination that a bond’s negotiable status does not prevent the assertion of section 502(d) and 510(c) actions against a good faith purchaser of that bond. Stated another way, applying *KB Toys* to bond debt would prevent a bond debt buyer from asserting negotiability as a defense to a trustee's attack under sections 502(d) or 510(c).

[147] *See supra* Part II.1.B.

[148] Only one of these arguments is addressed in this Section. There is, however, another significant counterargument against extending *KB Toys* to cover bond debt trades. This other counterargument concerns the impact such an extension would have on the liquidity of the post-bankruptcy bond market. It is better, however, to address this argument in conjunction with this Article’s proposed mandatory indemnity. Accordingly, this argument is addressed below in Part III.2.A.

[149] *See* N.Y. UCC § 3-104.

[150] *See id.*

[151] *See* N.Y. UCC §§ 3-104, 3-302, 3-305 (establishing good faith purchaser protection); *see also* Levitin, *supra* note 27, at 90–91.

[152] *See* N.Y. U.C.C. §§ 3-104, 3-302, 3-305.

Nevertheless, for several reasons it is intuitive to treat the transferability of debt inside of bankruptcy differently than it is treated outside of bankruptcy.

Bankruptcy claims are already treated differently from pre-petition debt in many respects. For example, the Code treats such claims differently than pre-petition debt to help accomplish one of the Code's overriding purposes—the fair and equal distribution of the debtor's property to creditors. The Code accomplishes this goal, in part, through its statutory priority provisions.[153] These priority provisions change the rights of one creditor with respect to other creditors. Obviously, these changes could not take place absent the bankruptcy forum. Along these same lines, courts use section 510(c) to restructure claimants' priorities—i.e., modify their rights—in order to avoid imposing unfair costs on innocent, injured creditors. These priority shifts cannot occur outside of the bankruptcy process. A final example is section 502(d). As explained above, section 502(d) requires courts to hold hostage a creditor's claim—whether the claim is derived from a publicly traded bond, bank debt, or trade debt—until the creditor returns an avoidable transfer.[154] Outside of bankruptcy, no court possesses this type of power.

Therefore, treating bond debt differently inside of bankruptcy than outside of bankruptcy would be nothing new. Moreover, for the reasons described above, bond debt *should* be treated differently in bankruptcy than outside of bankruptcy. To do otherwise would allow bond sellers to eviscerate the benefits of both sections 502(d) and 510(c) by simply selling their bond debt-based claims. As a result, innocent creditors and the court would lose the benefits provided by sections 502(d) and 510(c).

As discussed in this Section, courts should extend *KB Toys* to apply to both sections 502(d) and 510(c), and to all types of claims. A universal *KB Toys* rule, however, does not prevent all of the problems associated with claims washing from occurring. Rather, even if courts extend *KB Toys*, claims washing can still cause problems for sections 502(d) and 510(c). The next Section discusses these problems.

4. The Problems that Remain Even If Courts Extend *KB Toys*

Although the simplest way to solve the claims washing problem is to adopt and extend *KB Toys* so that a claim's defects always pass with the claim, this solution does not prevent all of the negative consequences caused by claims washing. Indeed, even if the court subordinates or disallows the claim in the purchaser's hands, the *seller* might be able to avoid liability. The seller can

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[153] *See* 11 U.S.C. § 507(a).
[154] *See* 11 U.S.C. § 502(d).

easily do this by refusing to provide a buyer with protection against section 502(d) or section 510(c) liability. A seller's ability to shield itself from section 502(d) and 510(c) liability is problematic because it frustrates the purposes of those provisions.

The seller's ability to shield itself from section 502(d) or 510(c) liability generally varies with the *type* of debt sold. As explained above, the trading mechanics for both trade debt and bank debt generally allow buyers to acquire some sort of protection.[155] As a result, it may be difficult for a claimholder to sell its trade debt or bank debt and simultaneously shield itself from section 502(d) or 510(c) liability.[156] It should be noted, however, that these buyer protections are not *required*. Thus, in some circumstances, sellers may be able to sell trade debt or bank debt without providing protection to the buyer.

In the bond market, however, the seller can easily sell a bond without providing the buyer with protection. As explained above, bond sale transactions are typically anonymous, and sellers do not generally provide loss protection to buyers.[157] Thus, if a seller sells a bond in an OTC transaction, it can easily shield itself from any liability that passes with that bond by refusing to provide the buyer with any protection. As explained below, this result is troubling because, if allowed, it continues to undermine the purposes of sections 502(d) and 510(c).

A. Allowing a Seller to Shield Itself Against Section 502(d) Liability Undermines Section 502(d)'s Coercive Function

If a seller can protect itself against section 502(d) liability by selling a claim, the seller can undermine the coercive function of that provision. As explained above, section 502(d) has two purposes: (1) to ensure the fair and equal distribution of the debtor's assets, and (2) to make it easier for trustees to recover avoidable transfers.[158] Section 502(d) accomplishes its coercive goal by requiring the court to disallow a creditor's claim until the creditor returns any avoidable transfer in its possession.[159] In other words, section 502(d) provides the trustee with leverage to coerce the creditor's return of an avoidable transfer.

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[155] *See supra* Part I.1.C.

[156] *See* Abrams Decl., *supra* note 35, at 7 (stating investment fund Abrams Capital "ordinarily will not purchase bank debt [or] trade debt . . . unless it receives warranties, representations and indemnities of the kind contained in the LSTA [form contracts]").

[157] *See supra* Part I.1.C.

[158] *See supra* Part I.2.A.

[159] *See* 11 U.S.C. § 502(d).

When the creditor keeps its claim, the provision works perfectly. Indeed, it is the creditor that suffers the loss if it does not return the avoidable transfer. Thus, the court is able to use section 502(d) so that it has its coercive effect.

If the creditor sells its claim, however, section 502(d) will not, by itself, have its intended coercive effect. Rather, if the creditor sells its claim to a buyer, and a court uses section 502(d) to disallow the buyer's claim, the court is placing the loss upon the buyer. Placing the loss on the buyer will not, by itself, have a coercive effect on the seller. Indeed, the court's initial disallowance of the buyer's claim will have its coercive effect only if the buyer is able to sue the seller for the loss caused by the disallowance.

To illustrate, assume that Debtor *D* transfers $500 to Creditor *S* the day before *D* files for bankruptcy. After *D* files for bankruptcy, *S* files a proof of claim for $1,000. *S* then sells the claim to purchaser *P* for 35% of its face value. Subsequently, the trustee brings an action to disallow *P*'s claim under section 502(d) and the court, applying *KB Toys*, disallows the claim. If *S* is able to sell its claim to *P* without providing *P* with any loss protection, *P* will not have a legal action against *S*. Additionally, if *P* has no legal action to recover from *S*, *P* has no power to coerce *S* to return the $500 preferential transfer. Thus, in this situation, section 502(d) fails to serve its purpose—neither the court nor *P* has any leverage to coerce *S* into returning the $500 avoidable transfer.[160] Moreover, the disallowance of *P*'s claim ultimately punishes *P* for *S*'s bad conduct.

