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The *Firestar Diamond* Case Saga

Can a Claim Transferor that Received an Avoidable Transfer Wash Away Claim Disallowance Risk?

The market for the purchase and sale of bankruptcy claims has grown exponentially into a largely unregulated multibillion-dollar industry over the last several decades. A body of case law has developed surrounding the limitations on trading bankruptcy claims, especially focused on whether transferred claims can be disallowed based on the transferor's prior acts or omissions.

For nearly two decades, practitioners in the U.S. Bankruptcy Court for the Southern District of New York (SDNY) lacked guidance concerning the circumstances under which a transferred claim could be disallowed. Given the significant number of commercial bankruptcy filings in this jurisdiction, the lack of controlling precedent has created material uncertainties for market participants. In a series of decisions issued between April 2020 and May 2024 in the *In re Firestar Diamond Inc.* chapter 11 cases, both the SDNY Bankruptcy Court and, through appeals, the U.S. District Court for the Southern District of New York have provided some much-needed guidance.

First, these courts have adopted the majority view that the disallowance of a transferred claim is solely dependent on the attributes of the claim itself and not on the party asserting the claim. In other words, a claim transferee possesses no greater rights to allowance of its claim than the claim transferor. This bedrock principle eliminates a claimholder's ability to "wash" or "cleanse" a claim simply by transferring it to a third party.

Second, these courts have provided guidance concerning what constitutes a "transfer" of a claim and whether a creditor's pledge of its claim against a debtor, as part of the creditor's loan transaction with its lender that includes the granting of a security interest in the creditor's accounts receivable, is a "transfer" of a claim that is subject to § 502(d) disallowance. In doing so, these courts rejected the secured lenders' arguments that the underlying loan transaction created an independent direct obligation from the debtor to the lender/transferee, rather than just a transfer of a claim based on the grant of a security interest that is subject to disallowance.

Disallowance of Claims Pursuant to § 502(d)

Section 502 of the Bankruptcy Code empowers a bankruptcy court to reduce or disallow claims asserted against a debtor for enumerated reasons. Specifically, § 502(d) governs the disallowance of claims that are held by a creditor that received a preference, fraudulent transfer or other avoidable transfer that has not been repaid or returned to the debtor. The section provides, in relevant 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.[1]

This provision was enacted to coerce creditors to return or repay avoidable transfers to a debtor

1 11 U.S.C. § 502(d) (emphasis added).

before the creditor can receive a distribution. This furthers the goal of *pro rata* distributions to holders of similarly situated claims.

However, the goals and application of the § 502(d) disallowance process becomes more complicated when a claimholder that received an avoidable transfer that has not been returned then transfers the claim to a third party that did not receive an avoidable transfer from the debtor. The question becomes whether the transferred claim is subject to disallowance under § 502(d) even when the transferee did not receive an avoidable transfer.

The SDNY Bankruptcy Court addressed this issue in an April 2003 decision in *In re Metiom Inc.*,[2] holding that the transfer of a claim to a third party is irrelevant to disallowance of the claim based on the transferor's receipt of an avoidable transfer. The court noted that disallowance of a claim under § 502(d) "cannot be altered by the claimant's subsequent assignment of the claim to another entity."[3]

Three years later, in *In re Enron Corp. (Enron I)*,[4] the SDNY Bankruptcy Court similarly rejected a claim transferee's argument that § 502(d) "does not focus on the claims, but on who holds the claims."[5] Following the same statutory interpretation and reasoning of *Metiom*, the *Enron I* court ruled that "there is no basis to find or infer that a transferee should enjoy greater rights than the transferor."[6]

This § 502(d) jurisprudence was thrown into disarray when the *Enron I* decision was appealed to the SDNY District Court. The district court, in its 2007 *Enron II* decision, reversed *Enron I*'s holding and noted that claim disallowance under § 502(d) is a personal disability of the original claimant and is not an attribute of the claim itself.[7]

The *Enron II* court also stated that the disallowance of a transferred claim pursuant to § 502(d) depends on the manner in which the claim was transferred. The court ruled that a claim could be "sold" free and clear of the transferor's § 502(d) disabilities (*i.e.*, the transferor's avoidance liability). By contrast, an "assignment" of a claim is subject to § 502(d) disallowance because the transferee steps into the transferor's shoes, including whatever transferred disabilities that would have caused disallowance of the claim.[8]

The *Enron II* decision has been roundly criticized as being inconsistent with the statutory language of § 502(d) and because the state law it relied on makes no distinction between a "sale" and an "assignment" of a claim.[9] However, the claims-trading industry uses the two terms interchangeably. Moreover, neither the parties to the *Enron I* appeal, nor *amici curiae*, thought that these interchangeable terms carried any significance.[10]

In 2013, the U.S. Court of Appeals for the Third Circuit in *In re KB Toys*[11] rejected *Enron II*'s holding and ruled that all claims subject to disallowance under § 502(d) must be disallowed regardless of the holder of the claim. The *KB Toys* court noted that "claims that are disallowable under § 502(d) must be disallowed no matter who holds them" because § 502(d) focuses on claims and not claimants.[12] The Third Circuit's decision has provided greater certainty to the claims-trading market concerning the application of § 502(d) to transferred claims.

