ALERT MEMORANDUM

Buyer Beware! Claims Disabilities Travel with Transfers

April 29, 2020

Claims trading is a big business in the bankruptcy world. Even so, relatively few courts have grappled with the issue of whether debtors' defenses to proofs of claim, such as disallowance or equitable subordination, can be enforced against third party claims purchasers to the same extent they would be enforceable against the original holder of the claims. For many years, the leading cases have been the *Enron II* case in the U.S. District Court for the Southern District of New York ("SDNY") and the *KB Toys* case in the U.S. Court of Appeals for the Third Circuit. In *Enron II*, the district court ruled that a "sale" would allow the transfer of a claim to a third party free of any prior disability but an "assignment" would not. In *KB Toys*, the Third Circuit rejected *Enron II*'s reasoning, ruling instead that a claim's disabilities "travel" with the claim regardless of whether the transfer is deemed a sale or an assignment. Recently, Judge Sean H. Lane of the SDNY bankruptcy court faced this issue in *In re Firestar Diamond, Inc.*,[1] ultimately agreeing with the Third Circuit that claim disabilities "travel" with the claim, regardless of whether the purchase was made in good faith. The *Firestar* decision helps build growing consensus against the *Enron II* analysis, and counsels that purchasers of claims should not count on claims trading to avoid defenses stemming from the original creditors' conduct. Instead, secondary purchasers should obtain customary protections in claims documentation, including "no bad acts" representations and indemnities and put back rights for breaches of representations.

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors.

NEW YORK

Sean A. O'Neal
+1 212 225 2416
soneal@cgsh.com

Lisa M. Schweitzer
+1 212 225 2629
lschweitzer@cgsh.com

Luke A. Barefoot
+1 212 225 2829
lbarefoot@cgsh.com

Jane VanLare
+1 212 225 2872
jvanlare@cgsh.com

Rahul Mukhi
+1 212 225 2912
rmukhi@cgsh.com

Kara A. Hailey
+1 212 225 2197
khaileyi@cgsh.com

Ryan Yeh
+1 212 225 2924
ryeh@cgsh.com

Thomas Lynch
+1 212 225 2566
tlynch@cgsh.com

[1] Case No. 18-10509 (SHL) (Bankr. S.D.N.Y. Apr. 22, 2020).

Background and Procedural History

On February 26, 2018, Firestar Diamond, Inc., Fantasy, Inc., and A. Jaffe, Inc. (collectively "Firestar" or "the Debtors") filed for Chapter 11 protection in the SDNY Bankruptcy Court (the "Court").[2] Firestar was mainly a wholesaler of fine jewelry to department stores, specialty chain stores, wholesale clubs, and U.S. armed services bases.

Firestar filed for Chapter 11 after Indian authorities initiated a criminal investigation into Nirav Modi, the principal of Firestar's ultimate corporate parent, for the "largest bank fraud in Indian history." A court-appointed bankruptcy examiner in the Chapter 11 case investigated the Debtors' involvement with the alleged fraud and found substantial evidence that the Debtors had knowledge of the alleged criminal conduct.[3] As a result of the Debtors' involvement in the fraud, and certain communications between Modi and the Debtors during the Chapter 11 proceeding, the Court appointed a Chapter 11 Trustee (the "Trustee") to oversee the Debtors' affairs.

In April 2018, certain Indian banks (collectively, the "Banks") filed millions of dollars of claims in Firestar's Chapter 11 proceeding. The Banks had all entered into "pledge" agreements with various non-debtor entities controlled by Modi (the "Shadow Entities").[4] Under the terms of these agreements the Banks extended credit to the Shadow Entities, secured by the entities' rights under specific invoices for amounts allegedly owed by Firestar to the Shadow Entities. The Banks filed claims against Firestar seeking payment of the invoices.

The Trustee objected to the Banks' claims in October, 2019, arguing that they were barred under § 502(d) of the Bankruptcy Code because, notwithstanding whether the Banks had acquired the claims through a "sale" or a "transfer", the disabilities arising from the Shadow Entities' fraudulent activities had traveled with the claim.[5] The Banks responded to the Trustee's objections in November, 2019, arguing that § 502(d) disallowance was a personal liability which had been washed away following the sale of the claims.[6]

Prior Decisions on "Travelling" Disabilities

Enron v. Ave. Spec. Situations Fund II (In re Enron)

After Enron's Chapter 11 filing, a number of its creditors sold their claims against Enron. Enron brought actions against the claims purchasers seeking: (1) equitable subordination of the purchasers' claims under § 510(c), and; (2) disallowance of the claims under § 502(d).

