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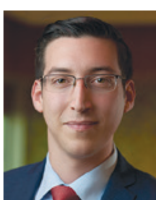
Claims Buyers Beware: Your Shiny New Claim May Face Avoidance Risk

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The claims trading market provides a useful avenue for creditors who seek to quickly monetize their prepetition claims in bankruptcy cases. Rather than waiting out the bankruptcy process with the hope of obtaining a recovery from the bankruptcy estate, creditors may obtain an immediate recovery by selling their claims at a discount. Claims buyers are willing to purchase claims for less than the claims' face value for a number of reasons. They may expect that the bankruptcy estate's eventual distribution on account of the purchased claims will exceed the price they paid for the claims. Alternatively, they may believe there is an opportunity to receive equity in the reorganized debtor, or they may seek to influence a debtor's reorganization by obtaining a significant portion of the debtor's capital structure.

While a claims buyer purchases the right to receive whatever distribution is made on the purchased claim, the claims buyer also bears the risk that it will receive less than anticipated with respect to the purchased claim or that the purchased claim will be disallowed entirely. This risk has been exacerbated by a recent decision of the United States Bankruptcy Court for the Southern District of New York—a very active jurisdiction for claims trading—in the Chapter 11 cases of *In re Firestar Diamond, Inc.* In *Firestar*, the bankruptcy court rejected a prior decision by the United States District Court for the Southern District of New York and joined the growing majority of courts that have held that a purchased claim may be disallowed under Bankruptcy Code Section 502(d) where the claim seller had received, and had not returned, an avoidable transfer (such as a preference or fraudulent transfer).

Opposing Views on Section 502(d): *Enron* and *KB Toys*

As prudent creditors are well aware, the Bankruptcy Code grants certain "avoidance" powers to bankruptcy trustees and debtors-in-possession. Bankruptcy Code

Section 547(b) grants the power to avoid preferential payments made within 90 days of the bankruptcy filing (or within one year of the bankruptcy filing, if the recipient is an insider of the debtor). Bankruptcy Code Section 548(a) grants the power to avoid fraudulent transfers made within two years of the bankruptcy filing. Bankruptcy trustees and debtors-in-possession may also assert causes of action pursuant to state law fraudulent transfer statutes that have longer statutes of limitation.

Bankruptcy Code Section 502(d) provides for the disallowance of any claim asserted by an entity that has received, and not turned over, an avoidable transfer (such as a preference or fraudulent transfer). Section 502(d) states, in pertinent part:

> [T]he court shall disallow any claim of any 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.

In 2007, the United States District Court for the Southern District of New York ruled, in the *Enron* bankruptcy cases, that claims buyers are free from any risk of disallowance under Section 502(d) where the claims seller had received an avoidable transfer. The *Enron* court concluded that disallowance under Section 502(d) is a "personal disability of the specific claimant and not an attribute of a claim" and any disallowance of a transferee's claim under Section 502(d) depends upon the nature of the transfer. Drawing a distinction between whether the claim was "assigned" or "sold," the court explained that "[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.*" The court's decision flowed from its policy consideration that the purpose underlying Section 502(d) is not served by disallowing a claim held by a claims buyer. While Section 502(d) is intended to coerce recipients of avoidable transfers to return the transferred property, a third-party claims buyer has nothing to return to the estate because the claims buyer was not the recipient of the avoidable transfer.

In 2013, the United States Court of Appeals for the Third Circuit (the "Third Circuit") issued a decision in the *KB Toys* bankruptcy cases that explicitly rejected the *Enron* court's holding. The Third Circuit explained that the *Enron* court's distinction between "assignments" and "sales" is problematic because it has no support in the Bankruptcy Code. The Bankruptcy Code does not distinguish between the two terms and, instead, appears to include both assignments and sales in its definition of "transfer." The Third Circuit also concluded that policy considerations weigh in favor of applying Section 502(d)'s disallowance to claims held by third-party transferees. Otherwise, recipients of avoidable transfers could "wash" their claims by simply selling the claim to a third-party transferee who would then take the claim free and clear of the Bankruptcy Code's avoidance powers. The Third Circuit believed this result would contravene the primary goal of Section 502(d) to ensure "equality of distribution of estate assets." Numerous other courts and respected bankruptcy pundits share the Third Circuit's view on Section 502(d).

Background Regarding the *Firestar* Decision

On February 26, 2018, jewelry wholesalers Firestar Diamond, Inc., Fantasy, Inc., and A. Jaffe, Inc. (collectively, the "Debtors")—U.S. corporations owned by Nirav Modi—filed their Chapter 11 cases in the United States Bankruptcy Court for the Southern District of New York. Less than one month before the bankruptcy filing, Punjab National Bank ("PNB") filed a complaint against 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 Letters of Understanding to obtain approximately $4 billion in financing from the victimized banks. These allegations resulted in the appointment of an examiner in the *Firestar* Chapter 11 cases, who concluded that the Debtors had been involved in the criminal conduct alleged by PNB and the Indian authorities. As a result, the United States Trustee and PNB sought and obtained the appointment of a Chapter 11 trustee (the "Trustee") to administer the Debtors' estates.