B. Allowing a Seller to Shield Itself Against Section 510(c) Liability Undermines Section 510(c)'s Deterrence Function

Similarly, if a seller can shield itself against section 510(c) liability on a transferred claim, the seller can undermine one of the purposes of section 510(c). As explained above, section 510(c) has two purposes: the first is a remedial function, the second is a deterrence function.[161] Section 510(c) serves its deterrence function by forcing bad actors to pay for their bad conduct. As long as bad actors know that they will be held liable for their bad conduct, section 510(c) serves its deterrence function. If, however, bad actors know that they can avoid section 510(c) liability merely by selling their claims,

[160] It has been noted that market pressures may incentivize the claim seller to return the preferential transfer even without a purchaser lawsuit. This is because "failure to ultimately do so will limit that transferor's access to the claim-transfer market as a seller." *In re* Enron Corp., 340 B.R. 180, 203 (Bankr. S.D.N.Y. 2006), *rev'd*, 379 B.R. 425 (S.D.N.Y. 2007). However, the likelihood of this outcome depends on whether the seller anticipates being a repeat seller in the claims trading market. Thus, reliance on market pressures to carry the day is unwise.

[161] *See supra* Part I.2.B.

section 510(c) will no longer serves its deterrence function. In this context, the seller can engage in inequitable conduct, benefit from that conduct, and then sell its claim, avoiding liability and pocketing the claim sale price. This results in a net benefit for claim sellers that engage in inequitable conduct.

To illustrate, assume that before Debtor *D* files for bankruptcy, Creditor *A* engages in inequitable conduct. *A*'s inequitable conduct injures other creditors, but also results in *A* acquiring a $100 claim to *D*'s bankruptcy estate. Subsequently, after *D* files, *A* sells that claim to purchaser *P* for 35% of its face value. Finally, the trustee brings an action under section 510(c) to subordinate *P*'s claim and the court, applying *KB Toys*, subordinates the claim. If *A* is able to sell its claim to *P* without providing *P* with any loss protection, *P* will not have a legal action against *S*. Additionally, if *P* cannot sue *A* for the loss caused by the subordination, *A* will have earned a $35 profit by engaging in inequitable conduct. This result directly undermines section 510(c)'s deterrence function by allowing *A* to engage in inequitable conduct and escape accountability for that conduct. Moreover, it leaves *P* holding the tab for *A*'s wrongdoing.

C. Allowing a Seller to Shield Itself Against Section 502(d) or 510(c) Liability May Incentivize Collusion in Claims Trading

The inability for a claim buyer to recover against a claim seller may also incentivize collusion in claims trading. For instance, if a seller is aware that it can protect itself against section 502(d) or 510(c) liability, it may be incentivized to structure a claims sale so that the initial buyer always waives buyer protections. The seller may be able to do so simply by creating a puppet corporation and having the corporation waive all recourse when it buys the claim. The puppet corporation could then turn around and resell the claim to an unsuspecting buyer. In this structure, the initial seller would pocket the claim purchase price while also ensuring that future buyers would have no recourse against it. Stated another way, the seller could unilaterally insulate itself from liability and leave the—likely insolvent—puppet corporation to indemnify any injured purchaser. If this practice were to become widespread, it would significantly undermine buyer confidence in the market, leading to a decrease in market liquidity.

III. THIS ARTICLE'S PROPOSED COMPREHENSIVE SOLUTION: THE MANDATORY INDEMNITY

As explained above, if a court allows a creditor to wash a claim, the court allows the creditor to undermine the purposes of both sections 502(d) and 510(c). The adoption and extension of *KB Toys* is a necessary first step to addressing claims washing problems. But the sole extension of *KB Toys* is insufficient to address all of the problems caused by claims washing. Indeed, merely allowing the defect to follow the claim leaves the door open for claim sellers to undermine sections 502(d) and 510(c) in other ways: If the claim-seller can escape ultimate liability, the seller continues to undermine the purposes of these provisions. Accordingly, a comprehensive solution is needed.

This Part discusses the comprehensive solution proposed by this Article: a mandatory indemnity. Section 1 describes the indemnity and its function. Section 2 describes the indemnity's effect on the liquidity of the claims trading market. Section 3 explains that all parties affected by claims trading will be better off with a mandatory indemnity.

1. The Mandatory Indemnity

In light of the problems posed by claims washing, a comprehensive solution must be found. As explained above, a *KB Toys*-like rule is a necessary, but incomplete, first step to solving these problems. In order to ensure that claims washing does not undermine the purposes of sections 502(d) and 510(c), the bad-acting seller must always be held accountable for its bad conduct. A mandatory indemnity accomplishes this goal.

This Section explains the structure and function of the mandatory indemnity. Section A suggests what the indemnity should look like. Section B explains how the indemnity would prevent claims washing from undermining the purposes of sections 502(d) and 510(c). Section C explains how the mandatory indemnity could be implemented into the Bankruptcy Code.

A. Crafting the Perfect Indemnity: An Industry Solution

A mandatory indemnity in claims trading would solve the problems identified in Part II. Nevertheless, before exploring how the indemnity would solve these problems, it is important to first understand how the indemnity would work. Accordingly, this Section provides a sketch of what the indemnity should look like and how it should function.

This Article does not purport to suggest the "perfect indemnity." Rather, it acknowledges that market participants may identify problems not discussed in this Article, and that market participants may want to protect themselves via a broad indemnity provision. Thus, ideally, the industry would craft this indemnity provision and then embed it into an industry standard form contract. Nevertheless, the indemnity should have certain features, and so this Article suggests a baseline indemnity on which industry participants should build, if they choose to do so.

At a minimum, the indemnity should have certain characteristics. As outlined above, the indemnity should at least cover liability arising out of sections 502(d) and 510(c). This Article has identified those two provisions as particularly problematic in the claims trading context because unscrupulous claimholders may actively seek to wash claims that are susceptible to sections 502(d) or 510(c).[162]

Additionally, the indemnity should cover *all future buyers*. Only in this way can a seller be made to pay for its misconduct no matter how many times the claim is traded.[163] Finally, each seller should be made to indemnify all future buyers *every time a claim is sold*. As discussed above, section 502(d) and 510(c) liability is not fixed as of the petition date.[164] Rather, both provisions cover mid-bankruptcy conduct. Thus, requiring sellers to indemnify buyers every time the claim is sold ensures that mid-bankruptcy misconduct is covered by the indemnity.

The industry may find it useful to develop different indemnity provisions based on the type of claim being sold; a proper indemnity provision for one type of claim may not be appropriate for another.[165] For example, trade debt often bears higher risk of loss than bond debt: A trade creditor may have breached its contract with the debtor, which would reduce the return on the trade creditor's claim. In contrast, bondholders generally have very little pre-petition contact with the debtor.[166] Therefore, bonds generally pose much less risk for investors. Accordingly, the TCBA may want to craft a specific indemnity to be included in trade claim agreements. This indemnity, however, may not be appropriate for bond debt trades.[167]

Moreover, the industry may want to develop different indemnity provisions based on *the identity* of the claim seller. This may be a useful distinction

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[162] *See supra* notes 9–10 and accompanying text.

[163] It should be noted that this is essentially the manner in which the LSTA form agreement's buyer protections operate. *See* Huber & Young, *supra* note 8, at 30.

> It is important to note that the [LSTA form agreement's] representations, warranties, covenants, and indemnities, in general, inure to the benefit of and are enforceable by and against the parties' respective successors and assigns, which means the seller can be sued under the purchase and sale agreement by downstream buyers of whom it is not yet aware and with whom the seller will not have had any prior dealings.

