UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

Hearing Date: June 7, 2018
Hearing Time: 10:00 a.m.

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In re

FIRESTAR DIAMOND, INC., *et al.*,

Debtors.

Case No. 18-10509 (SHL)

(Chapter 11)

(Jointly Administered)

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NOTICE OF UNITED STATES TRUSTEE'S MOTION: (A) FOR THE APPOINTMENT OF A CHAPTER 11 TRUSTEE PURSUANT TO SECTION 1104 OF THE BANKRUPTCY CODE OR, ALTERNATIVELY, FOR CONVERSION OF THESE CASES TO CHAPTER 7

PLEASE TAKE NOTICE that, upon the within motion and the concurrently filed memorandum of law, William K. Harrington, the United States Trustee for Region 2, in furtherance of the duties and responsibilities set forth in 28 U.S.C. § 586(a)(3) and (a)(5), will move this Court before the Honorable Sean H. Lane, United States Bankruptcy Judge, in the United States Bankruptcy Court, Alexander Hamilton Custom House, One Bowling Green, New York, New York 10004 on **June 7, 2018, at 10:00 a.m.,** or as soon thereafter as counsel can be heard, for: (a) an order shortening time and scheduling a hearing to consider the U.S. Trustee's motion for a the appointment of a Chapter 11 trustee pursuant to section 1104 of the Bankruptcy Code, or (b) for the conversion of these cases to Chapter 7, and for such other and further relief as this Court may deem just and proper. The original motion is on file with the Clerk of the Bankruptcy Court.

PLEASE TAKE FURTHER NOTICE, that any responsive papers should be filed with the Court, and personally served on the United States Trustee, at 201 Varick Street, Room 1006, New York, New York 10014, to the attention of Richard C. Morrissey, Esq., no

later than seven days prior to the return date set forth above. Such papers shall conform to the Federal Rules of Civil Procedure and identify the party on whose behalf the papers are submitted, the nature of the response, and the basis for such response.

Dated: New York, New York
May 24, 2018

WILLIAM K. HARRINGTON
UNITED STATES TRUSTEE
Region 2

By: */s/ Richard C. Morrissey*
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UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK
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In re	Chapter 11
FIRESTAR DIAMOND, INC., *et al.*,	Case No. 18-10509 (SHL)
Debtors.	(Jointly Administered)

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MEMORANDUM OF LAW IN SUPPORT OF MOTION OF THE UNITED STATES TRUSTEE FOR THE APPOINTMENT OF A CHAPTER 11 TRUSTEE PURSUANT TO SECTION 1104 OF THE BANKRUPTCY CODE OR, ALTERNATIVELY, FOR CONVERSION OF THESE CASES TO CHAPTER 7

William K. Harrington, the United States Trustee for Region 2 (the "United States Trustee"), respectfully submits this memorandum in support of his motion for the appointment of a chapter 11 trustee in the above-referenced cases pursuant to sections 1104(a) and (b)) of title 11, United States Code (the "Bankruptcy Code") or, alternatively, for the conversion of these cases to chapter 7. In support of this motion (the "Motion"), the United States Trustee respectfully states as follows:

PRELIMINARY STATEMENT

At the time of the filing of these chapter 11 cases in February 2018, a major banking scandal allegedly involving the above-captioned debtors' ultimate owner, Nirav Modi ("**Modi**"), had raised serious questions as to whether the debtors could and should have continued to act as debtors-in-possession in these Chapter 11 cases. To help answer this question, the United States Trustee moved under section 1104(c) of the Bankruptcy Code for the appointment of an examiner to investigate, among other things, whether, and to what extent, Modi controlled or

influenced the decisions and actions taken by the debtors in these cases, as well as whether an officer or director of the debtors participated in fraud or dishonesty in the management of the debtors' affairs. The Court granted the motion for the appointment of an examiner and an examiner was duly appointed, but the debtors remained in control of their cases.

As a result of recent events, however, the Court and the parties-in-interest cannot wait for the examiner to issue his report. An independent trustee must be appointed to preserve what remains of the debtors' operations and value after the failure of the debtors' attempts to sell their assets, followed by the abrupt departure of its chief executive officer. Moreover, allegations of communications between the Modi and the Debtors during the sale process casts further doubts about the integrity not only of the sale process, but also of the administration of these cases.

