

Clients & Friends Memo

“Caveat Emptor”: New York Bankruptcy Court Disallows Bankruptcy Claims Purchased from Recipients of Avoidable Transfers; Is *Enron* Going, Going, . . . ?

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A recent Bankruptcy Court decision, In re Firestar Diamond, Inc., out of the Southern District of New York (“SDNY”) by Bankruptcy Judge Sean H. Lane, disallowed creditors’ bankruptcy claims purchased from sellers who allegedly received (and had not repaid) avoidable preferences and fraudulent transfers from the debtors.¹ Judge Lane provides a cogent warning to claims purchasers that they bear the risk of Bankruptcy Code section 502(d) disallowance.

Judge Lane based the Firestar Diamond decision on Bankruptcy Code section 502(d), which mandates disallowance of claims of an entity that has received property that the estate may recover (*e.g.*, avoidable transfers) unless that entity or its transferee has repaid the avoidable or recoverable amount.² Further, in so ruling, Judge Lane aligned his Court with the view of the Third Circuit Court of Appeals in In re KB Toys Inc.³ There, when faced with the same issue, the Third Circuit held that the taint of section 502(d) disallowance risk travels with the claim itself and the taint cannot be cleansed through a subsequent transfer of the claim to a third-party transferee.

Notably, in reaching its holding in Firestar Diamond, Judge Lane rejected a holding by a District Court in its own district. Thirteen years ago, in the aftermath of the Enron bankruptcy, District Court Judge Shira Scheindlin held that Bankruptcy Code section 502(d) is a “personal disability and does not travel with the ‘claim,’ but with the ‘claimant.’” In a decision that was regarded as a boon to the secondary bankruptcy claims trading market, Judge Scheindlin ruled that purchasers of claims (not mere assignees) would take free from the risk of section 502(d) disallowance.⁴ The District Court

¹ In re Firestar Diamond, Inc., et al., No. 18-10509 (SHL), 2020 WL 1934896 (Bankr. S.D.N.Y. Apr. 22, 2020) (“Firestar Diamond”).

² Section 502(d) provides, in part, “[T]he court shall disallow any claim of an entity from which property is recoverable under section 542, 543, 550, or 553 of this title or that is a transferee of a transfer avoidable under section 522(f), 522(h), 544, 545, 547, 548, 549, or 724(a) of this title, unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable under section 522(i), 542, 543, 550, or 553 of this title.”

³ 736 F.3d 247 (3d Cir. 2013) (“KB Toys”).

⁴ Judge Scheindlin limited protection from section 502(d) disallowance to claims held by creditors who acquired their claims by “sale” rather than “assignment.” The District Court reasoned that a transfer by assignment will not grant the assignee more

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vacated the Bankruptcy Court's order disallowing claims and remanded to determine the nature of the transfer. If the transfer were a sale, rather than an assignment, it would not be disallowed under section 502(d).⁵ But the Enron decision found few adherents. Firestar Diamond joins a lengthening line of decisions criticizing or declining to follow it.

Some risk mitigation suggestions are set forth in the "Implications" section below.

Background:

In Firestar Diamond, the Debtors were three wholesalers of jewelry – Firestar Diamond, Inc., Fantasy, Inc., and A. Jaffee, Inc. (collectively, "Firestar" or the "Debtors") – who sold mainly to department stores and specialty chain stores in the United States. Firestar filed for Chapter 11 protection in February of 2018 in the SDNY in the "shadows of an alleged massive fraud" conducted by Firestar's owner, Nirav Modi, who allegedly used a number of shadow entities ("Non-debtor Entities") to pose as independent third parties in sham transactions in order to obtain billions of dollars in bank financing.

The SDNY Bankruptcy Court appointed an examiner to look into these allegations. The examiner found "substantial evidence" of the Debtors' "knowledge and involvement" in the alleged criminal conduct. As a result, the court appointed a Chapter 11 trustee to administer the Debtors' estates.⁶

A number of banks filed proofs of claims in the Chapter 11 case. The banks' claims were not based on their dealings with the Debtors. Instead, the banks' claims were based on amounts that the Debtors owed to the Non-debtor Entities, which had pledged their receivables or sold their invoices to the banks at a discounted price for amounts the Debtors owed.⁷

The Chapter 11 trustee objected to the banks' claims under section 502(d) because the claims had been acquired from claim sellers who had received fraudulent transfers and preferences from the Debtors. The banks opposed the trustee's argument based on Enron, arguing instead that "disallowance under Section 502(d) is a personal disability and does not travel with the 'claim,' but

rights than possessed by the assignor – an assignee "stands in the shoes of the assignor" and takes with the assignor's limitations. 379 B.R. at 435. But a claim that is "sold" is not subject to the personal disabilities of the transferor. *Id.* at 436.

⁵ In re Enron Corp., 379 B.R. 425, 445-46 (S.D.N.Y. 2007) ("Enron") ("the nature of the transfer will determine whether [the] claims can be subject to . . . disallowance based on [Debtor]'s conduct"). The Third Circuit, other courts, and bankruptcy commentators have questioned the distinction between "sale and "assignment," finding it "problematic" and unsupported by state law. *See KB Toys*, 736 F.3d at 254; Firestar Diamond, 2020 WL 1934896 at *9-12.

⁶ Firestar Diamond, 2020 WL 1934896 at *2-3.

⁷ *Id.* at *4 n.3.

with the ‘claimant’” and that the banks had “acquired rights to payment from the Debtors through a ‘sale’ rather than an ‘assignment’.” Therefore, the claims had been washed clean.⁸

In contrast, the trustee argued that “sale” or “assignment” was of no import and urged the Court to reject Enron and follow rulings by other courts, including the Third Circuit’s decision in KB Toys. In the trustee’s view, the banks’ claims should be treated the same as if they had been filed by the Non-debtor Entities and disallowed.