SDNY Bankruptcy Court Judge Arthur Gonzalez considered whether Enron could assert disallowance and equitable subordination against the claims purchasers in two separate published opinions, one addressing § 502(d) ("*Enron I*")[7] and the other addressing § 510(c).[8] Judge Gonzalez held that claim disabilities under both §§ 502(d) and 510(c) traveled with the claim. He focused on the text and legislative history of the Bankruptcy Code provisions to arrive at this decision, in addition to a policy against allowing claims holders to "wash" their claims of disabilities and profit from that activity simply by selling them to third parties. Judge Gonzalez also noted that participants in the claims trading market "assume the liabilities arising from the claims when participating in the claims-transfer market."[9] He stated that distressed debt investors are sophisticated parties with tools at their disposal for managing risk, such as including

2 Cleary Gottlieb Steen & Hamilton represents Punjab National Bank in the Chapter 11 proceeding but did not represent a party in the claims objection litigation or decision described herein.

3 *Id.* at 3–4.

4 *See e.g.*, Trustee's Objection to Filed Claim of Union Bank of India (UK) Ltd. *In re Firestar Diamond, Inc., et al.*, Dkt. No. 1161, at 4.

5 *Id.*

6 Trustee's Reply in Support of Objection to Filed Claim of Union Bank of India (UK) Ltd., *In re Firestar Diamond, Inc. et al.*, Dkt. No. 1232, at 2.

7 *Enron v. Ave. Spec. Situations Fund II (In re Enron) [Enron I]*, 340 B.R. 180 (Bankr. S.D.N.Y. 2006).

8 *Enron v. Ave. Spec. Situations Fund II (In re Enron)*, 333 B.R. 180 (Bankr. S.D.N.Y. 2005).

9 *Enron I*, 340 B.R. at 202.

indemnification provisions in purchase agreements and demanding discounts when purchasing claims.[10]

On appeal, U.S. District Judge Shira Scheindlin overturned the bankruptcy court and rejected its analysis ("*Enron II*").[11] The district court concluded that disallowance and equitable subordination were "personal disabilities" that attached to the claimant rather than to the claim itself. Therefore, whether a disability traveled with a claim turned on whether the transfer was a "sale" or an "assignment." The district court held that disabilities would only travel with an "assignment" whereas a "sale" would permit the purchaser to take the claim free of any disability.[12] However, the district court noted that this analysis would not apply to bad faith claims purchasers and that purchasers with actual knowledge of the seller's receipt of an avoidable transfer may still be subject to equitable subordination.[13] The *Enron II* decision has been roundly criticized, including by the *KB Toys* court.[14]

In re KB Toys, Inc.[15]

Several years post-*Enron II*, the Third Circuit analyzed a similar question when it considered whether trade claims, purchased post-petition by third parties, remained subject to § 502(d) disallowance. The purchased trade claims were originally subject to disallowance as avoidable preferences paid by the debtors within 90 days of the bankruptcy filing. The bankruptcy court, district court, and appellate court in *KB Toys* all rejected the analysis in *Enron II* and followed the reasoning in *Enron I*.

Specifically, the Third Circuit held that claims that are disallowable under § 502(d) must be disallowed no matter who holds them, unless and until the preferential payment has been returned to the estate.[16] The Third Circuit noted that holding otherwise would negatively impact creditors by limiting the amount of money returned to the estate and by forcing the estate to pay on a claim that would otherwise have been disallowed. The Third Circuit reasoned that allowing this type of "claim washing" undercut the aims of § 502(d).[17] In addition, the Third Circuit rejected the claims purchasers' "good faith" defense because claims purchasers do not purchase property of the estate, but rather claims against the estate.[18]

In re Firestar Diamond, Inc.

In *Firestar*, the Trustee argued that, consistent with the reasoning of *KB Toys*, the claims should be disallowed because the Banks were "stepping into the shoes" of wrongdoers (the so-called "Shadow Entities") and, therefore, the claims were subject to any defenses available to Firestar against the Shadow Entities.[19] Further, because the Shadow Entities were participants in the fraud, the Trustee argued it would be inequitable to force Firestar's creditors to effectively pay claims against the Shadow Entities. The Trustee also argued that the claims should be disallowed because the transactions between the Shadow Entities and the Banks were not sales and, therefore, the *Enron II* analysis did not apply.[20] Finally, the Trustee argued that the Court should reject the *Enron II* analysis and hold that disabilities travel with a claim. Echoing the Third Circuit, the Trustee stated that doing so would solve the "problematic" assignment/sale distinction set forth in *Enron II* and support the purposes of § 502(d).[21]

The Banks, on the other hand, argued that § 502(d) disallowance did not apply. Relying on *Enron II*, the Banks stated that § 502(d) disallowance is a personal disability that does not necessarily travel with a