The links among the debtor entities, their suppliers, and Modi alone would justify the appointment of an independent fiduciary. However, those links, coupled with the collapse of the sale process and the sudden resignation of the debtors' principal, require that an independent trustee assume the reins of the company. Because the debtors are still operating, the United States Trustee believes that the appointment of a chapter 11 trustee would be preferable. In the alternative, the United States Trustee would support the conversion of these cases to chapter 7.

FACTS

A. General Background

1. On February 26, 2018 (the "Petition Date"), Firestar Diamond, Inc. ("**FDI**"), Fantasy, Inc. ("**FI**"), and A. Jaffe, Inc. ("**AJI")** (collectively, the "**Debtors**") each commenced a voluntary case under Chapter 11 of the Bankruptcy Code. *See* Voluntary Petitions, SDNY Case Nos. 18-10509 (SHL), 18-10510 (SHL), 18-10511 (SHL), ECF Doc. No. 1; *see also* Declaration

of Richard C. Morrissey ("**Morrissey Decl.**"), attached hereto and made a part hereof, ¶ 1. The Debtors continue to operate their businesses and manage their properties as debtors-in-possession pursuant to sections 1107(a) and 1108 of the Bankruptcy Code. Morrissey Decl., ¶ 1. On March 9, 2018, the Court entered an Order directing that these cases be jointly administered. ECF Doc. No. 24; Morrissey Decl. ¶ 2.

2. Due to lack of creditor interest, no Official Committee of Unsecured Creditors was appointed in these cases. Morrissey Decl., ¶ 3.

3. The Debtors are fine jewelry wholesalers. *See* Declaration of Mihir Bhansali, President of the Debtors, Containing Information Required Pursuant to Local Bankruptcy Rule 1007-2 and in Support of the Debtors' First Day Motions, dated February 28, 2018 (the "**Bhansali Decl.**"), ECF Doc. No. 2, ¶ 6.

4. The Debtors are Delaware and New York Corporations. *Id.* at ¶¶ 14-16. FI is a wholly owned subsidiary of FDI. *Id.* at ¶ 18. FDI is a wholly owned subsidiary of Firestar Group, Inc., which is, in turn, a wholly owned subsidiary of Synergies Corporation ("**Synergies**"). *Id.* at ¶ 17. Synergies is wholly owned by Firestar Holdings Limited ("**FHL**"), a Hong Kong corporation. *Id.* at ¶ 17. FHL is a wholly owned subsidiary of Firestar International Limited ("**FIL**"), an Indian corporation. *Id.* Modi is the majority shareholder of FIL. *Id.*

5. Synergies owns approximately 95% of the equity of AJI; the remainder of the equity is owned by Sam Sandberg. *Id.* at ¶ 19.

6. As of the Petition Date, Mihir Bhansali ("**Bhansali**") was the sole director[1] and president of each of the Debtors. *Id.* at ¶ 20. Bhansali was also the sole director and president of FGI and Synergies. *Id.*

7. Bhansali is not listed as an owner of any portion of any of the aforementioned entities. *See id.*

Events in India

8. As the Debtors have disclosed to the Court, news reports from India have alleged that Modi, along with certain overseas entities with which he was affiliated, had procured "unauthorized loans from Punjab National Bank ["**PJB**"). . . ." *Id.* at ¶ 33. The Debtors' principal reports that, according to PJB, the allegedly unauthorized loans exceeded $1 billion. Id. at ¶ 34.

9. In connection with the alleged unauthorized loans, PJB filed a criminal complaint and an investigation by the Indian authorities (the "**Criminal Investigation**") is pending. *See id.* at ¶ 35. Meanwhile, in connection with the Criminal Investigation, the Indian authorities have seized and/or frozen certain assets and properties belonging to Modi and "to various entities in which he had a direct or indirect ownership interest." *Id.* at ¶ 36. As a result of these enforcement actions, "multiple business entities" were shuttered, including "factories which produced most of the fine jewelry merchandise sold by the Debtors" and entities that performed back office and other functions for the Debtors. *See id.*

[1] Upon information and belief, during the pendency of the chapter 11 cases, the Debtors named an independent director, Neil Bivona, first to serve alongside Mr. Bhansali, then to serve as the sole board member when Bhansali resigned from the board. Morrissey Decl., ¶ 6.

The Appointment of the CRO

10. By Order entered on March 29, 2018, this Court approved the Debtors' retention of Getzler Henrich & Associates LLC to Provide Mark Samson as Chief Restructuring Officer (the "**CRO**") and Related Services *nunc pro tunc* to the Petition Date. ECF Doc. No. 80; Morrissey Decl. ¶ 5.