Id.

[164] *See supra* Part I.2.

[165] *See* Levitin, *supra* note 1, at 92.

[166] *See id.* at 86.

[167] *See id.* at 92 ("The differences in the asset classes also suggest that there should be different rules about transient liability with claims.").

because the counterparty risk of an *initial* seller is generally greater than the counterparty risk of a *secondary* seller. For example, due to a trade creditor's likely significant pre-petition dealings with the debtor, there may be a substantial risk that a trade creditor is in possession of an avoidable transfer. In contrast, many professional distressed debt investors—who regularly acquire and resell claims during bankruptcy cases—may have little or no pre-petition contact with the debtor. Thus, in many cases, there is little risk that the distressed debt investors will have engaged in conduct that would result in disallowance under section 502(d) or subordination under section 510(c).[168] Accordingly, an indemnity that would be more appropriate for an initial seller may not be appropriate for a secondary seller.

This Article's suggestion is not as outlandish as it may initially seem. Rather, as discussed above, the LSTA has already accomplished much of this Article's suggestion in the context of bank debt. As described in Part I, the LSTA is a group of syndicated loan broker-dealers that have organized and drafted standardized agreements for the trading of bank debt.[169] These agreements contain significant buyer protection.[170] Accordingly, the LSTA's process—as well as the LSTA form agreements—provide industry participants with an excellent example of how to begin standardizing agreements for other types of bankruptcy claims. Furthermore, the LSTA demonstrates that this process can work.

In fact, the LSTA is not the only trade association currently seeking to standardize claims trading documentation. As noted in Part I, a number of professional trade claim buyers have formed the TCBA with an aim toward standardizing the practices and documentation used by trade claim market participants.[171] Unfortunately, the TCBA has not acquired the same traction as the LSTA. Nevertheless, the existence of these two trade associations demonstrates the ability—and willingness—of market participants to come together to standardize claims trading contracts.

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[168] That is not to say, however, that secondary sellers can never be liable under sections 502(d) or 510(c) for mid-bankruptcy conduct. *See, e.g.*, *In re* Clamp-All Corp., 233 B.R. 198, 210–11 (Bankr. D. Mass. 1999) (subordinating claimholder's claim when, during debtor's exclusivity period, claimholder improperly promoted its own proposed reorganization plan).

[169] *See supra* Part I.1.C.ii.

[170] *See supra* note 42 and accompany text.

[171] *See supra* notes 45–46 and accompanying text.

B. A Mandatory Indemnity Would Prevent Claims Washing from Undermining the Purposes of Sections 502(d) and 510(c)

The mandatory indemnity described in Section A would solve the problems posed by claims washing. With respect to section 502(d), the mandatory indemnity would prevent a claim seller from undermining the provision's coercive purpose. Although a court would be unable to use section 502(d) to coerce the return of an avoidable transfer from a seller *directly*, the mandatory indemnity would allow the court to do so *indirectly*. To illustrate, assume that Creditor *S* is in possession of an avoidable transfer and sells his claim to Buyer *B*. The court's disallowance of *B*'s claim will not *directly* coerce *S* into returning the avoidable transfer. Nevertheless, if *B* holds an indemnity, *B* always has the ability to sue *S*. And this ability to sue under the indemnity provides *B*—*the buyer*—with the power to coerce the creditor's return of the avoidable transfer. Thus, although the court's *direct* ability to coerce the creditor disappears when the creditor sells its claim, the mandatory indemnity provides the court with the ability to coerce the creditor *indirectly*, through the buyer. In other words, the court can use section 502(d) to create a domino effect: the court disallows buyer's claim, the buyer sues the creditor.[172] In this way, the mandatory indemnity would allow section 502(d) to continue serving its coercive purpose.

With respect to section 510(c), the mandatory indemnity would ensure that the provision would continue to serve its deterrence function. A mandatory indemnity ensures that a buyer will always have a cause of action against a bad-acting seller. Thus, if a court subordinates a buyer's claim based on the seller's bad conduct, the buyer will always be able to sue the seller. And if an injured buyer can always sue the bad-acting seller, the seller has nothing to gain by selling the claim. As noted by Professor Adam Levitin, "claims washing is not a concern if an inequitable creditor can be made to pay for its misdeeds."[173] Therefore, the mandatory indemnity would preserve section 510(c)'s deterrence function by always requiring the seller to bear the cost of its bad conduct.

As a final point, the mandatory indemnity would neutralize the risk of claims trading collusion. Under the framework suggested by this Article, a seller would be required to indemnify *every future purchaser* whenever the claim is sold. Thus, even if a creditor attempts to protect itself from section 502(d) and 510(c) liability by selling its claim to a shell corporation, the

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[172] *See In re* Enron Corp., 340 B.R. 180, 202–03 (Bankr. S.D.N.Y. 2006) ("[U]nder an indemnity arrangement, the transferees do possess the power to coerce repayment . . . . Pressure on the transferors remains because claim transferees can ensure that the coercive effect under section 502(d) is preserved against the original transferors."), *rev'd*, 379 B.R. 425 (S.D.N.Y. 2007).

[173] Adam J. Levitin, *The Limits of Enron: Counterparty Risk in Bankruptcy Claims Trading*, 15 J. BANKR. L. & PRAC. 4, Art. 3 (August 2006).

creditor will fail. Accordingly, if a court subordinates a claim in the hands of a future buyer, that injured buyer will always have a cause of action against the bad actor. With a mandatory indemnity in place, a bad-acting creditor simply cannot avoid the inevitable conclusion that it will eventually have to pay for its misconduct.

C. Putting the Industry Solution into the Code: Congress's Approval

After the industry reaches consensus on the appropriate indemnity language, Congress could codify the industry decision by amending Bankruptcy Rule 3001(e). Specifically, Congress could amend Rule 3001(e) to require that claim sellers provide indemnification language in claim sale agreements. Additionally, Congress could include a statutory safe harbor for indemnification language in the amended Rule 3001(e). This language should be based on the industry's consensus, but should, at a minimum, cover loss on a claim under section 502(d) or section 510(c) caused by the seller's misconduct.

Congress could ensure compliance with the mandatory indemnity by implementing a notice requirement (the "Proposed Notice Requirement"), similar to Rule 3001(e)'s current requirements. Under the Proposed Notice Requirement, all claim purchasers would be required to file a notice with the court every time a claim is transferred.[174]

The Proposed Notice Requirement, however, would differ from current Rule 3001(e) in several important ways. First, current Rule 3001(e) only requires transferees to file a notice if they have received claims that are derived from non-publicly traded debt (e.g., bank debt, trade debt).[175] The Proposed Notice Requirement, however, would encompass transfers of *all types of claims*. Additionally, current Rule 3001(e) requires a transferee to merely file *evidence of the transfer* with the court.[176] The Proposed Notice Requirement would go further, and require a transferee to file the *terms of the transfer* with the court. If the court later disallowed or subordinated a purchaser's claim based on a seller's misconduct, the court could examine the terms of the claim sale. If the

[174] Alternatively, Congress could place the burden of filing the notice on the seller. This Article suggests that the purchaser bear the burden of filing the notice merely to bring the Proposed Notice Requirement closer to the format of Rule 3001(e)'s current notice requirement.

