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Open Questions Regarding Disallowance Under Section 502(d)

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The intra-district divide in the Southern District of New York continued to deepen on the issue of whether claims disallowance under section 502(d) of the Bankruptcy Code applies to the claim or to the claimant, with the recent decision from a S.D.N.Y. bankruptcy court disagreeing with the S.D.N.Y. district court decision in *In re Enron Corp.*, 379 B.R. 425 (S.D.N.Y. 2007) (*Enron II*). *See, In re Firestar Diamond, Inc.*, 2020 WL 1934896, — B.R. — (Bankr. S.D.N.Y. Apr. 22, 2020) (*Firestar*).

Under Section 502(d) of the Bankruptcy Code, any claim of an entity that received an avoidable transfer and that has not repaid the amount of the avoidable transfer shall be disallowed. 11 U.S.C. §502(d). If, however, the claim was transferred by the original creditor so that the entity holding the claim is not the entity that received an avoidable transfer, can the claim still be disallowed under Section 502(d) of the Bankruptcy Code? The district court in *Enron II* held that the answer depends on whether the claim was acquired through a sale or an assignment. *Enron II* reasoned that, because disallowance under Section 502(d) is a disability applicable to the claimant and is not an attribute of the claim, a sale of the claim cleanses the disability. *Enron II*, 379 B.R. at 443-45. According to *Enron II*, an assignment of the claim, however, does not purge the disability because the assignee stands in the shoes of the assignor. *Id.* at 439.

One court in a published decision (which was reversed on other grounds) has approvingly cited to *Enron II* in support of this proposition. But several courts (including the Third Circuit Court of Appeals) have criticized *Enron II*. *Firestar* is the latest decision to reject the reasoning in *Enron II*. *Firestar* also presents an opportunity to consider another issue pertinent to section 502(d) that was not raised in that case: whether a judicial determination avoiding the underlying transfer is a condition to disallowance under section 502(d).

Does Section 502(d) Apply to the Claim or the Claimant

Enron II involved an appeal of an adversary proceeding commenced by Enron against third party distressed debt funds seeking to disallow claims originally held by Fleet National Bank. Before the adversary proceeding was filed against the claims purchasers, Enron had sued its bank lenders, including Fleet, for alleged fraudulent transfers and preferences, and that adversary proceeding was pending at the time without a judicial determination of the avoidability of the transfers to the banks. The claims purchasers filed a motion to dismiss the adversary complaint on the basis that, among other things, the claims they acquired from Fleet should not be disallowed under Section 502(d) because only Fleet, and not the claims purchasers and current holders of the claims, was being sued for fraudulent transfers and preferences that were unrelated to the claims Enron was seeking to disallow. Bankruptcy Judge Gonzalez denied the motion to dismiss and held that "the transfer of a claim subject to disallowance in the hands of the transferor remains subject to disallowance in the hands of a transferee." *In re Enron Corp.*, 340 B.R. 180, 210 (Bankr. S.D.N.Y. 2006) (*Enron I*).

On appeal, District Judge Scheindlin vacated and remanded *Enron I*. She held that disallowance under Section 502(d) is a personal disability of the claimant and not an attribute of the claim, and thus the method of transfer of the claim will affect whether a transferee of the claim will be subject to disallowance under Section 502(d). A transferee who acquires a claim through a sale will not be subject to the disabilities of the transferor, but a transferee who acquires a claim by pure assignment stands in the shoes of the assignor and must take subject to disabilities personal to the transferor, including disallowance under Section 502(d). *Enron II*, 379 B.R. at 443-45.

The only case to cite *Enron II* for the proposition that Section 502(d) disallowance is a personal disability of the transferor, and the disability is only transferred through an assignment of the claim, is *Longacre Master Fund Ltd v. ATS Automation Tooling Sys., Inc.*, 456 B.R. 633 (S.D.NY. Aug. 4, 2011). *Longacre* involved a claims trader asserting its put back rights after a claim it purchased became subject to an omnibus objection that preserved the debtor's right to object to claims pending conclusion of related avoidance actions. The claims trader argued the objection was an "impairment" that triggered its put back right. The court in *Longacre* found that there was no impairment, because, among other things, even if a section 502(d) disallowance was sought, the claims trader's claim would not be impaired because, pursuant to the holding in *Enron II*, the claim was acquired by sale and thus not subject to disallowance under section 502(d). *Longacre Master Fund Ltd v. ATS Automation Tooling Sys., Inc.*, 456 B.R. at 640.