Facts of the *Firestar* Case

On Feb. 26, 2018, Firestar Diamond Inc. and two of its affiliates (collectively, the debtors) filed chapter 11 cases in the SDNY Bankruptcy Court.[13] The debtors were wholesalers of finished jewelry to major retailers, including Costco, JCPenney and Macy's. The chapter 11 case was filed amid allegations of a multibillion-dollar bank fraud, through which the debtors' principals used a series of entities (the "nondebtor affiliates") to pose as independent third parties to enter into sham transactions to import gemstones and other jewelry in an effort to obtain bank financing.[14]

Following the appointment of a chapter 11 examiner to investigate potential misconduct by the debtors, the SDNY Bankruptcy Court appointed a chapter 11 trustee to administer the debtors' estates.[15] The nondebtor affiliates were alleged to have received, as part of the bank fraud scheme, millions of dollars in fraudulent transfers and preferences from the debtors that were not repaid.[16]

Four banks that extended credit to the nondebtor affiliates (but not to the debtors) filed proofs of claim against the debtors on account of their outstanding loan balances. As part of a financing transaction between the nondebtor affiliates and the banks, the nondebtor affiliates pledged to the banks the accounts receivable that the debtors owed to the nondebtor affiliates.[17]

Objection to the Banks' Proofs of Claim

The chapter 11 trustee filed objections to the banks' proofs of claim and sought disallowance of the claims pursuant to § 502(d) because the nondebtor affiliates that granted the banks a security interest in the nondebtor affiliates' accounts receivable, including claims against the debtors, were the recipients of avoidable transfers (*i.e.*, preferences and fraudulent transfers) from the debtors that had not been returned or repaid to the debtors.[18] In response, the banks relied on *Enron II* to argue that disallowance under § 502(d) "is a personal disability and does not travel with the 'claim,' but with the 'claimant.'"[19]

2 301 B.R. 634 (Bankr. S.D.N.Y. 2003).

3 *Id.* at 643; *accord, Swarts v. Siegel*, 117 F. 13, 15 (8th Cir. 1902) (holding under Bankruptcy Act that "disqualification of a claim for allowance created by a preference inheres in and follows every part of the claim, whether retained by the original creditor or transferred to another, until the preference is surrendered").

4 340 B.R 180 (Bankr. S.D.N.Y. 2006), *rev'd by In re Enron Corp.*, 379 B.R. 425 (S.D.N.Y. 2007) (*Enron II*).

5 *Id.* at 193.

6 *Id.* at 198.

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

8 *Id.* at 435-36.

9 *In re KB Toys Inc.*, 736 F.3d 247, 254, n.11 (3d Cir. 2013).

10 *See* Tally M. Wiener & Nicholas Malito, "On the Nature of the Transferred Bankruptcy Claim," 12 *U. Pa. J. Bus. L.* 35, 49 (2009) (*Enron II* opinion "draws a distinction between the consequences of transferring a claim through a sale, as opposed to an assignment, that neither the parties that appealed to the District Court nor the *amici curiae* thought carried any significance").

11 *KB Toys*, 736 F.3d at 252-53.

12 *Id.* at 252.

13 *In re Firestar Diamond Inc.*, 615 B.R. 161, 162-63 (Bankr. S.D.N.Y. 2020).

14 *Id.*

15 *Id.* at 163-64.

16 *Id.* at 164.

17 *Id.*

18 *Id.*

19 *Id.* at 165.

The banks also argued that they acquired new and independent claims against the debtors through the banks' transactions with the nondebtor affiliates, not by an assignment of claims from the nondebtor affiliates.[20] In addition, the banks argued that it would be inequitable to disallow their claims against the debtors because the banks were innocent victims of the fraud committed by the debtors and the nondebtor affiliates, and that refusing to follow the *Enron II* decision would "wreak havoc in the claims trading market."[21] In response, the chapter 11 trustee argued that the SNDY Bankruptcy Court should follow *KB Toys* and other court holdings that the transfer of a claim does not impact a court's ability to disallow the claim pursuant to § 502(d), and to reject *Enron II*'s holding.