11. According to the Debtors' motion for the appointment of the CRO, the latter was to "report[] directly to the Debtors' sole director, unless and until such time as an independent director is appointed. . . ." CRO Motion, ¶ 9. In addition to developing a restructuring plan for the Debtors, *id.*, the CRO is to perform numerous tasks, including assessing the Debtors' financial condition and needs, "assisting in developing a cash flow budget," assisting in the negotiation of a plan of liquidation, assisting with reporting requirements, protecting the Debtors' fine jewelry assets, and interviewing independent director candidates. *See id.* at ¶ 10.

The Appointment of the Examiner

12. On March 30, 2018, the United States Trustee moved for the appointment of an examiner under Section 1104(c) of the Bankruptcy Code. ECF Doc. No. 87.

13. By Order dated April 13, 2018, the Court granted the motion for the appointment of an examiner, and directed the United States Trustee to appoint an examiner (the "**Examiner Order**"). The Examiner Order provided, among other things, that the examiner must file a final report within 120 days of his or her appointment by the United States Trustee. *See* Examiner Order, pp. 2-3.

14. On April 19, 2018, the United States Trustee filed an Application for Order Approving Appointment of Examiner. ECF Doc. No. 115.

15. By Order dated April 20, 2018, the Court approved the appointment of John J. Carney, Esq. (the "**Examiner**") as examiner in these chapter 11 cases.

The Sale Process

16. On March 23, 2018, the Debtors moved, *inter alia*, to Sell Property Free and Clear of Liens and to Consider Bidding Procedures in Connection with the Debtors Sale of Substantially All of their Assets (the "**Sale Motion**"). ECF Doc. No. 60. By Order entered on April 3, 2018, this Court granted the Debtors' Motion Establishing Bidding Procedures and Related Relief Regarding the Sale of Substantially All of the Debtors' Assets. ECF Doc. No. 95.

17. Subsequently, on May 1, 2018, the Debtors filed a Notice announcing that the auction for the sale of the FDI and FI assets, as well as an "all-asset" auction – for the combined assets of all of the Debtors -- was "adjourned to a date to be determined." ECF Doc. No. 136. The Notice also advised parties-in-interest that the business-line auction for the AJI assets was scheduled for May 3, 2018. *Id.*

18. On May 11, 2018, the Debtors filed a Statement to the effect that they had executed a modified purchase agreement with Paramount Gems, LLC, the winning bidder at the auction, for the purchase of AJI's assets. ECF Doc. No. 157.

19. At a hearing on May 15, 2018 on the Sale Motion (the "**Sale Hearing**"), the Court, declining to grant the Sale Motion, directed the Debtors to allay, if possible, its concerns regarding certain alleged communications between Modi and Bhansali or other employees of the Debtors and the Debtors use of its business judgment in connection with its valuation of the AJI assets to be sold.

Post-Sale Events

20. Shortly after the Sale Hearing, the Debtors announced that Bhansali had resigned from his position as president of the Debtors.[2] Morrissey Decl. ¶ 7.

21. On May 9, 2018, the Debtors filed a Notice of Withdrawal of the Sale Motion without prejudice. ECF Doc. No. 177.

22. On May 23, 2018, Punjab National Bank filed a Motion for the Appointment of a Chapter 11 Trustee. ECF Doc. No. 181.

III. DISCUSSION

The facts of this case warrant the appointment of a chapter 11 trustee pursuant to 11 U.S.C. §§ 1104(a)(1) and (a)(2) or, alternatively, the conversion of these cases to chapter 7.

A. Legal Authority – Chapter 11 Trustee

The Bankruptcy Code is designed to allow a debtor-in-possession to retain management and control of the debtor's business operations. *See* 11 U.S.C. §§ 1007, 1008; *see also In re Eurospark Indus.*, 424 B.R. 621, 627 (Bankr. E.D. N.Y. 2010). It is well recognized, however, that a debtor-in-possession owes fiduciary duties to the bankruptcy estate and must, among other things, "protect and . . . conserve property in [its] possession for the benefit of creditors" and "refrain [] from acting in a manner which could damage the estate, or hinder a successful reorganization of the business." *In re Ionosphere Clubs, Inc.*, 113 B.R. 164, 169 (Bankr. S.D.N.Y. 1990) (quoting *In re Sharon Steel Corp.*, 86 B.R. 455, 457 (Bankr. W.D. Pa. 1988), *aff'd*, 871 F.2d 1217 (3d Cir. 1989)). "The willingness of Congress to leave a debtor-in-possession is premised on an expectation that current management can be depended upon to

