Can a Claim Transferee "Wash" the Claim From Disallowance Risk? *Another Chapter in the Firestar Saga*

By: Bruce S. Nathan, Esq, Scott Cargill, Esq, John P. Schneider, Esq, Lowenstein Sandler LLP

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For the complete version of this Article -- including a comprehensive analysis of how the U.S. District Court for Southern District of New York in I*n re Enron Corp*. and the U.S. Court of Appeals for the Third Circuit in *KB Toys, Inc*. previously reached opposite conclusions on this issue, **see the upcoming Q2 2021 edition of CRF's The Credit and Financial Management Review**.

Claims trading is an efficient avenue for creditors of bankrupt companies to quickly liquidate their prepetition claim by selling the claim, at a discount, rather than waiting out the bankruptcy process hoping to receive a recovery from the bankruptcy estate. Conversely, buyers are often willing to purchase a claim for a variety of reasons, including with an expectation that the bankruptcy estate's eventual distribution on account of the purchased claim will exceed the price they paid for the claim.

There are risks for a buyer when acquiring claims. For instance, many Chapter 11 plans propose the creation of a trust, overseen by a trustee or administrator, tasked with pursuing causes of action on behalf of the estate. Reconciliation of claims typically takes months or even years before distributions can be paid, if at all. Depending on how the liquidation process plays out, claims buyers carry the risk that any distribution ultimately received from the debtor will be lower than anticipated, and perhaps even less than the amount the buyer paid to purchase the claim.

Shrewd claim buyers build into their business model administrative delays and the risk of lower than initially anticipated distributions from a bankruptcy estate. However, having a purchased claim that is subsequently disallowed pursuant to Bankruptcy Code § 502(d) based on the claim seller's exposure to an avoidance claim, such as a preference or fraudulent transfer claim, continues to engender significant concern in the claims trading market, especially in light of conflicting and at times confusing court decisions. A recent decision by the U.S. District Court for the Southern District of New York addressing § 502(d) in the Chapter 11 cases of I*n re Firestar Diamond, Inc*. provides some comfort to claims traders, but has not eliminated these worries.

Using Bankruptcy Code § 502(d) to Disallow Certain Claims

The Bankruptcy Code gives trustees and debtors-in-possession the power to "avoid" certain transfers, including preferential payments made by a debtor to a creditor within 90 days of the bankruptcy filing, as well as fraudulent transfers made to creditors within two or more years of the filing that can be set aside pursuant to the Bankruptcy Code or otherwise applicable state law. Section 502 sets forth procedures governing the allowance of asserted claims and provides for the disallowance of any claim asserted by an entity that has received, and not returned to the estate, an avoidable transfer (such as a preference or fraudulent transfer).

The *In re Firestar Diamond, Inc.* Case

On February 26, 2018 (the "Petition Date"), U.S. jewelry wholesalers Firestar Diamond, Inc. ("Firestar"), Fantasy, Inc., and A. Jaffe, Inc. (collectively with Firestar, the "Debtors") commenced voluntary Chapter 11 proceedings (the "Chapter 11 Cases") in the U.S. Bankruptcy Court for the Southern District of New York. Approximately one month prior to the Petition Date, Punjab National Bank ("PNB") filed a complaint against the Debtors' owner, Nirav Modi, and several of his companies alleging that they had committed "the largest bank fraud in Indian history" against PNB and several other banks by using fraudulently issued documents to obtain approximately $4 billion in financing. Due to the Debtors' involvement in the fraud, and certain communications between Modi and the Debtors during the Chapter 11 Cases, the bankruptcy court appointed a Chapter 11 trustee (the "Trustee") to administer the Debtors' estates.

A number of Indian financial institutions (the "Banks") filed proofs of claim in the Chapter 11 Cases against the Debtors. Although the record is unclear, it appears that the Banks' claims arose from amounts Firestar owed

to three of its subsidiaries (the "Non-Debtor Firestar Subsidiaries") arising from the Non-Debtor Firestar Subsidiaries' sales of diamonds to Firestar. The Banks had extended credit to the Non-Debtor Firestar Subsidiaries and the Non-Debtor Firestar Subsidiaries had pledged their accounts receivable, including accounts generated from the sales to Firestar, to secure payment of the Non-Debtor Firestar Subsidiaries' obligations to the Banks. In some instances, the Non-Debtor Firestar Subsidiaries designated the Banks as payees on the invoices issued to Firestar and directed Firestar to make payment directly to the Banks. In other instances, the Non-Debtor Firestar Subsidiaries sold their invoices owing by Firestar at a discount to the Banks. Some of these invoices remained unpaid on the Petition Date, and these unpaid invoices are the basis for the Banks' claims against Firestar that were at issue in the appeal to the district court.