The Second Circuit vacated *Longacre* on other grounds, without addressing whether the holding in *Enron II* would have shielded the claims trader from disallowance. *See, Longacre Master Fund Ltd v. ATS Automation Tooling Sys., Inc.*, 496 Fed. Appx. 135 (2d Cir. Sep. 14, 2012). But the Second Circuit did note that the district court held that a claim objection was not an impairment because "section 502(d) objections *purportedly* do not attach to the claim itself and thus do not encumber a purchaser." *Longacre Master Fund Ltd v. ATS Automation Tooling Sys., Inc.*, 496 Fed. Appx. at 137-38 (emphasis added) (citing *Enron II*). Thus, the Second Circuit's citation to *Enron II* is not necessarily an endorsement of its holding. It is unclear whether the "purportedly" language represents skepticism about *Enron II*'s conclusion.

On the other hand, several courts have expressly rejected or criticized *Enron II*, most notably the Third Circuit Court of Appeals in *In re KB Toys, Inc.*, 736 F.3d 247 (3d Cir. 2013) (*KB Toys II*). *See also, In re Motors Liquidation Co.*, 529 B.R. 510 (Bankr. S.D.N.Y. 2015), *vacated in part on other grounds*, 590 B.R. 39 (S.D.N.Y. 2018); *In re KB Toys, Inc.*, 470 B.R. 331 (Bankr. D. Del. 2012) (*KB Toys I*); *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). In *KB Toys*, a litigation trustee filed objections to claims purchased by a claims trader from original claimants. The trustee sought disallowance of the claims under Section 502(d) on the grounds that the trustee already had obtained judgments for preferences against the original claimants, which remained unpaid. The claims trader had purchased all but one of the claims before the preference actions were filed. The bankruptcy court sustained the trustee's claims objections and disallowed the claims under Section 502(d). On appeal, the Third Circuit affirmed the bankruptcy court's decision and expressly rejected the reasoning of *Enron II*. The Third Circuit held that, because Section 502(d) "focuses on claims — and not claimants — claims that are disallowable under 502(d) must be disallowed no matter who holds them." *KB Toys II*, 736 F.3d at 252. The court described *Enron II*'s distinction between an assignment and a sale as determinative of whether Section 502(d) could apply as "problematic." *Id.* at 254.

Firestar Rejects *Enron II*

Bankruptcy Judge Lane's decision in *Firestar* is the most recent rejection of *Enron II*. Firestar Diamond, Inc. (collectively with its affiliated debtors, Firestar) was a diamond wholesaler that entered bankruptcy following a criminal investigation of an alleged massive fraud perpetrated by Nirav Modi, the principal of Firestar's ultimate parent. Early in Firestar's Chapter 11 case, the bankruptcy court appointed an examiner, who found substantial evidence of the involvement of Firestar and its senior officers and directors in criminal conduct under investigation in India. Thereafter, the bankruptcy court appointed a Chapter 11 trustee (the Trustee) for Firestar.

The Trustee filed objections to proofs of claim filed by four banks (the Claimants) based on receivables or invoices they acquired from three non-debtor entities that held claims against Firestar. The three non-debtor entities — Firestar Diamond International Pvt. Ltd. (FDIPL), Firestar Diamond BVBA (BVBA), and Firestar Diamond FZE (FZE) — were affiliates (and thus, insiders) of Firestar, but they did not file any proofs of claim. The Trustee sought to disallow all of the proofs of claim filed by the Claimants on the basis that, among other things, FDIPL, BVBA, and FZE received millions of dollars of transfers that were avoidable as fraudulent transfers and preferences and that had not been repaid to Firestar's estates. The Trustee argued that the claims asserted by the Claimants were barred under Section 502(d) as if they were filed by FDIPL, BVBA, and FZE because the claims were based on Firestar's dealings with those entities. Relying almost exclusively on *Enron II*, the Claimants argued that any disability based on disallowance under Section 502(d) was personal to FDIPL, BVBA and FZE, from whom the Claimants acquired rights to payment through a sale, and did not travel with the claims that the Claimants had acquired.