[2] The United States Trustee is not aware as to whether Bhansali has also resigned his positions at the non-debtor entities FGI and Synergies.

carry out the fiduciary responsibilities of a trustee." *In re V. Savino Oil & Heating Co., Inc.*, 99 B.R. 518, 526 (Bankr. E.D. N.Y. 1989). If a debtor-in-possession defaults in that respect, then the debtor may be dispossessed of its officers and alternative management may be appointed in the form of a Chapter 11 trustee. *See Schuster v. Dragone*, 266 B.R. 268, 271 (D. Conn. 2001).

The Bankruptcy Code sets forth two separate standards for the Court's determination of the necessity of appointing a trustee: Section 1104(a)(1) and (a)(2). The sections provide, in pertinent part:

> (a) At any time after the commencement of the case but before confirmation of a plan, on request of a party in interest or the United States trustee, and after notice and a hearing, the court shall order the appointment of a trustee –
>
> (1) for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, or similar cause, but not including the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor. . . .
>
> (2) if such appointment is in the interests of creditors, any equity security holders, and other interests of the estate, without regard to the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor [ ].

11 U.S.C. § 1104(a)(1), (a)(2).

A finding of "cause" under § 1104(a)(1) mandates the appointment of a trustee. *1031 Tax Group*, 374, 386 (Bankr. S.D.N.Y. 2007); *Oklahoma Refining Co. v. Blaik (In re Oklahoma Refining Co.)*, 838 F.2d 1133, 1136 (10th Cir. 1988); *In re V. Savino Oil & Heating Co., Inc.*, 99 B.R. at 525. The list of wrongs constituting "cause" warranting the appointment of a trustee is non-exclusive; thus, factors relevant for a court's consideration to the appointment of a trustee under Section 1104(a)(1) include: conflicts of interest, including inappropriate relations between

corporate parents and the subsidiaries; misuse of assets and funds; inadequate record keeping and reporting; various instances of conduct found to establish fraud or dishonesty; and lack of credibility and creditor confidence. *In re Altman*, 230 B.R. 6, 16 (Bankr. D. Conn. 1999), *aff'd in part, vacated in part*, 254 B.R. 509 (D. Conn. 2000). The "court need not find any of the enumerated wrongs to find cause for appointing a trustee." *Oklahoma Refining*, 838 F.2d at 1136. The appointment of a Chapter 11 trustee is,

> in the appropriate case, . . . critical for the court to exercise in order to preserve the integrity of the bankruptcy process and to insure that the interest of creditors are served.

In re Lopez-Munoz, 553 B.R. 179, 189 (1st Cir. BAP 2016), quoting *In re Nartron Corp.*, 330 B.R. 573, 591-92 (Bankr. W.D. Mich. 2005).

The existence of voidable preferences or fraudulent conveyance actions and a debtor-in-possession's apparent conflicts in prosecuting them is also an important consideration. *See*, e.g., *In re Veblen West Dairy LLP*, 434 B.R. 550, 553-54 (Bankr. D. S.D. 2010) (holding that debtor's failure to adequately explain suspicious prepetition dealings and fact that there were possible preference and fraudulent transfer claims against these affiliated entities that would need to be evaluated by independent entity provided sufficient "cause" for appointment of trustee). *See also In re Keeley and Grabanski Land Partnership*, 455 B.R. 153 (B.A.P. 8th Cir. 2011) (emphasis added) (noting that in determining whether to appoint a Chapter 11 trustee for "cause," bankruptcy courts may consider the materiality of any misconduct, the debtor-in-possession's evenhandedness or lack thereof in dealings with insiders and affiliated entities in relation to other creditors, *the existence of prepetition voidable preferences or fraudulent conveyances*, whether any conflicts of interest on the part of the debtor-in possession are interfering with its ability to

fulfill its fiduciary duties, and whether there has been self-dealing or squandering of estate assets.); *In re SRJ Enterprises, Inc*., 151 B.R. 189, 195 (Bankr. N.D. Ill. 1993) (noting that a debtor-in-possession is vested with fiduciary duties that may be breached if he or she fails to institute a suit to recover voidable preferences).