The Trustee sought disallowance of the Banks' claims under § 502(d), arguing that the Non-Debtor Firestar Subsidiaries had received and failed to return millions of dollars in avoidable pre-petition transfers from the Debtors. The Trustee argued that the disabilities (i.e., fraudulent transfers) arising from the Non-Debtor Firestar Subsidiaries' claims traveled with the claims, and therefore the Banks' claims should be disallowed under §502(d). The Banks responded that disallowance under § 502(d) is a personal disability arising from the Non-Debtor Firestar Subsidiaries' receipt of the avoidable (fraudulent) transfers and did not travel with the claims and, therefore, the claims could not be disallowed after the Non-Debtor Firestar Subsidiaries had pledged or sold the claims to the Banks.

On April 22, 2020, the bankruptcy court ruled in favor of the Trustee and concluded that for purposes of § 502(d), the disability and disallowance risk rides with the claims -- not the claimants. The bankruptcy court ruled that § 502(d) applies to both purchased and assigned claims, because an alternative interpretation would contravene the policy of ensuring equality of distribution of estate assets. Specifically, it would be inequitable to allow a recipient of an avoidable transfer to "wash" its claim by selling it to a third party. The *Firestar* bankruptcy court expressly rejected the holding of the U.S. District Court for the Southern District of New York in I*n re Enron Corp*. that ruled a claim that is "purchased" from a seller with preference or fraudulent transfer risk is not subject to disallowance under § 502(d), but a claim that is "assigned" from such a seller is subject to disallowance under §502(d).

The Banks appealed the *Firestar* bankruptcy court's decision. In April 2021, the district court agreed with the bankruptcy court's holding that transferees of claims are subject to the same burdens under § 502(d) as the transferors. The *Firestar* district court also noted that the plain language of § 502(d) focuses on claims, and therefore claims transferred from creditors that received and did not repay an avoidable transfer to transferees must also be disallowed under § 502(d).

The *Firestar* district court decision did include one wrinkle that muddled whether the district court's ruling supported the Trustee's position. While there were no allegations in the record that the Banks received fraudulent or preferential payments – it was only the Non-Debtor Firestar Subsidiaries that received such payments -- the Banks had argued that at least some of the claims at issue were *direct* claims by the Banks against the Debtors. The district court noted that the Trustee cannot invoke § 502(d) to object to the Banks' claims against Firestar if the Non-Debtor Firestar Subsidiaries had never transferred their claims to the Banks. The *Firestar* bankruptcy court had failed to make any factual finding concerning whether the Banks' claims against Firestar arising from the Non-Debtor Firestar Subsidiaries' pledge and sale of invoices owing by Firestar that the Trustee had sought to disallow were, in fact, direct claims the Banks asserted against Firestar, or were instead transferred to the Banks by a sale or assignment from the Non-Debtor Firestar Subsidiaries.

The bankruptcy court concluded that it did not matter to its analysis if the claims were transferred to the Banks by the Non-Debtor Firestar Subsidiaries or if the Banks had asserted direct claims against the Debtors, because in either case the claims must be disallowed. The district court disagreed, concluding that if the claims were directly held by the Banks, then § 502(d) does not apply at all and the Banks' claims against Firestar would not be subject to disallowance. Accordingly, the district court vacated the bankruptcy court's order sustaining the Trustee's objection to the Banks' claims and remanded the case to the bankruptcy court to determine the nature of the Banks' claims.

Takeaway

Even though the district court vacated and remanded the *Firestar* case back to the bankruptcy court for further proceedings, the claims trading industry has gained clear insight from the district court analysis that all transferred claims -- whether "assigned" or "purchased" from the transferor -- may be subject to disallowance under § 502(d). For a claim seller and buyer, this means taking a long and objective look and conducting the necessary due diligence to determine whether the seller had received a preferential payment or fraudulent transfer from the debtor that could be avoided. A seller's receipt of such a transfer prior to the bankruptcy would materially increase the likelihood that a claims buyer will negotiate for the inclusion of, and then invoke, indemnification provisions of its claim transfer documents and insist on unwinding the sale – months or years later – in the event the debtor or trustee seeks to disallow the claim under § 502(d) as it was subject to avoidance as a preference or fraudulent transfer.

About the Authors

Bruce S. Nathan is a Partner in Lowenstein Sandler's Bankruptcy, Financial Reorganization & Creditors' Rights Department. He has more than 35 years of experience in the bankruptcy and insolvency field, and is a recognized national expert on trade creditor rights and the representation of trade creditors in bankruptcy and other legal matters.

Scott Cargill is Of Counsel for Lowenstein Sandler, and has represented various parties in numerous restructuring and insolvency proceedings in bankruptcy courts. He has also advised clients on such matters as the auction and sale of debtor assets, setoff rights, preference and fraudulent transfer liability issues.

John P. Schneider is an associate in Lowenstein Sandler's Bankruptcy, Financial Reorganization & Creditors' Rights Department. He represents debtors, creditors, and creditors' committees in Chapter 11 matters and has served as counsel to Chapter 7 bankruptcy trustees in asset cases of varying complexity.