[175] FED. R. BANKR. P. 3001(e). Presumably, Rule 3001(e) exempts transferees of publicly traded debt securities from the filing requirement in order to avoid interfering with the markets for these publicly traded debt securities. Chaim J. Fortgang & Thomas Moers Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1, 21 (1990) ("Rule 3001(e) exempts from regulation claims based on 'a bond or debenture,' presumably to permit public markets in debt securities to function during a bankruptcy case without interference by the bankruptcy court.").

[176] FED. R. BANKR. P. 3001(e).

claim sale agreement did not contain the appropriate indemnification language, the court could simply void the transfer of the claim.[177]

Importantly, Congress's codification of this type of mandatory indemnity would be consistent with the purposes of other statutory mandatory indemnities currently in force. For example, in the corporate law context, every State has enacted a statute that requires a corporation to indemnify an innocent director in certain situations.[178] One of these situations occurs when shareholders bring a corporate action through a shareholder's derivative suit (an "SDS") against a director, and the director has proved his or her innocence.[179] In that context, the corporation must indemnify the director for his or her reasonable expenses incurred during his or her defense.[180]

These State SDS indemnification statutes serve to protect innocent directors from bearing the costs associated with defending themselves against an SDS.[181] To understand how they accomplish this goal, it is helpful to think about what would happen if they did not exist. Without these statutes, shareholders could bring an SDS against a director and impose significant litigation costs on the director, regardless of the director's innocence. Even if the director were innocent, the director would be forced to pay his own litigation costs every time. The statutory mandatory indemnity acts against this unjust outcome by forcing the corporation (i.e., the shareholders) to reimburse innocent directors for reasonable defense expenses.[182] Accordingly, the statutes function to place an

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[177] Ultimately, for the buyer to recover in this context, the buyer would likely have to sue the seller to void the claim transfer as in violation of federal bankruptcy law. Of course, problems could arise as to determining the specific damages to be awarded. If the buyer and seller were in contractual privity, the court would likely unwind the transaction. However, if the buyer and seller were not in contractual privity, the court would likely have a harder time determining the appropriate measure of damages. Ascertaining the precise relief in this context is beyond the scope of this Article.

[178] *See* 13 Fletcher Cyc. Corp. § 6045.10.

[179] *See id.*

[180] *See id.*

[181] *See* Homestore, Inc. v. Tafeen, 888 A.2d 204, 211 (Del. 2005) (discussing how, under Delaware law, indemnification protects director's financial resources from expenses incurred during litigation when successfully defending themselves in legal proceedings).

[182] *See, e.g.*, DEL. CODE ANN. tit. 8, § 145(c) (2011).

> To the extent that a present or former director or officer of a corporation has been successful on the merits or otherwise in defense of any action, suit or proceeding referred to in subsections (a) and (b) of this section, or in defense of any claim, issue or matter therein, such person shall be indemnified against expenses (including attorneys' fees) actually and reasonably incurred by such person in connection therewith.

Id.

innocent director's defense costs on the parties that caused the director to incur the costs—the shareholders.

The mandatory indemnity suggested by this Article functions in a similar manner. This Article's mandatory indemnity protects an innocent claim buyer by forcing a claim seller to indemnify the buyer against a loss on the claim caused by the seller's misconduct. As explained above, without the mandatory indemnity, a claim seller's misconduct could cause significant injury to a claim buyer—the buyer would be stuck holding the tab for the seller's misconduct.[183] The mandatory indemnity prevents this unjust result by shifting the loss from the claim buyer to the bad-acting claim seller. Hence, the general function of this Article's mandatory indemnity is in accord with the general function of universally accepted SDS mandatory indemnification statutes.

2. The Effect of the Mandatory Indemnity on the Claims Trading Market: More Liquidity

The primary argument against the mandatory indemnity is that it will decrease the market's liquidity.[184] As explained in this Section, this argument does not hold water. In contrast, a mandatory indemnity should *increase* the claims trading market's liquidity.

A. A Mandatory Indemnity Should Not Decrease the Market's Liquidity

Those who oppose a mandatory indemnity will likely argue that the indemnity is unworkable because it will severely reduce liquidity in the claims trading market. This is because a large segment of the claims trading market—the trading of bond debt—is conducted anonymously through broker-dealers.[185] Accordingly, because the parties do not typically know each other, negotiating an indemnity would be difficult, if not impossible.[186] The resulting effect on the market, the argument goes, is to decrease liquidity.

The fear that a mandatory indemnity would destroy the bond debt market's liquidity is overstated. The trading of bank debt makes the point well. As discussed above, bank debt typically trades OTC, through broker-dealer transactions, using the LSTA form agreements.[187] Importantly, these LSTA

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[183] *See supra* Part II.4.A.

[184] *See* Levitin, *supra* note 173, at 416; *see also In re* Enron Corp., 379 B.R. 425, 448 (S.D.N.Y. 2007) (stating *KB Toys*-like rule "threaten[s] to wreak havoc on the markets for distressed debt").

[185] *See supra* Part I.1.C.ii.

[186] Levitin, *supra* note 1, at 86 ("There is minimal diligence involved in a bond debt trade, and the identity of counterparties is typically not known, making more serious diligence impossible.").

[187] *See supra* Part I.1.C.ii.

form agreements contain multiple layers of buyer protection, and include indemnities.[188] Even with the indemnities imposed by the LSTA form agreements, the market for bank debt remains robust and liquid.[189] Accordingly, the post-bankruptcy market for bank debt demonstrates that a claims trading market can continue to operate even if significant buyer protection is customary.

Of course, the bank debt market differs from the bond debt market in one key respect—whereas buyers and sellers of bank debt may have contact with one another,[190] buyers and sellers of bond debt generally do not.[191] Due to this anonymity, it would be much more difficult for bond debt buyers to negotiate indemnities with sellers. Indeed, in many circumstances, bond debt buyers may have to evaluate the indemnity price without access to relevant information about the seller. In this situation, buyers would have to rely heavily on sellers' characterization of an indemnity's worth. This leads to the risk that sellers will overcharge for the mandatory protection. This risk, however, does not pose a serious challenge to the validity of the mandatory indemnity.

The risk that sellers will overcharge, while ever-present, is minimal in the mandatory indemnity context. The risk is low because sellers cannot legitimately overcharge for an indemnity and remain competitive in the claims trading marketplace. Indeed, a seller's indemnity price is a very real signal to the market. If a seller vigorously overcharges for an indemnity, the buyer can infer that the seller is charging that price for a reason: to compensate for the added risk of a claim's defect becoming troublesome. Accordingly, while sellers may slightly overcharge, egregious overpricing will result in the seller's inability to sell its claim.[192]

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[188] *See supra* note 42 and accompanying text.

[189] *See* Huber & Young, *supra* note 8 ("Distressed bank debt constitutes a significant market in dollar terms and has been growing exponentially in recent years."). Some may argue that the market for distressed bank debt is so robust *because* of, in part, the LSTA form agreements. *See* Abrams Decl., *supra* note 35, at 9 ("Trading in bank debt continues to be more robust than ever, and the development of the standard form LSTA Distressed Trade Agreement—including the standardization of seller representations and warranties—has made trading in bank debt easier than ever.").