Through Section 1104(a)(1) of the Bankruptcy Code, Congress has mandated that a Chapter 11 debtor-in-possession, who acts as a fiduciary of the bankrupt estate, be an honest broker. *See Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 355 (1985) ("[T]he willingness of courts to leave debtors in possession 'is premised upon an assurance that the officers and managing employees can be depended upon to carry out the fiduciary responsibilities of a trustee.'"). When a debtor-in-possession, its management, or its professionals have exhibited an inability or unwillingness to comply with their basic fiduciary duties, there is but one remedy established by Congress to supplant management while allowing the case to remain in chapter 11: The appointment of a trustee pursuant to 11 U.S.C. § 1104(a). *See In re V. Savino Oil*, 99 B.R. at 526 ("And if the debtor-in-possession defaults in this respect, [s]ection 1104(a)(1) [of the Bankruptcy Code] commands that stewardship of the reorganization effort must be turned over to an independent trustee.").

In turn, section 1104(a)(2) of the Bankruptcy Code allows appointment of a trustee even when no "cause" exists. *See In re Sharon Steel Corp.*, 871 F.2d 1217, 1226 (3d Cir. 1989); *In re Ionosphere Clubs, Inc.*, 113 B.R. 164, 168 (Bankr. S.D.N.Y. 1990). Under Section 1104(a)(2), the Court may appoint a trustee, in its discretion, to address the "interests of the creditors, any equity security holders, and other interests of the estate." 11 U.S.C. § 1104(a)(2). *See, e.g.*, *Sharon Steel*, 871 F.2d at 1226; *Comm. of Dalkon Shield Claimants v. A.H. Robins Co.*, 828 F.2d

239, 242 (4th Cir. 1987); *see also The 1031 Tax Group*, 374 B.R. at 90 (Section 1104(a)(2) standard is "flexible" so as to give court discretion to appoint trustee where such appointment would benefit the parties and estate). Even "in the absence of fraud or dishonesty," the appointment of a Chapter 11 is appropriate where "the debtor-in-possession suffers from conflicts of interest which impact its ability to fulfill its fiduciary duties." Lopez-Munoz, 553 B.R. 179 at 196; *see also In re Ridgemour Meyer Props., LLC*, 413 B.R. 101, 113 (Bankr.S.D.N.Y.2008) (independent trustee should be appointed when debtor and its managers "suffer from material conflicts of interest").

B. Cause Exists for the Appointment of a Chapter 11 Trustee Under Section 1104(a)(1)

In the instant case, there is cause for the Court to appoint a Chapter 11 trustee under subsection (a)(1) of Section 1104 of the Bankruptcy Code. As noted above, the list of wrongs constituting "cause" is non-exclusive and, in evaluating the need for a Chapter 11 trustee, bankruptcy courts may consider, among other things, conflicts of interests that exist, including inappropriate relations between entities in a corporate structure, the existence of prepetition voidable preferences or fraudulent conveyances as well as the debtor-in-possession's unbiased ability to pursue them. *See In re Altman*, 230 B.R. at 16; *Oklahoma Refining*, 838 F.2d at 1136.[3]

First, the petitions were filed in the wake of (1) the filing of a criminal complaint by PJB in India against Modi and the Modi Entities, (2) the seizure of assets and properties that belong to Modi and to the Modi Entities, and (3) the closure of factories that belong to Modi and to

[3] Although the Second Circuit has stated that the United States Trustee has the burden of showing by "clear and convincing evidence" that the appointment of a trustee is warranted, *Adams v. Marwil (In re Bayou Group, LLC)*, 564 F.3d 541, 546 (2d Cir. 2009), a recent Supreme Court decision casts doubt on that holding. In *Octane Fitness, LLC v. ICON Health & Fitness, Inc.*, __ U.S. __; 134 S. Ct. 1749, 1758 (2014), the Court stated that "a preponderance of the evidence standard… is the 'standard generally applicable in civil actions.'"

Modi Entities. *See* Bhansali Decl., ¶¶ 35-36. The connection between these factories and the Debtors' businesses went far beyond the mere fact that Modi was the ultimate owner of both sets of Modi Entities: According to the Debtors' principal, the Modi-related factories that were shuttered in connection with the Criminal Investigation "produced most of the fine jewelry merchandise sold by the Debtors" and performed back-office and other functions for the Debtors. *See id.*

Although the Debtors retained the CRO, they did so not to *supplant* the Debtors' principal, but rather to *assist* him in running the Debtors' businesses. *See* CRO Motion, ¶ 9; *see also* Bhansali Decl., ¶ 74. As the CRO motion made clear, the CRO was to play a subordinate role. *See* CRO Motion, ¶ 9 ("the CRO reports directly to the Debtors' sole director"). [4] Bhansali, under Modi's auspices, still called the shots until his recent resignation.

