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On the Edge

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Are Courts More Likely to Disallow Claims Purchased from Recipients of Avoidable Transfers?

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One of the greatest advantages of chapter 11 is that upon commencement, pre-petition debt is "frozen" and the debtor in possession is free from the collection efforts of creditors on such debts. That pre-petition debt will be resolved, hopefully, via a reorganization plan. For those creditors not willing to wait and see whether the debtor will successfully emerge, there are investors willing to purchase those claims. For the creditor, the opportunity to obtain an immediate recovery and free itself from the uncertainties of the bankruptcy process can be quite attractive. For the investor, it is an opportunity to earn a profit on an undervalued asset or perhaps an opportunity to accumulate a debt position significant enough to influence the bankruptcy and potentially increase recoveries.

However, the seller of a bankruptcy claim is typically required to bear some continuing risk in connection with the transaction. For example, if the claim is ultimately disallowed, the seller might have to repurchase the claim from the buyer. The buyer also bears the risk that, for example, there will be a recovery exceeding the amount it paid for the claim, or any recovery at all.

Section 502(d)

Under § 550 of the Bankruptcy Code, if the trustee is able to avoid a transfer such as a preference or a fraudulent transfer, the value must be returned to the debtor's estate.[1] Section 502(d) of the Bankruptcy Code provides that "the court shall disallow any claim of any entity from which property is recoverable under" § 550.[2] Thus, if a claimant who has been ordered to return property to the debtor's estate has not done so, that claimant is prevented from having a claim against the debtor unless the avoided transfer is returned.[3]

Where a creditor sells its claim, and that claim is subject to disallowance under § 502(d) because the seller had received an avoidable transfer, there have been conflicting decisions on who should bear the risk: the claim-purchaser (and likely the original creditor as a result of indemnification or repurchase obligations) or the bankruptcy estate. On the one hand, there is the district court decision in *In re Enron Corp*. ("*Enron II*"),[4] which held that § 502(d) imposes a personal disability on a claim that does not transfer with the claim to the purchaser when it is sold. Thus, under *Enron II*, the claim-purchaser would not bear the risk of having the purchased claim disallowed under § 502(d).

On the other hand, there is the Third Circuit Court of Appeals's decision in *In re KB Toys Inc*.,[5] which rejected *Enron II* and held that a claim subject to disallowance under § 502(d) in the hands of the original claimant is also disallowable in the hands of a transferee claims-purchaser. The recent decision in *In re Firestar Diamond Inc*.[6] rejected the *Enron II* decision and aligned itself with *KB Toys* and other more recent decisions on the issue.

Firestar Diamond Facts

Firestar Diamond Inc. and affiliated companies (the "debtors") filed for chapter 11 protection in the U.S. Bankruptcy Court for the Southern District of New York on Feb. 26, 2018. Prior to

1 *See Mellon Bank NA v. Dick Corp.*, 351 F.3d 290 (7th Cir. 2003).
2 11 U.S.C. § 502(d).
3 *See Cent. Va. Cmty. Coll. v. Katz*, 546 U.S. 356 (2006).
4 *In re Enron Corp.*, 379 B.R. 425 (S.D.N.Y. 2007).
5 *In re KB Toys Inc.*, 736 F.3d at 247 (3d Cir. 2013).
6 2020 Bankr. LEXIS 1089 (Bankr. S.D.N.Y. April 22, 2020).

the bankruptcy filing, Indian authorities announced criminal charges against Nirav Modi, the founder of Firestar, accusing him of perpetrating the largest bank fraud in Indian history. Mr. Modi and his co-conspirators allegedly used various entities posing as independent third parties for sham transactions to import jewelry, gemstones and related goods, valued at billions of dollars, and obtained bank financing in the form of letters of understanding (LOUs) based on these fraudulent transactions.

The bankruptcy court appointed an examiner in the chapter 11 case to investigate the fraud, and the examiner determined there was substantial evidence that senior officers and directors of the debtors knew of, or were involved in, criminal conduct. As such, the court appointed a trustee over the debtors' estates in the proceedings.