Against this backdrop, the Trustee filed objections to proofs of claim filed by a number of Indian banks (collectively, the "Banks"). The Banks' claims were not based on any direct dealings with the Debtors. Rather, the claims reflected amounts that the Debtors owed to three non-debtor affiliates of the Debtors (the "Non-Debtor Entities"). Each of the Non-Debtor Entities had pledged its receivables or sold invoices owed by the Debtors to the applicable claimant Bank.

The Trustee argued that the Banks' claims were barred under Bankruptcy Code Section 502(d) because the initial transferees of the Banks' claims—the Non-Debtor Entities—had each received millions of dollars in avoidable fraudulent transfers and preferences from the Debtors that were not repaid. Relying on *Enron*, the Banks asserted they acquired the claims through a "sale" rather than an "assignment." Therefore, the Banks argued, the Trustee's fraudulent transfer and preference claims were not grounds for disallowing the claims after the claims had been transferred to the Banks since disallowance under Section 502(d) is personal to the Non-Debtor Entities and did not travel with the claims.

The Bankruptcy Court's Decision

The *Firestar* bankruptcy court rejected the *Enron* decision and disallowed the Banks' claims based on Section 502(d). The court concluded that Section 502(d) "focuses on claims [...] and not claimants" and, therefore, "claims that are disallowable under [Section] 502(d) must be disallowed no matter who holds them." The claims the Banks had acquired from the Non-Debtor Entities were subject to disallowance while they were held by the Non-Debtor Entities and should remain subject to disallowance following their transfer to the Banks.

The *Firestar* court noted that in *KB Toys*, the Third Circuit had rejected the *Enron* court's distinction between "assignments" and "sales" because the distinction has no support in the Bankruptcy Code. Additionally, the court agreed with the Third Circuit's conclusion that Section 502(d) applies to purchased claims because an alternative interpretation would contravene the underlying purpose of Section 502(d) to ensure equality of distribution of estate assets. It would be inequitable to allow a recipient of a fraudulent transfer to "wash [its problematic] claim entirely" by selling the claim, while depriving the bankruptcy estate of one of its valuable asset-collection tools—its right under Section 502(d) to seek disallowance of claims that are asserted by recipients of avoidable transfers.

The *Firestar* court rejected the Banks' policy argument that disallowing their claims would "wreak havoc in the claims trading market or unfairly punish good faith transferees." The court reasoned that claims purchasers, not the bankruptcy estate and its innocent creditors, should bear the risk that a claims seller may have received an avoidable transfer. Claims purchasers "voluntarily choose to take part in the bankruptcy process," and, therefore, claims purchasers should: (1) take into account possible claim defenses when negotiating an assignment or purchase of a claim, and (2) mitigate their risk through due diligence or indemnity clauses in their transfer agreements. In contrast, "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."

The Banks have appealed the *Firestar* court's order disallowing their claims. Among other things, the Banks argue that the bankruptcy court erred by: (i) disallowing the claims where the Banks were *bona fide* purchasers for value, (ii) overlooking that the Banks had a direct right to recovery from the Debtors in light of the Debtors' acceptance of the Banks' pledged invoices, (iii) failing to follow the *Enron* holding, and (iv) conducting an "inherently flawed analysis" with respect to its policy considerations. It is also worth noting that the bankruptcy court never addressed whether the Non-Debtor Entities had pledged or otherwise assigned (and not sold) the claims to the Banks, in which event the claims would have been subject to disallowance under Section 502(d) even according to the holding in the *Enron* cases. These issues may all be fleshed out as the appeal proceeds.

Conclusion

The bankruptcy court's holding in *Firestar* has certainly increased the likelihood that a court may disallow claims acquired from recipients of avoidable transfers, such as preferences and fraudulent transfers from a debtor, notwithstanding the continuing division of authority within the Southern District of New York over whether transferees' claims are subject to disallowance under Bankruptcy Code Section 502(d). The persuasiveness of the Southern District of New York's holding in *Enron* appears to be fading as the decision has been rejected by multiple other courts, including the United States Court of Appeals for the Third Circuit in *KB Toys* and the United States Bankruptcy Court for the Southern District of New York in *Firestar*. The Banks' appeal of the bankruptcy court's order in *Firestar* will provide an opportunity for the United States District Court for the Southern District of New York to either further diminish, or breathe new life into, its prior decision in *Enron*.

In any event, purchasers of claims in bankruptcy cases outside of the Third Circuit (which covers Delaware, New Jersey, and Pennsylvania) should continue to structure their transfer agreements as "sales" in case the bankruptcy court chooses to follow the *Enron* court's ruling. However, claims buyers should also prepare themselves for the possibility that a court will reject the *Enron* holding altogether. Claims buyers should be vigilant by: (i) conducting due diligence by reviewing the debtor's schedules and statements and investigating the selling creditor's relationship and transactions with the debtor, (ii) ensuring that the agreement governing the sale of the claim contains restitution and indemnification provisions in the event the claim is subject to disallowance, and (iii) ensuring that the purchase price of the claim takes into account the risk of disallowance.