[190] *See* Huber & Young, *supra* note 8 ("The [bank debt] trade itself invariably occurs over the phone with both buyer and seller noting the material terms of the trade on their respective trade tickets.").

[191] *See* Levitin, *supra* note 1, at 91 ("There is no direct contract between the buyer and the seller . . . ."); *see also* Abrams Decl., *supra* note 35, at 8 (stating "purchase of publicly traded bonds is typically anonymous").

[192] Price-fixing poses a potential problem. Specifically, if claimholders developed a practice of fixing their prices at a certain level, they could drive the claim price upward, and away from its fair market value. This argument against a mandatory indemnity, however, proves too much; it exists whether or not the indemnity is mandated. Accordingly, it is not so much an argument against a mandatory indemnity, as it is an argument against the process in which claims are traded in general.

Additionally, as noted by Professor Levitin, bond debt generally does not carry much section 502(d) or 510(c) risk.[193] This is because most bondholders have minimal pre-petition contact with the debtor, and as a result there is little risk that the original bondholder received an avoidable transfer or engaged in inequitable conduct that would merit equitable subordination.[194] Thus, as a general rule, buyers should realize that the amount paid for an indemnity should not be much higher than the claim's intrinsic value. Similar to the discussion above, any great price variance indicates serious risk of subordination or disallowance.

The seller's ability to lie is another fact that undercuts the argument that the lack of buyer access to seller information makes the mandatory indemnity unworkable. The notion that a buyer benefits from direct informational exchange with the seller is premised on one assumption: the seller is acting honestly. But even if the buyer has access to information directly from the seller, there is no guarantee that the seller will provide the buyer with all of the information needed to price the indemnity properly. Indeed, only ethics, good business practices, and the fear of a lawsuit may keep a counterparty honest. Thus, a truly unscrupulous claimholder may simply provide a buyer with false information to mislead them as to the true risk of section 502(d) or 510(c) liability.[195] In this event, the buyer's access to the seller would do nothing to help the buyer price the indemnity.[196] Accordingly, the argument that the mandatory indemnity is unworkable because buyers will not have access to information is a weak one: a related problem exists even if the parties are face to face.

Finally, if buyers are willing to shoulder the transactional costs, there is no reason why the post-bankruptcy market for bond debt could not use broker-dealers to facilitate the exchange of relevant information.[197] Of course, in current bond market transactions, it is uncommon for such information to be exchanged. Nevertheless, past practice does not dictate future practice; broker-dealers could modify their structure to accommodate necessary changes.

SecondMarket Inc.'s former claims trading platform[198] provides an example of how a financial intermediary could facilitate this informational exchange.[199]

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[193] *See* Levitin, *supra* note 1, at 86.

[194] *Id.*

[195] One would hope that these counterparties are few and far between.

[196] In fact, it would likely hurt the buyer by giving him a false sense of security in the price he paid for the indemnity.

[197] To the extent that buyers can properly price the indemnity without significant informational exchange, transaction costs should not pose a significant obstacle to the mandatory indemnity's workability.

[198] SecondMarket, Inc. closed its claims trading platform in the Spring of 2013. *See* Rachel Feintzeig, *SecondMarket Shuts Down Its Bankruptcy Claims Platform*, DOW JONES, Mar. 18, 2013,

When acting as a broker for a claimholder, SecondMarket would reach out to potential buyers. Interested buyers would then sign confidentiality agreements and return them to SecondMarket.[200] After receiving the signed agreements, SecondMarket would forward diligence to the potential buyers.[201] The potential buyers could then use this diligence to help determine the proper price for the indemnity. There is no reason to think that this format would not work in the context of bond debt trading. Thus, although broker-dealers do not foster this informational exchange currently, they should be able to adjust their services to meet necessary changes.[202]

Finally, a mandatory indemnity in the post-bankruptcy bond market should not have a significant impact on the *pre-bankruptcy* market for bonds. At first blush, it may appear that the mandatory indemnity would make bonds less attractive to investors because, in the event that the debtor filed for bankruptcy, bondholders would be forced to either (1) hold onto the bonds through the bankruptcy process, or (2) sell the bonds while indemnifying the buyer against loss in certain circumstances. This indemnity requirement would mean more risk for investors that held bonds at the time of bankruptcy. Additionally, added risk may decrease investors' interest in buying bonds, thus resulting in a less liquid market.

Nevertheless, a deeper analysis demonstrates that the mandatory indemnity should not significantly impact the liquidity of the pre-bankruptcy bond market. To understand why, it is important to remember the scope of the indemnity proposed by this Article. The mandatory indemnity proposed by this Article would only require sellers to indemnify buyers against loss caused by the

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http://bankruptcynews.dowjones.com/Article?an=DJFDBR0020130318e93iln7q3&cid=32135012&ctype=ts&pid=310&ReturnUrl=http%3a%2f%2fbankruptcynews.dowjones.com%2fArticle%3fan%3dDJFDBR0020130318e93iln7q3%26cid%3d32135012%26ctype%3dts%26pid%3d310.

[199] *See* SecondMarket, *How the Bankruptcy Claims Market Works*, YOUTUBE (Apr. 30, 2012), http://www.youtube.com/watch?v=0ACYYS_QWMg).

[200] *See id.*

[201] *See id.*

[202] Another potential argument against the mandatory indemnity is that the claim seller's creditworthiness creates additional counterparty risk for the buyer. Indeed, the indemnity sold by a claim seller is only as good as the seller's ability to fulfill the indemnity obligations, should they arise. As demonstrated in *KB Toys*, claims sellers may go out of business, or be unable to fulfill their indemnity obligations for other reasons. *See In re* KB Toys, 736 F.3d 247, 250 (3d Cir. 2013). Nevertheless, this argument does not seriously undercut the workability of the mandatory indemnity. If an initial claim buyer is worried about the creditworthiness of a claim seller, the buyer could simply buy insurance against the seller's default on the underlying indemnity obligation. This insurance could be in the form of an agreement similar to a credit default swap. In the event that the initial buyer decides to sell the claim, the initial buyer could bundle the default insurance with the claim, and sell the package to a future buyer. This would allow buyers at all levels of the claims transfer process to be protected against the risk of upstream sellers' default on their indemnity obligations.

seller's conduct under section 502(d) or section 510(c). Therefore, sellers that have no reason to fear disallowance or subordination will not actually be taking on any additional risk.

B. A Mandatory Indemnity Should Increase the Market's Liquidity

Far from reducing market liquidity, a properly implemented mandatory indemnity should actually increase market liquidity. This is because the mandatory indemnity helps to identify "lemons."

The "lemons" issue is easy to understand with a car dealership hypothetical. Assume Buyer *B* walks into a used car dealership and spots the perfect ride. *B* approaches Salesman *S* and discusses the car's history. After this discussion, *B* decides that he wants the car and offers to buy it. *B* is wary, however, of buying a "lemon" and thus has one condition: *S* must give *B* a "money back guarantee" covering the first one hundred miles of driving. Under this guarantee, *S* would be required to buy the car back if it breaks down during the first one hundred driving miles. *S* refuses, but takes a little more off of the car price. At this point, however, *B* has become concerned about the car's condition: What kind of seller refuses to guarantee that his product will drive one hundred miles? With this new information, *B* leaves. Had *B* not requested the guarantee in the first place, he would not have been alerted to the likely poor condition of the car.