Certain nondebtor affiliates (the "Firestar affiliates") had received millions of dollars in fraudulent transfers and preferences from the debtors that remained outstanding. Four Indian banks (the "banks") filed proofs of claim in the chapter 11 proceedings claiming to be owed millions of dollars. These claims arose from a transaction between the banks and the Firestar affiliates, pursuant to which the banks extended credit to these nondebtor affiliates secured by the rights the affiliates had under specific invoices allegedly owed by the debtors to the Firestar affiliates. As such, the banks' claims against the debtors were premised on the Firestar affiliates' claims for unpaid invoices, which were pledged to the banks.

The trustee objected to the banks' claims on the grounds that they should be disallowed under § 502(d). The trustee argued that the claims filed by the banks, based on the debtors' dealings with the Firestar affiliates, would be disallowed under § 502(d) if the claims had been filed by those affiliates instead of by the banks, because the Firestar affiliates had received potentially avoidable transfers.[7] The trustee relied on the reasoning of *KB Toys* and other aligned decisions for the proposition that a claim that would be disallowed under § 502(d) in the hands of an original creditor is also subject to disallowance in the hands of a transferee.

In response, the banks relied heavily upon *Enron II*, arguing that because their claims were acquired through a "sale" and not an "assignment," § 502(d) does not apply to the transferred claims. Therefore, the claims could not be disallowed on that ground.

Firestar adopted the reasoning of *KB Toys*. Like a number of other courts, *Firestar* was not persuaded by the *Enron II* analysis and held that § 502(d) "follows the claim, not the claimant."[8]

Discussion of *Enron II*

The bankruptcy court in *Firestar* first considered the *Enron II* decision, which was rendered by a district court in its district. In *Enron II*, the court concluded that disallowance under § 502(d) is a personal disability of the original claimant and not an attribute of the claim.[9] The *Enron II* court found that the plain language of § 502(d) supported its conclusion, observing that the section requires the disallowance of "any claim of any entity from which property is recoverable ... or that is a transferee of a transfer avoidable ... unless *such entity* or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable."[10] The *Enron II* court focused on the "such entity" *proviso* to hold that "the language and structure of the statute is plain, and requires [that] the entity that is asserting the claim be the same entity (*i.e.*, "such entity") that is liable for the receipt of and failure to return property."[11]

The *Enron II* court further concluded that any disallowance under § 502(d) of a transferee's claim depends on "the nature of the transfer."[12] The court reasoned that a transfer by assignment will not grant the assignee more rights than possessed by the assignor, but the court noted that these principles of assignment law do not apply to a sale transaction.[13] Thus, the court opined, "[a] personal disability that has attached to a creditor who transfers its claim will travel to the transferee if the claim is *assigned*, but will not travel if the claim is *sold*."[14]

As observed by *Firestar*, the *Enron II* court also found that the purpose of § 502(d) is to coerce the return of assets obtained by preferential transfer. *Enron II* stated that this purpose "would not be served if a claim in the hands of a claimant could be disallowed, even where that claimant never received the preference to begin with, and as a result, could not be coerced to return it."[15] The *Enron II* court observed that § 502(d)

> was not intended to punish, but rather to give *creditors* an option to keep *their* transfers (and hope for no action by the trustee) or to surrender *their* transfers and their advantages and share equally with other creditors. Applying section 502(d) to purchasers of claims would be punitive because they have no option to surrender something they do not have, which means they have not personally obtained any advantage that they could surrender.[16]

KB Toys Discussion

However, the *Firestar* court found the Third Circuit's reasoning in *KB Toys* more persuasive. In *KB Toys*, the court's analysis also began with the text of the statute. The court focused on the first part of § 502(d), which requires a court to "disallow *any claim of any entity* from which property is recoverable" under the avoidance provisions of the Bankruptcy Code. The Third Circuit held that the plain language of § 502(d) therefore "focuses on claims — and not claimants" and that "claims that are disallowable under [section] 502(d) must be disallowed no matter who holds them."[17] Interestingly, the *KB Toys* court also looked to the purpose of § 502(d) to support its conclusion. As *Firestar* observed:

> The Third Circuit warned that to "hold otherwise would contravene the aims of [Section] 502(d), the

7 The fact that there had not yet been any adjudication that the transfers at issue were avoidable or that an avoidance action had not even been commenced raises the issue of whether disallowance under § 502(d) had been triggered in *Firestar*, as it requires disallowance only if the claimant has not paid or returned amounts "for which such entity or transferee is liable." This issue was not addressed in *Firestar* and is beyond the scope of this article.