The court in *Firestar* declined to follow the *Enron II* precedent, noting "[a] bankruptcy court in a multi-judge district is not bound by *stare decisis* to the decision of a single district judge in that district." *Firestar* at 4 n. 4 (citing *In re Jamesway Corp.*, 235 B.R. 329, 336 n.1 (Bankr. S.D.N.Y. 1999)). Instead, the court adopted wholesale the reasoning in *KB Toys II*, granted the Trustee's objections to the claims, and disallowed the claims of each of the Claimants pursuant to Section 502(d).

Is a Judicial Determination a Prerequisite to Disallowance Under Section 502(d)?

Although the court in *Firestar* was persuaded by *KB Toys II*, there is an important factual difference between the two cases that was not raised by the Claimants in *Firestar* or discussed in the decision. In *KB Toys*, the litigation trustee had already obtained unpaid judgments for preferences against the original holders of the claims before seeking to disallow the claims held by the claims trader that purchased the claims. Thus, the question of whether the trustee was required to first obtain a judicial determination of an avoidable claim under Section 502(d) was never at issue.

In *Firestar*, however, the pleadings filed by the litigants in the Firestar bankruptcy dockets indicate that the trustee had not obtained any judicial determination of the avoidability of transfers made to the underlying affiliated non-debtor entities. In fact, an adversary proceeding against FDIPL and BVBA (among other defendants) had only been commenced a few months before entry of the *Firestar* decision. The majority of courts hold that a judicial determination of the avoidability of the underlying transfer is a prerequisite to relief under section 502(d). *See, e.g., In re S. Produce Distribs., Inc.*, 2020 WL 1228719, at 3 (Bankr. E.D.N.C. Mar. 11 2020) ("[T]he weight of the authority holds that it is premature to disallow the [creditor's] claims under §502(d) prior to an adjudication on the

merits of the adversary proceedings.") (collecting cases); *In re FBI Wind Down, Inc.*, 2020 WL 1900454, at 30 (Bankr. D. Del. Apr. 17, 2020) (denying liquidating trustee's motion to disallow claim under Section 502(d) and noting that "[b]ecause the Court has not made a judicial determination as to any of the Disputed Transfers, Plaintiff remains unable to produce the requisite evidence for 502(d) relief"); *In re Pennysaver USA Publ'g, LLC*, 587 B.R. 445, 468 (Bankr. D. Del. 2018) ("Disallowing a claim under Section 502(d) requires a judicial determination that a claimant is liable. A debtor wishing to avail itself of this section's benefits must first obtain a judicial determination on the complaint.") (citations and footnotes omitted); *but see, Enron I*, 340 B.R. at 183 (denying dismissal of Section 502(d) claim because "a cause of action based on Section 502(d) should not be dismissed even though the court has not yet adjudicated an avoidance action concerning the unrelated transactions because a debtor may, in the form of either an objection to a proof of claim or commencement of an adversary proceeding, use Section 502(d) as a defense to the assertion of a claim"); *In re TMST, Inc.*, 518 B.R. 329, 357-58 (Bankr. D. Md. 2014) (denying motion to dismiss section 502(d) count because complaint stated cause of action for avoidance); *In re Covenant Partners, L.P.*, 531 B.R. 84, 100 (Bankr. E.D. Pa. 2015) (same). The failure of the Claimants to raise this argument in *Firestar* may have been a lost opportunity.

Conclusion

Firestar makes clear that it is not settled law, even in the Southern District of New York, whether a claim in the hands of a transferee is subject to disallowance under Section 502(d). The majority view follows the reasoning and conclusion of *KB Toys II*. It can be argued that *Firestar* expands the reach of *KB Toys II*, because the Claimants in *Firestar* were not claims traders that purchased claims post-petition, but lending institutions that acquired rights to payment pre-petition.

Moreover, *Firestar* should help to remind claims purchasers to raise every defense available to them in a Section 502(d) claims disallowance proceeding, including (if applicable) that the debtor or trustee must first obtain a judicial determination of the avoidability of a transfer to a relevant entity before relief under Section 502(d) can be granted.

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