The same basic principle applies to claims trading. A mandatory indemnity would require all claim sellers to "stand behind" their claims. It is axiomatic that, when a seller provides a buyer with an indemnity, the seller will price the indemnity in accordance with the risk that the indemnity will be triggered; higher risk results in higher price. Thus, the seller's indemnity price is a very real hint to the marketplace. If the seller charges an exorbitant amount for an indemnity, the seller is effectively telling prospective purchasers that something is wrong with its claim. Accordingly, from the seller's asking price, the buyer can get a good sense of whether the claim is tainted by a defect. The seller's price, then, helps the buyer determine whether the claim is good investment or a low-quality lemon.

After buyers identify these low-quality lemon claims, it becomes more difficult for the low-quality claimholders to sell their lemons. In this way, the mandatory indemnity helps remove low-quality products from the claims trading market. Consequently, buyers can be more confident that they are buying high-quality products. With more confidence comes more buyers; with more buyers comes more liquidity.

The lemons issue is not mere theory. Rather, the lemons phenomenon actually occurred during the trading of the Refco bankruptcy claims. During the Refco bankruptcy, buyers and sellers were engaged in significant claims trading.[203] At one point, however, the market became aware that one of Refco's pre-petition creditors—BAWAG—may have engaged in inequitable conduct that would merit section 510(c) subordination.[204] As a result, trading of Refco claims froze.[205] Buyers were afraid that they might be buying a lemon claim that was previously owned—or acquired and then sold—by BAWAG, i.e., a worthless investment.[206]

A mandatory indemnity would counteract the problems that arose in the trading of Refco claims. As an initial matter, the mandatory indemnity should reduce the number of low-quality claims in the marketplace simply by forcing all sellers to stand behind their claims. Moreover, buyers would be less afraid of buying potentially valueless claims because they would know that any claim they bought would come with an indemnity. Thus, buyers would understand that even if a claim were subject to disallowance or subordination, they would be protected on the back end.[207] Of course, the heightened risk that a court will ultimately disallow or subordinate a claim would depress the value of such claims. However, even in a depressed market, the market would remain active; the mandatory indemnity should prevent the market from drying up entirely.

3. The Mandatory Indemnity Will Benefit All Parties in Other Ways

As explained above, the mandatory indemnity should benefit all market participants by weeding out low-quality claims. However, this is not the only benefit to be derived from the mandatory indemnity. Rather, the mandatory indemnity should benefit buyers, sellers, and non-market participants in other ways as well.

A. Claim Buyers Will Benefit from an Industry Standard Indemnification Clause

As a matter of logic, all claim purchasers should be in favor of including a mandatory indemnity clause in claims sale contracts; this is protection that every buyer should want. As explained above, every time a buyer buys a claim, there is a risk that a claim seller may have engaged in conduct that would result in section 502(d) disallowance or section 510(c) subordination of the claim. Under

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[203] *See* Levitin, *supra* note 173.

[204] *See id.* ("In April 2006, as BAWAG's involvement in Refco's fraud came out, Refco's creditors filed suit against BAWAG.").

[205] *See id.*

[206] *See id.*

[207] If a buyer is concerned that its back end protection will not hold up—i.e., that a seller will default on its indemnity obligations—then the buyer can simply buy insurance against such an event. *See supra* note 202.

a *KB Toys*-like rule, a claim's defect will pass with the claim to the buyer.[208] Accordingly, all rational buyers, if given the opportunity, should seek to protect themselves from these risks by negotiating *ex ante* for representations, warranties, and indemnities. Indeed, in the context of claims trading, "[t]he importance of such representations, warranties and indemnities should not be underestimated."[209]

The significance of these protective provisions is demonstrated by the LSTA's form contracts, which provide a multitude of different protections for claim purchasers.[210] The value of these protections is further demonstrated by the conduct of industry participants. David Abrams—the manager of Abrams Capital, a one billion dollar investment fund[211]—has stated that his fund "ordinarily will not purchase bank debt [or] trade debt [against a debtor] unless it receives warranties, representations and indemnities of the kind contained in the LSTA [form contracts]."[212] Abrams continues, "given the standard nature of such indemnities, I would view a seller's unwillingness to provide such an indemnity as a 'red flag' that there was something wrong with the claim."[213] Indeed, commentators regularly advise claim purchasers to protect themselves, especially in light of the uncertain legal climate surrounding claims trading.[214]

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[208] *See supra* Part II.3.

[209] *See* Fortgang & Mayer, *supra* note 175, at 19 ("Failure to agree on these provisions [indemnities, representations, warranties] has destroyed a surprisingly large number of deals after claims buyers and claims sellers agreed on economic terms."); *see also* Huber & Young, *supra* note 8 ("[T]here have been instances where banks and investors have agreed on the economic terms of a sale of bank debt, but then failed to agree on the representations and warranties to be given by the selling bank, killing the deal.").

[210] *See* Levitin, *supra* note 173 ("The standardized loan participation transfer documentation only includes upstream chains of title, warranties of good behavior and non-impairment, or indemnities for the transfer of distressed loans."); *see also* Abrams Decl., *supra* note 35, at 6–8.

[211] *See Hedge Funds—Abrams Capital Management*, INSIDER MONKEY, http://www.insidermonkey.com/hedge-fund/abrams+capital+management/150/.

[212] Abrams Decl., *supra* note 35, at 7.

[213] *Id.*

[214] *See* Eric Winston, *Bankruptcy Claim Buyers Must Guard Against Counterclaims*, LAW360.COM, February 5, 2014, http://www.law360.com/bankruptcy/articles/507457/bankruptcy-claim-buyers-must-guard-against-counterclaims; Scott K. Charles et al., *Buying Claims Against a Chapter 11 Debtor*, AM. RESTRUCTURING AND INSOL. GUIDE 193, 195 (2008/2009), *available at* www.wlrk.com/webdocs/wlrknew/AttorneyPubs/WLRK.15641.08.pdf ("Given the uncertainty that currently prevails on the issue, buyers would be well advised to insist upon indemnities from their sellers that would require the sellers to cover any losses and expenses resulting from an equitable subordination action.").

B. Claim Sellers Will Benefit from an Industry Standard Indemnification Clause

As noted by Professors Fortgang and Mayer, a claim seller "usually wants as clean a break with the debtor as possible. Most [claim sellers] want to avoid any representations, warranties or indemnities."[215]

For sellers with something to fear, this is very true. Indeed, if a seller is worried that it may have engaged in conduct that has created a defect in its claim, the seller will want to avoid insuring against loss based on that defect. Thus, a mandatory indemnity would work against these sellers' interests.

For sellers with little to fear, however, a mandatory indemnity presents a benefit. In all debt markets where sellers do not customarily provide buyer protection, the mandatory indemnity allows claim sellers to charge a higher price. Indeed, even if a seller is certain that it has not engaged in conduct that has created a defect in its claim, its insurance against that hypothetical defect is still worth *something* to the buyer.

Accordingly, claim sellers that have nothing to fear will benefit from the mandatory indemnity by being able to charge a higher price for the same claim. But those with serious doubts as to their quality of their claims will likely be pushed out of the market. Thus, the mandatory indemnity benefits sellers with high-quality claims, while it removes low-quality claims from the market.