Therefore, notwithstanding the turmoil surrounding the operations of the Debtors' ultimate owner in India, the Debtors' principal remained in control of the Debtors' operations. Although, as far as the United States Trustee is aware, the Debtors themselves have not been charged with any wrongdoing in connection with the Criminal Investigation, they cannot simply divorce themselves from that investigation by virtue of the fact that (1) they operate in the United States, and (2) they are debtors-in-possession in these cases.[5]

The Debtors are part of Modi's jewelry business. He, as the ultimate owner of the Debtors – albeit through various holding companies – controls the Debtors. Although Bhansali served as both president and sole director of the Debtors, *see id.* at ¶ 20, the Bhansali Decl.

[4]Although the Debtors subsequently named a new independent director and Bhansali recently resigned as director, Bhansali was the Debtors' sole director as of the Petition Date. See Morrissey Decl., ¶ 6.

[5] This problem is only exacerbated by allegations that Modi was in communication with Bhansali during the pendency of the chapter 11 cases and, possibly, during the sale process.

makes clear that he was not even a partial owner of the Debtors. *See id.* Accordingly, not only was the CRO not in control of the Debtors, but also Bhansali was not in control of the Debtors. Ultimately, Modi still controlled the whole operation in a chain of command leading from him, through the Modi Entities, down to the Debtors.

Moreover, simply divorcing current management from the ultimate owner of the enterprise is no solution. Directors have a fiduciary duty to shareholders that, if breached, may give rise to a cause of action by shareholders against one or more directors. *See Ampal-American Israel Corp.*, 543 B.R. 464, 473 (Bankr. S.D.N.Y. 2016) (discussing limits on personal liability of directors to shareholders in certificate of incorporation). Here, the parties and the Court will undoubtedly be assured that current management, comprised of the CRO and the sole director – following the departure of Bhansali – will wall off Modi from all corporate actions and decisions. But what of the director's fiduciary duty to the ultimate shareholder? If the Court allows the director to operate the Debtors without a fiduciary duty to the ultimate shareholder makes a mockery of the Chapter 11 process.

Finally, the director, through no fault of his own, cannot escape the taint of his association with Bhansali. It was, after all, Bhansali who appointed the director and worked with him through the failed sale process. The director could not be adversarial to Bhansali. The director would be hard-pressed, for example, to bring a cause of action against Bhansali, the person who named him as the director. Simply put, the director cannot fairly be expected to bite the hand that fed him.

Fortunately, there is a remedy to this corporate governance problem. In the instant cases, turning control of the Debtors, their assets, and their potential causes of action over to a Chapter 11 trustee would reassure creditors and other parties-in-interest that the estate's fiduciary is

looking out for *them*. It is evident that a thorough investigation is needed in these cases by an independent fiduciary in whom the Court and the parties can have confidence. Current ownership and former management would likely be the subjects of the investigation. Just as Modi and Bhansali could not fulfill the fiduciary duties of an independent trustee, neither can the CRO and the current board member. *See In re Veblen West Dairy LLP*, 434 B.R. at 553.

More specifically, in order for the current management and board to fulfill their fiduciary duties, they may have to bring actions against former management. The Debtors' principals would also have to take action against Modi and the Modi Entities that are the very targets of the Criminal Investigation. *See Oklahoma Refining*, 838 F.2d at 1136 (recognizing that transactions with affiliated companies may constitute cause for appointment of a trustee). If a trustee is not appointed to administer these cases, and the Debtors are to remain in control of their cases, the Court and parties-in-interest would have to rely on the director installed by Bhansali and, perhaps, on Modi and the Modi Entities whose alleged actions brought about the Criminal Investigation.[6]

Accordingly, "cause" exists under 11 U.S.C. §1104(a)(1) for the appointment of a Chapter 11 Trustee as an independent fiduciary necessary to restore confidence of the creditors in the liquidation of the estate for the ultimate benefit of all parties in interest.