8 *Firestar*, 2020 Bankr. LEXIS 1089 at *14.

9 *See Firestar* (citing *Enron II*, 379 B.R. at 439-5).

10 11 U.S.C. § 502(d) (emphasis added).

11 *Enron II*, 379 B.R. at 443.

12 *Id.* at 445.

13 *Id.* at 436.

14 *Id.* (emphasis in original; citations omitted).

15 *Id.* at 443.

16 *Id.* at 443-44 (emphasis in original).

17 *KB Toys*, 736 F.3d at 252.

> first of which is to ensure equality of distribution of estate assets." As the Third Circuit explained, an alternative reading would permit an original claimant who received a voidable transfer to then "sell" the claim to a transferee, thereby allowing the original claimant to "wash" the claim of disabilities and get a (discounted) value for it. In return, the transferee of the original claimant would be able to take the property at issue free and clear of the trustee's powers. "To allow the sale to wash the claim entirely of the cloud 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."[18]

Therefore, both the *KB Toys* and *Enron II* courts interpreted the purpose of § 502(d) to support their respective conclusions. *KB Toys* focused on § 502(d) as a tool for the estate, and *Enron II* found that § 502(d) provides *creditors* with the option of how to proceed with their claims.

The *Firestar* court also considered the equities: Who should bear the risk of disallowance under § 502(d), the claim-purchaser or the bankruptcy estate? *Firestar* was persuaded by the reasoning of *KB Toys* and concluded that claim-purchasers should be the ones to bear the risk for two reasons:

> First, claim-purchasers "voluntarily choose to take part in the bankruptcy process" and are aware of the risks associated therein. Indeed, it is incumbent "on prospective assignees to take into account possible claim defenses when they negotiate the terms of their assignments." Second, claim-purchasers can mitigate their risk through due-diligence and indemnity clauses in the transfer agreement. But while informed claims traders have the ability to reduce and mitigate risk, creditors in a bankruptcy [proceeding] have no way to protect themselves against the risk that claims with otherwise avoidable transfers will be washed clean by a sale or assignment.[19]

Conclusion

Firestar is the latest shift in the trend away from the *Enron II* decision, such that creditor claims acquired from sellers who received avoidable transfers may be subject to disallowance under § 502(d).[20] Whether *Firestar* will cause any change in the practices of the claims-trading industry, and the agreements they use to document the transfers, remains to be seen. While there is not yet binding authority in the Second Circuit, the weight of authority in the circuit now appears to be on the side of disallowance under § 502(d) following the claim.

With the Third Circuit Court of Appeals having spoken on the issue in *KB Toys*, claim-purchasers should be well prepared for the potential disallowance of their claims under § 502(d) in two of the most active claims-trading jurisdictions. Section 502(d) can result in disallowance of a claim in full regardless of the size of the avoidable transfer. Thus, for example, a claim for $1 million could be disallowed under § 502(d) on account of an avoidable transfer of just $10,000. While the existing claims-trading practice typically attempts to shift the risk of loss in this situation back to the original creditor through indemnification and repurchase provisions, these provisions and the scope of due diligence, particularly for larger claim purchases, might need to be strengthened and reevaluated in light of *Firestar*. abi

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18 *Firestar* at *11-12 (citing *KB Toys*, 736 F.3d at 252) (internal citations omitted).
19 *Firestar* at *19 (citing *KB Toys*).
20 *See, e.g., In re Motors Liquidation Co.*, 529 B.R. 510, 572, n.208 (Bankr. S.D.N.Y. 2015); *In re Wash. Mut. Inc.*, 461 B.R. 200, 256 n.44 (Bankr. D. Del. 2011), *vacated in part on other grounds*, 2012 Bankr. LEXIS 895, 2012 WL 1563880 (Bankr. D. Del. Feb. 23, 2012); *see also In re Metiom Inc.*, 301 B.R. 634, 643 (Bankr. S.D.N.Y. 2003).