C. Debtors and Non-Claims Trading Creditors Will Benefit from an Industry Standard Indemnification Clause

Both debtors and non-claims trading creditors should be in favor of a mandatory indemnity as well. As discussed above, the mandatory indemnity helps preserve the purposes of the sections 502(d) and 510(c). With respect to section 502(d), the mandatory indemnity helps ensure that courts retain the provision's coercive power. This coercive power makes it easier for the trustee to recover avoidable transfers and, in turn, reduces litigation costs for the estate. With respect to section 510(c), the mandatory indemnity helps preserve the provision's deterrence function. This will lead to a reduction in inequitable conduct, which should reduce the trustee's expenses associated with litigating section 510(c) lawsuits. In sum, the mandatory indemnity helps reduce the trustee's litigation expenses and provides for a fairer distribution of estate assets to creditors.

Additionally, the mandatory indemnity provides "a good market moment to kick the tires of the underlying claim."[216] As discussed above, the mandatory

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[215] Fortgang & Mayer, *supra* note 175, at 18.

[216] Adam Levitin, *Bankruptcy Claims Trading: Part II*, CREDIT SLIPS, Oct. 1, 2007,

indemnity will help buyers—and the trustee—identify lemons in the marketplace. This early identification would serve to reduce the trustee's expenses in determining which claims to pursue in the first place. Indeed, by requiring a claim seller to price an indemnity, the seller is essentially being forced to disclose its assessment of the risk that its claim is tainted by a defect. The trustee will have an opportunity to see who has successfully sold their claims, and may want to begin by investigating the claims that have not been sold. Of course, there are many legitimate reasons why a claimholder may want to keep its claim. Nevertheless, the mandatory indemnity may provide trustees with a cost-reducing head start that they would not have had otherwise.

IV. AN ALTERNATIVE FRAMEWORK

As mentioned above, this Article is not the first publication to discuss the intersection of claims trading and certain provisions of the Bankruptcy Code. Rather, judges—in several judicial decisions—have considered these issues.[217] Moreover, legal scholars have noted and commented on the claims washing issue as well. In particular, one well-respected claims trading scholar—Professor Adam J. Levitin—has researched and written extensively on the topic.[218] Professor Levitin has authored several articles that discuss claims washing, and has suggested a solution that differs from this Article's proposal. This Part discusses Professor Levitin's solution, and explains why it is less desirable than a mandatory indemnity.

1. Professor Levitin's Alternative Proposal

Professor Levitin has authored two articles—in addition to other writings—that consider the claims washing issues raised in this Article.[219] Over the course

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http://www.creditslips.org/creditslips/2007/10/bankruptcy-clai.html (comment of John Pottow).

> We could say that the buyers of debt [present] a good market moment to kick the tires of the underlying claim, and so we can ferret out the infirmities at this juncture by charging them with a duty of diligence (by visiting the consequences of the 'tainted' claim on them).

Id.

[217] *See generally In re* KB Toys, Inc., 736 F.3d 247 (3d Cir. 2013); *In re* Enron Corp., 379 B.R. 425, 438 (S.D.N.Y. 2007); *In re* Enron Corp., 340 B.R. 180 (Bankr. S.D.N.Y. 2006), *rev'd*, 379 B.R. 425 (S.D.N.Y. 2007); *In re* Enron Corp., 333 B.R. 205 (Bankr. S.D.N.Y. 2005), *rev'd*, 379 B.R. 425 (S.D.N.Y. 2007); *In re* Metiom, 301 B.R. 634 (Bankr. S.D.N.Y. 2003).

[218] *See generally* Levitin, *supra* note 173; Levitin, *supra* note 27; Levitin, *supra* note 1.

[219] *See* Levitin, *supra* note 173; Levitin, *supra* note 27.

of these two articles, Professor Levitin has sketched out a rough plan for dealing with claims washing. It is important to note, however, that Professor Levitin's articles—and corresponding solution—do not deal with section 502(d).[220] Rather, Professor Levitin distinguishes section 502(d) from section 510(c), and would apply his suggested rule only to the latter.[221] Accordingly, the discussion in this Part is limited to the application of section 510(c) to a traded claim.

In a general sense, Professor Levitin agrees with Judge Scheindlin that a good faith purchaser should take a claim free of defenses that a debtor could have asserted against the claim's seller.[222] He arrives at this conclusion, however, in a different manner: Professor Levitin advocates for a federal common law of negotiability for bankruptcy claims;[223] in other words, bankruptcy courts should begin holding that bankruptcy claims are negotiable instruments.[224] This "negotiable" status would bring with it a good faith purchaser defense.[225] Thus, although Professor Levitin's solution does not recognize Scheindlin's distinction between a pure assignment and a sale,[226] as a practical matter it arrives at generally the same result.[227]

Professor Levitin's solution, however, is not merely an endorsement of an

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[220] Levitin, *supra* note 27, at 108 ("[S]ubordination and disallowance should not be conflated simply because they may have a similar effect. They are different legal processes. A valid claim may be subordinated, and a claim may be disallowed even though it could not have been subordinated.").

[221] Levitin, *supra* note 216.

> I think there is a distinction between claim disallowance and claim subordination. It's hard for me to accept that a claim that is invalid in the hands of a seller could become valid in the hands of a purchaser. That's just alchemy. If the claim itself isn't valid, it shouldn't matter who holds it.

Id.

[222] Levitin, *supra* note 27, at 171–73.

[223] *Id.* Professor Levitin actually suggests three manners in which his proposal could be adopted: (1) Congress could amend section 550(a) to include a good faith purchaser defense for section 510(c), (2) either Congress or the courts could define bankruptcy claims as securities, and (3) courts could begin holding that bankruptcy claims are negotiable instruments. *Id.* at 171. Professor Levitin favors a common law approach, however, because of his fear that a codification of negotiable instrument law would create "'a strait-jacket to confine' new types of commercial activity." *Id.* (citation omitted).

[224] *Id.* at 171–72 ("Because Congress has not addressed the issue directly, there is room for the courts to create a federal common law of bankruptcy claims trading that presumes negotiability of claims, regardless of formalities.").

[225] *Id*. at 91 ("Thus, U.C.C. Article 2 provides for good faith purchaser protections for the sale of goods, a negotiability standard.").

[226] Professor Levitin has described Judge Scheindlin's *Enron* decision as "sorely confused." *See* Levitin, *supra* note 1, at 92.

[227] Levitin, *supra* note 216 ("Although the [*Enron*] District Court introduced some strange, non-standard terminology[,] . . . it strikes me (not surprisingly) as basically on the money. The District Court essentially stated a good faith purchaser for value protection in the claims trading market.").

Enron-like rule. Rather, Professor Levitin realizes that the good faith purchaser defense would encourage claims washing. To address the resulting ability for creditors to wash claims, Professor Levitin encourages creditors that have been injured by the claim seller's inequitable conduct to bring lawsuits against the bad-acting seller.[228] As noted by Professor Levitin, "[c]laims washing is only a problem if there is no liability for the inequitable party. So long as the inequitable party remains liable, then it should not matter if he sells his claims."[229]

Thus, while this Article advocates for a system in which a court subordinates the claim of a purchaser and encourages the purchaser to recover from the bad-acting seller, Professor Levitin would protect the good faith purchaser and put the onus of recovery on the injured creditors themselves.[230] While Professor Levitin's solution appears workable at first blush, its costs outweigh its benefits.