10 *Id.* at 204 n.23.
11 *Enron v. Springfield Associates (In re Enron) [Enron II]*, 379 B.R. 425, 437–49 (S.D.N.Y 2007).
12 *Id.* at 435.
13 *Id.* at 442, 445.
14 *See, e.g., In re Motors Liquidation Co.*, 529 B.R. 510, 572 (Bankr. S.D.N.Y. 2015) (criticizing *Enron II*'s assignment/sale distinction as "problematic").
15 736 F.3d 247, 250 (3d Cir. 2013).
16 *Id.* at 252.
17 *Id.* at 252–53.
18 *Id.* at 255.
19 *See, e.g.*, Trustee's Reply in Support of Objection to Filed Claim of Union Bank of India (UK) Ltd., *In re Firestar Diamond, Inc., et al.*, Dkt. No. 1232, at 2.
20 *Id.* at 3–4 (arguing the transactions were secured loans).
21 *Id.* at 4–7, 6.

claim.[22] The Banks urged the Court to look to the nature of the pledge agreements to determine the applicability of § 502(d) defenses rather than assuming that the defenses travel with the claims. Further, the Banks contended that § 502(d) was not applicable to good faith transferees because it would be "punitive" in nature.[23] Finally, the Banks argued that if the massive fraud alleged by the Trustee proved to be true then, as innocent victims of the fraud, it would be inequitable to disallow their claims.[24]

The Opinion

Jude Lane rejected the Banks' arguments and disallowed their claims.[25] The Court first discussed the analysis of *Enron II* before stating that it found "more persuasive the analysis of courts that reached the opposite result."[26] The Court agreed with the Third Circuit that § 502(d) focuses on claims—not claimants—and therefore disallowable claims must be disallowed no matter who holds them. The Court also echoed the Third Circuit's concern that an alternate holding would contravene the purpose of § 502(d) by allowing an original claimant to "wash" a claim of disabilities and sell it in order to get a (discounted) value for it, while the transferee took the property free and clear of the disability. In addition, the Court was persuaded by the Third Circuit's evaluation of *Enron II*'s assignment/sale distinction as "problematic."[27] The Court also rejected the Banks' equitable argument that it should allow the Banks' claims because they were innocent victims of the Debtors' fraud.[28]

Finally, the Court rejected the argument that it should allow the claims because to do otherwise would "wreak havoc in the claims trading market or unfairly punish good faith transferees."[29] Turning again to *KB Toys*, the Court was persuaded that claims purchasers, who voluntarily take part in the bankruptcy process, are aware of the associated risks and should take them into account when negotiating their agreements.[30] The Court also pointed out that, while informed claims traders have the ability to mitigate their risk through due diligence and indemnity clauses, creditors in a bankruptcy have no way to protect themselves against the risks of claims being "washed" through a sale or assignment.[31] Although the Court's rulings obviated the need for it to consider whether the transactions underlying the claims at issue were "sales" or "assignments," it did note that there was reason to think that some or all of the transactions would not be considered "sales" under *Enron II* and thus would still be subject to disallowance under § 502(d).[32]

Implications

The Court's decision, although non-binding on other New York courts, is another nail in the coffin of *Enron II*. By rejecting *Enron II's* reasoning, *Firestar* provides a brighter-line rule than the "problematic" assignment/transfer analysis. Like the *Enron I* court, the *Firestar* court makes it clear that claims traders should not count on claims transfers to "wash" claims. Nor should they take comfort as "good faith purchasers." As a result, secondary market purchasers must take care to obtain customary protections in claims trading documentation, including standard "no bad acts" representations and indemnities and put back rights for breaches of representations. Moreover, claims purchasers will need to evaluate credit risks associated with the transferor's financial wherewithal to satisfy such remedies when pricing claims purchases.

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CLEARY GOTTLIEB

22 Response of Union Bank of India (UK) Ltd. in Opposition to the Chapter 11 Trustee's Objection, *In re Firestar Diamond, Inc., et al.*, Dkt. No. 1215, at 5–6.
23 *Id.* at 6–7.
24 *Id.* at 6.
25 Memorandum of Decision, *In re Firestar Diamond, Inc., et al.*, Dkt. No. 1482, at 2.
26 *Id.* at 9.
27 *Id.*
28 *Id.* at 12–13.
29 *Id.* at 13.
30 *Id.* at 14 (citing *In re KB Toys, Inc.*; *Enron I*; *In re Metiom, Inc.*, 301 B.R. 634 (Bankr. S.D.N.Y. 2003)).
31 *Id.*
32 *Id.* at 14–15.