[6] As to the Examiner, he cannot participate in the management of the Debtors, nor can he pursue causes of action on behalf of the estates and their respective creditors. *See In re W.R. Grace & Co.*, 285 B.R. 148, 156 (Bankr. D, Del. 2002) ("the basic job of an examiner is to examine, not to act as a protagonist in the proceedings"); *see also In re Loral Space & Communications Ltd.*, 313 B.R. 577, 583 (Bankr. S.D.N.Y. 2004) (same).

D. Because the Appointment of a Chapter 11 Trustee Would Be in the Interests of Creditors and other Interests of the Estate, Appointment of a Chapter 11 Trustee is Warranted Under Section 1104(a)(2)

Similarly, even if the Court finds that the United States Trustee has failed to demonstrate cause for the appointment of a trustee under subsection (a)(1) of Section 1104, a Chapter 11 trustee would be in the best interests of creditors. Accordingly, the appointment is warranted under Section 1104(a)(2) of the Bankruptcy Code. See 11 U.S.C. § 1104(a)(2). Under Section 1104(a)(2), courts "eschew rigid absolutes and look to the practical realities and necessities." *See In re Taub*, 427 B.R. 208, 227 (Bankr. E.D.N.Y. 2010) (quoting *In re Adelphia Communication Corp.*, 336 B.R. 610, 658 (Bankr. S.D.N.Y. 2006)); *In re Euro-American Lodging Corp.*, 365 B.R. 421, 427 (Bankr. S.D.N.Y. 2007). As a court noted in *Schuster v. Dragone*, 266 B.R. 268 (D. Conn. 2001):

> In determining whether the appointment of a trustee is in the best interests of creditors, a bankruptcy court must necessarily resort to its broad equity powers." In equity, "courts eschew rigid absolutes and look to the practical realities and necessities inescapably involved in reconciling competing interests . . . . Moreover, equitable remedies are a special blend of what is necessary, what is fair, and what is workable.

Id. at p. 272-73 (quotations omitted). Accordingly, the standard for appointment of a Chapter 11 trustee under Section 1104(a)(2) is flexible. *See* 124 Cong.Rec. H11, 102 (daily ed. Sept. 28, 1978); S17,419 (daily ed. October 6, 1978). The House Report summarizes the reasons for Congress' adoption of a flexible standard for the appointment of trustees. The House Report, in part, reads as follows:

> The twin goals of the standard for the appointment of a trustee should be protection of the public interest and the interests of creditors, as contemplated in current chapter X and facilitation of a reorganization that will benefit both the creditors and the debtors, as contemplated in current chapter XI. Balancing the goals is a difficult process, and requires consideration of many factors.

H.R. Rep. No. 595, 95th Cong., 1st Sess. 232 (1977), U.S. Code Cong. & Admin. News 1978, p. 6192.

Among the factors considered by the courts in assessing motions brought under this section include: (1) the trustworthiness of the debtor, (2) the debtor's past and present performance and prospects for rehabilitation, (3) the confidence – or lack thereof – of the business community and of creditors in present management, and (4) the benefits derived from the appointment of a trustee, balanced against the cost of the appointment. *In re China Fishery Group Limited (Cayman)*, 16-11895, 2016 WL 6875903, at *14 (Bankr. S.D.N.Y. Oct. 28, 2016); *Euro-American*, 365 B.R. at 427. Still another factor in determining whether the appointment of a Chapter 11 trustee is appropriate is whether the debtor-in-possession would be willing – or even able – to pursue causes of action on behalf of the estate. *See William H. Vaughan & Co., Inc.*, 40 B.R. 524, 526 (Bankr. E.D. Pa. 1984) (unwillingness or inability of management of pursue estate causes of action among grounds for appointment of Chapter 11 trustee). Finally, courts will also consider such factors as "conflicts of interest, inappropriate relations between corporate parents and subsidiaries, [and] misuse of assets and funds. . . ." *In re Ancona*, No. 140-10532 (MKV), 2017 WL 7868696, at *9 (Bankr. S.D.N.Y. Nov. 30, 2016).