SDNY Bankruptcy Court Rejects *Enron II*

The SDNY Bankruptcy Court ruled that disallowance risk runs with the claim and not the claimant, following the *Enron I*, *KB Toys* and *Metiom* decisions and rejecting the *Enron II* holding. The court's decision surveyed the extensive criticisms of *Enron II*'s holding that a court's ability to disallow a transferred claim under § 502(d) was dependent on whether the transferred claim was "sold" or "assigned" to the transferee. This distinction was not recognized by the claims-trading industry or by applicable state law.[22]

The SDNY Bankruptcy Court also concluded that equitable considerations cannot override the statutory language of § 502(d). It would be inequitable to favor the banks' claims against the debtors over the claims of the debtors' other creditors.[23] The court also adopted *KB Toys*' holding that transferees should bear the risk of claim disallowance because (1) claim-purchasers voluntarily choose to engage in the bankruptcy process; and (2) claim-buyers can mitigate their risk through due diligence and by including indemnity provisions in claim transfer agreements.[24] The court rejected the banks' arguments that not following *Enron II*'s holding would negatively impact the claims-trading industry.[25]

In addition, the SDNY Bankruptcy Court disregarded whether the transactions between the nondebtor affiliates and the banks were "sales" or "assignments" based on the court's rejection of the *Enron II* holding. However, the court also noted that the transfer of the claims might not have been "sales," thereby rescuing the banks' claims from disallowance under *Enron II*'s approach.[26] The banks appealed the bankruptcy court's decision to the district court.

SDNY District Court Vacates and Remands

In April 2021, the SDNY District Court followed *KB Toys* and rejected *Enron II* for the same reasons articulated by the bankruptcy court.[27] However, the district court did not affirm the bankruptcy court's decision because the bankruptcy court had not considered whether the banks were asserting their own direct claims against the debtors —not claims that were transferred from the nondebtor affiliates. If the nondebtor affiliates did not transfer their claims against the debtors to the banks, then § 502(d) would be inapplicable to the banks' claims. Accordingly, the district court remanded the case to the bankruptcy court to consider and develop a factual record concerning the nature of the alleged transfers of the nondebtor affiliates' claims against the debtors to the banks as part of the nondebtor affiliates' pledge of those accounts receivable to the banks.[28]

The Bankruptcy and District Courts' Decisions Following Remand

In September 2022, the SDNY Bankruptcy Court issued a lengthy opinion that exhaustively discussed the transactional documents between each of the banks and nondebtor affiliates, as well as the timing of events relating to the banks' advance of funds to the nondebtor affiliates and the parties' course of dealings.[29] The bankruptcy court held that the chapter 11 trustee satisfied § 502(d) and disallowed the banks' claims against the debtors.[30] The court concluded that the nondebtor affiliates had pledged the debtors' accounts receivable owed to the nondebtor affiliates and that such pledge was a "transfer" within the meaning of § 502(d). The banks appealed the bankruptcy court's decision to the district court.

In May 2024, the SDNY District Court issued its opinion affirming the bankruptcy court's ruling and disallowing the banks' claims pursuant to § 502(d).[31] The district court's opinion exhaustively details the underlying transactions and agreements between the nondebtor affiliates and each of the banks. The district court concluded that the banks' claims against the debtors were all acquired from the nondebtor affiliates as a result of the nondebtor affiliates' grant of a security interest in their accounts receivable, including their claims against the debtors to the banks, and as such, the banks' claims were not independent obligations of the debtors owed to the banks.[32]

Conclusion

The two SDNY Bankruptcy Court opinions and the two SDNY District Court opinions in *Firestar*, spanning a period of four years, have significantly advanced the state of § 502(d) jurisprudence in one of the nation's leading jurisdictions for commercial bankruptcy cases. These decisions provide a thorough and well-reasoned analysis of why disallowance of a claim must focus on the attributes of the claim — not the claimholder — and rejected the nearly universally

20 *Id.* at 170-71.
21 *Id.*
22 *Id.* at 167-69.
23 *Id.* at 169.
24 *Id.* at 169-70.
25 *Id.* at 169.
26 *Id.* at 170.

27 *In re Firestar Diamond Inc.*, 627 B.R. 804 (S.D.N.Y. 2021).
28 *Id.* at 809.
29 *In re Firestar Diamond Inc.*, 643 B.R. 528 (Bankr. S.D.N.Y. 2022).
30 *Id.* at 554-55.
31 *In re Firestar Diamond Inc.*, 734 F. Supp. 3d 273 (S.D.N.Y. 2024).
32 *Id.* at 285.

criticized *Enron II* decision as unworkable and unsupported by applicable law.

The *Firestar* decisions also provide useful guidance to assist in determining whether a lender has an independent claim against a debtor or whether a creditor's pledge of its claims against the debtors to a lender is a "transfer" of a claim making it subject to disallowance pursuant to § 502(d). These decisions should provide useful guidance to the claims-trading market participants to identify and manage risk and properly structure transaction documents. abi

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