2. The Problems with Professor Levitin's Alternative Proposal

As explained above, Professor Levitin's proposal would protect a good faith claims purchaser and put the burden of recovery on the creditors injured by the seller's inequitable conduct.[231] Thus, rather than having the claims purchaser sue the seller under an indemnity provision, Professor Levitin would have the injured creditors sue the seller, seeking redress for the seller's inequitable conduct.[232] There are two significant problems with Professor Levitin's alternative proposal. First, it puts the burden of recovery on the wrong party. Second, the costs of litigating the injured creditor's claims against the seller potentially dwarf the litigation costs of this Article's proposal.

A. Professor Levitin's Framework Puts the Burden of Recovery on the Wrong Parties

One of the goals of economics is to identify and place the burden of recovery on the party for whom recovery will cost the least. In the context of the disallowance or subordination of a traded claim, that party is the claim purchaser.[233] Only the purchaser is in a position to investigate a claim and

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[228] Levitin, *supra* note 173 (stating claim purchasers can sue until inequitable actor is brought in).
[229] *Id*.
[230] *See id.*
[231] *See id.*
[232] *See id.*
[233] *See In re* KB Toys, Inc., 736 F.3d 247, 247, 252–53 n.8 (3d Cir. 2013) ("[C]laim purchasers are in a position to mitigate disallowance risk [through pricing or indemnification], whereas the other

demand protection from the seller *ex ante* through warranties and indemnities. This *ex ante* protection serves to reduce the cost of recovery in the event that the purchaser suffers a loss. Accordingly, the purchaser is the party in the best position to reduce the cost of recovery. It follows that the claim purchaser should bear that burden.

Notwithstanding the fact that the claim purchaser is the party best positioned to protect against this loss, Professor Levitin places the burden on the creditors that are *injured* by the seller's inequitable conduct.[234] Unlike claims purchasers, however, who have an opportunity to reduce their recovery costs *ex ante* by contract, injured creditors do not have a similar pre-injury opportunity to negotiate.[235] Rather, injured creditors' only form of recovery is *ex post* litigation, the costs of which have not been reduced by pre-negotiated indemnities and warranties. Therefore, Professor Levitin's proposal fails to place the burden of recovery on the party best positioned to bear that burden.

B. The Costs of Professor Levitin's Framework Potentially Dwarf the Litigation Costs of this Article's Framework

Professor Levitin's proposal is also flawed from the perspective of litigation costs. He argues that his solution is workable because an injured creditor's costs of litigating direct causes of action against a bad-acting claim seller (the "Direct Action") should approximate the costs of the debtor's subordination litigation against the claim buyer and the buyer's subsequent action against the inequitable claim seller (the "Subordination Actions")[236]—the recovery scheme suggested by this Article. In support of his proposal, Professor Levitin states: "There is no reason to suppose that transaction costs would vary significantly between direct actions and subordination actions."[237] However, this statement is true only if the injured creditors' Direct Actions would roughly approximate the Subordination Actions in timing, parties, and scope. For various reasons, this will be unlikely in many cases.

The litigation of the Subordination Actions should all occur in within the

creditors are not."). Although *KB Toys* only addressed section 502(d) risk—and not section 510(c) risk—it highlights the ability for claims purchasers to protect themselves, while other, innocent creditors do not have a similar opportunity.

[234] Levitin, *supra* note 173 ("Requiring direct actions by injured creditors ensures that injured creditors do not externalize their litigation costs and risks, and it ensures that inequitable parties are forced to internalize the full measure of their inequitable behavior.").

[235] *See id.* ("Creditors have other methods of protecting themselves. Ex-ante options include secured debt, sureties, and credit derivatives, while ex-post, they can undertake direct actions against inequitable parties.").

[236] *Id*.

[237] *Id*.

bankruptcy forum. That is, in the recovery framework suggested by this Article, the debtor would sue the buyer to subordinate the claim, and the buyer would implead the bad-acting seller.[238] In that way, all lawsuits can be decided in one forum with all interested parties participating.

In contrast, Professor Levitin's framework urges injured creditors to bring Direct Actions, the costs of which may dwarf the costs of the Subordination Actions. The cost of the Direct Actions should approximate the costs of the Subordination Actions only if the injured creditors bring *one* Direct Action against the bad-acting claim seller. If the injured creditors bring multiple Direct Actions, however, the total litigation costs will invariably increase. Thus, only if the injured creditors stick together as a single unit will the costs of the Direct Action resemble those of the Subordination Actions. This simply will not happen with all creditors in all cases.

It seems probable that, whenever injured creditors sue an inequitable claim seller, at least a few creditors will splinter off from the main group. While the exact number of lone rangers is impossible to predict in the abstract, it can be assumed that in some circumstances the splintering may be significant. The main reason for this splintering is the fact that the provisions of the Bankruptcy Code will no longer restrict the injured creditors' actions. Rather, the injured creditors will now be suing a (presumably) *solvent* entity, and it will be in each creditor's best interest to sue alone, and sue fast. In that way, the quickest creditor can establish its priority over all other creditors and ensure that it will get what it is owed.[239] This may very well result in different suits being brought in different forums. Because these suits would be based on the same facts, it is likely that the lawyers would make duplicative arguments and conduct duplicative discovery. In short, Professor Levitin's framework has the potential to be wasteful.

In contrast to Professor Levitin's framework, this Article's mandatory indemnity avoids all of these problems while increasing the liquidity of the claims trading market. Therefore, as a framework for solving the claims

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[238] In the framework suggested by this Article, the claim buyer would have a direct action against the inequitable claim seller, and thus would not need to sue up the chain of title to bring suit against the bad actor. *See supra* Part III.1.A.

[239] Of course, some smaller creditors may wish to band together, pool their resources, and accept a joint recovery. They may simply lack the funds to make a lawsuit by themselves worthwhile. In some circumstances, however, a smaller creditor may not be able to align itself with any bigger, cost absorbing creditors. In circumstances like these, the small creditor may choose to forgo recovery because of the litigation costs. This is undesirable because the bad-acting claim seller will have been able to successfully avoid liability (or at least a portion of liability) for its inequitable conduct. Because the creditor would not have to make up for all of the loss it caused, it will be able to retain some of the benefit of its inequitable conduct. This result would encourage creditors to engage in inequitable conduct.

washing problem, the mandatory indemnity is a more desirable solution.

CONCLUSION

Sections 502(d) and 510(c) create "defects" in claims that serve important purposes in the Bankruptcy Code. The claims trading market presents an opportunity for claimholders to undermine these purposes by "washing" their claims of these defects. The simplest way to prevent a claimholder from washing a claim is to require that the defects created by sections 502(d) and 510(c) attach to and travel with a claim. Even if courts adopt this approach, however, claims washing will continue to cause problems. Indeed, if sellers can shield themselves against liability under sections 502(d) and 510(c), sellers are still able to undermine the purposes of those provisions. Accordingly, a comprehensive solution must be found that will hold a seller accountable for its misconduct even after it sells a claim. This Article's mandatory indemnity serves this purpose while also benefitting all participants in the claims trading market.