Ultimately, Judge Lane agreed with the trustee and held that the banks’ claims should be disallowed because section 502(d) focuses on the claims themselves rather than who holds them. The original claims were disallowable and, therefore, remained disallowable even after their sale to the banks.

Enron and KB Toys:

Enron and KB Toys represent opposing views interpreting section 502(d). Generally, Enron attributed disallowance under section 502(d) to the claimant rather than a feature that transfers with a claim. On the other hand, KB Toys viewed section 502(d) disallowance as an attribute of the claim and therefore a feature that travels with the claim upon transfer.

In Enron, the court also held that when a claim is transferred, the “nature of that transfer” will dictate whether there may be a disallowance under section 502(d). Indeed, a transfer of a claim by assignment would allow the personal disability to transfer with the claim because an assignee “stands in the shoes of the assignor” and would, therefore, take on the transferred property with “whatever limitations it had in the hands of the assignor[.]” Meanwhile, a transfer by a sale would allow the purchaser only to receive the claim, washing the claim of the disability. Judge Scheindlin reasoned that recovery of property under the threat of section 502(d) disallowance would not be achieved if the claim was held by a creditor who had not received the preference.⁹

KB Toys rejected the distinction between “assignment” and “sale,” noting that there is no support for this distinction in the Bankruptcy Code. The Third Circuit concluded that “claims that are disallowable under [section] 502(d) must be disallowed no matter who holds them.”¹⁰ The Third Circuit reasoned that allowing a claim originally held by the recipient of a fraudulent or preferential transfer to be washed clean of section 502(d) disabilities would “contravene” the purpose of

⁸ *Id.* at *4-6.

⁹ Enron, 379 B.R. at 443 (The purpose of section 502(d) is to “coerce the return of assets obtained by preferential transfer. That purpose would not be served if a claim in the hands of a claimant could be disallowed even where that claimant had never received the preference to begin with, and as a result, could not be coerced to return it. It seems implausible that Congress would have intended such a result.”).

¹⁰ KB Toys, 736 F.3d at 252.

section 502(d), “which is to ensure equality of distribution of estate assets.”¹¹ If the original claimant could rid the claim of its disabilities by selling the claim to a transferee, trustees would be “deprive[d] . . . of one of the tools the Bankruptcy Code gives trustees to collect assets—asking the bankruptcy court to disallow problematic claims.”¹²

A number of other courts and scholars alike have agreed with the Third Circuit, thereby concluding that section 502 follows the claim rather than the claimant.¹³

In re Firestar Diamond:

Judge Lane’s recent decision in Firestar Diamond continues that trend. Indeed, Firestar Diamond adopted KB Toys’ reasoning and rejected the banks’ position and reliance on Enron.¹⁴ Judge Lane, focusing on the claims rather than the claimants, granted the trustee’s section 502(d) claim objections. The banks’ claims were tainted by fraudulent and preferential transfers received by participants in Firestar’s bank fraud scheme. Those Non-debtor Entities could not cleanse their other claims against the debtor by selling them to third parties, unless they repaid the avoidable transfers.

In addition, Judge Lane rebuffed the banks’ argument that disallowance of their claims would “wreak havoc in the claims trading market or unfairly punish good faith transferees.” Rather, the Court explained that it would be “inequitable” to favor the banks over other creditors.¹⁵

Following KB Toys, Judge Lane thus concluded that claims purchasers should bear that risk because (i) they voluntarily chose to participate in the bankruptcy and were aware of the risks of doing so, and (ii) they are able to mitigate that risk through due diligence and including an indemnity clause in the transfer agreement. On the other hand, other creditors in a bankruptcy “have no way to protect themselves against the risk that claims with otherwise avoidable transfers will be washed clean by a sale or assignment.”¹⁶

¹¹ *Id.* at 252.

¹² *Id.*

¹³ See Firestar Diamond, 2020 WL 1934896 at *10-11 (collecting cases and scholarly articles); In re Motors Liquidation Co., 529 B.R. 520 (Bankr. S.D.N.Y. 2015); In re Wash. Mut., Inc., 461 B.R. 200 (Bankr. D. Del. 2011), vacated in part on other grounds, 2012 WL 1563880 (Bankr. D. Del. Feb. 24, 2012); Adam J. Levitin, Bankruptcy Markets: Making Sense of Claims Trading, 4 Brook. J. Corp. Fin. & Com. L. 67, 92 (2009); Jennifer W. Crastz, Can a Claims Purchaser Receive Better Rights (Or Worse Rights) Than Its Transferor in a Bankruptcy?, 29 Cal. Bankr. J. 365, 637 (2007); Roger G. Jones & William L. Norton, III, Norton Creditor’s Rights Handbook § 8:8 (2008).

¹⁴ Firestar Diamond, 2020 WL 1934896 at *9.

¹⁵ *Id.*

¹⁶ *Id.* at *13-14.

Implications

Firestar Diamond continues the trend of disallowing creditor claims acquired from sellers who received avoidable or preferential transfers from the debtor. In light of yet another decision coming out this way, claims purchasers need to transact with eyes wide open and be mindful of potential consequences pursuant to section 502(d) of the Bankruptcy Code.

Duly informed claims purchasers may mitigate some risk by, among other things, considering the following measures:

- Conduct due diligence with the goal of aiming to minimize disallowance risk under section 502(d) by investigating and inquiring into the seller's relationship and transactions with the debtor.
- Consider including protections in claim transfer agreements, such as indemnification language in the event of a claim objection based on section 502(d).
- Consider documenting transfers as "sales" rather than assignments to take advantage of whatever protection or benefit the Enron rationale may still bestow and provide.

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