Here, the connection between the Debtors, Modi, and the Modi Entities under the Criminal Investigation in India is the elephant in the room. Parties-in-interest and the Court are currently in the dark as to whether the Debtors may have causes of action against any of the entities or individuals involved in the Criminal Investigation. *See In re Soundview Elite, Ltd.*, 503 B.R. 571, 583 (Bankr. S.D.N.Y. 2014) (Court directed appointment of Chapter 11 trustee, noting that "I have no faith that the Debtors' current managers are capable of acting

independently and in the best interests of the estates, or in objectively investigating themselves"). The Debtors themselves, even under new management, cannot be expected to conduct such an investigation of the Modi Entities, who are under Modi's control.[7] They certainly cannot be expected to investigate any possible causes of action against Modi himself. *See Oklahoma Refining*, 838 F.2d at 1135 (chapter 11 trustee appointed where debtor had made "no serious effort to collect the debt from the affiliated companies and . . . was in the awkward position of having to decide whether or not to sue itself"); *see also L.S. Good & Co.*, 8 B.R. 312, 315 (Bankr. W. Va. 1980) (Chapter 11 trustee appointed under Section 1104(a)(2) where debtor's management had "grave potential conflicts of interest" and could not "make the impartial investigations and decisions demanded in evaluating a pursuing inter-company claims on behalf of the debtor").

The failure of the sale process regarding the AJI assets led not only to the departure of Bhansali and the withdrawal of the sale motion, but also has resulted in a loss of confidence by the parties in current management. The collapse of the sale process can only have caused the creditors to question the ability of the Debtors to reorganize – let alone to maximize value -- with current management in place. *Ancona*, at *10 (Bankr. S.D.N.Y. Nov. 30, 2016) (duty to maximize value); *In re Sundale, Ltd.*, 400 B.R. 890, 909-10 (Bankr. S.D. Fla. 2009) (creditor confidence a factor). Given the sad history of these chapter 11 cases to date, the parties have no reason to believe that Bhansali's departure, by itself, will allay their concerns about the future

[7] The Court's observation in *In re The 1031 Tax Group, LLC*, 374 B.R. 78, 86 (Bankr. S.D.N.Y. 2007), that, "a court's focus [in a motion for the appointment of a chapter 11 trustee] is on the debtor's current management, not the [pre-petition] misdeeds of past management," is not applicable here. In this case, it is by no means certain that Modi, the ultimate majority shareholder, has not been calling the shots post-petition. Moreover, Bhansali, the now former principal of the Debtors was until very recently still in charge of the Debtors' operations. Finally, current management was installed by now former management, whose willingness or ability to pursue causes of action against the debtors is, to say the least, open to question.

course and conduct of these cases. *See Soundview Elite*, 503 B.R. at 583 ("confidence—or lack thereof—of the business community and of creditors in present management" a factor under Section 1104(a)(2)).

Current management is not free from blame in these cases. Even with the CRO and the independent director in place, the Debtors took no discernible steps to keep Modi out of the sale process or of the general administration of the estate. Having been selected by Bhansali, neither the CRO nor the independent director seem to have taken action to prevent Modi from influencing the course of these cases. Nor did current management bar Bhansali or any other employees of the Debtor from communicating with Modi, Finally, neither the CRO nor the independent director investigated whether there had, in fact, been any communications between Modi on the one hand, and Bhansali and other employees of the Debtors on the other. Accordingly, the parties and the Court have no reason to be confident that current management will best serve the interests of the creditors and the bankruptcy process.[8]

Rather, a fiduciary who can bring appropriate actions against the Debtors' current and former principal must be in place. The Bankruptcy Code provides for the appointment of such a fiduciary, a Chapter 11 trustee. And the facts of this case – notably the pendency of the Criminal Investigation and the failure of the sale process -- warrant the appointment of one at this stage of the case. The appointment of a Chapter 11 trustee is appropriate if a debtor has had "a history of transactions with companies affiliated with [it]" and "the best interest of the creditors require"

[8] Hence the facts described by the Court in *In re Bayou Group, LLC*, 564 F.3d 541, 547 (2d Cir. 2009), are distinguishable from the facts of these cases. In *Bayou*, no creditors supported the motion for a chapter 11 trustee. *Id.* Here, that is certainly not the case, as Punjab National Bank has filed its own motion for a Chapter 11 trustee. ECF Doc. No. 181. In addition, in *Bayou* the problems with management involved only former, not current management. *See id.* The same distinction applies between these cases and *1031 Tax Group*, 374 B.R. at 86, as in the latter case, the court focused its Section 1104 analysis on current, not past, management.

such appointment. *See id.* at 1136. Surely, then, the appointment of a Chapter 11 trustee is warranted where certain of those affiliated companies are under the cloud of a criminal probe. *See id.* at 1136 n.2 ("Case law . . . supports lenders' claims that debtor's effort to manage the company was impeded by the existence of at least four criminal cases pending against either the debtor's president ... or some of the affiliated companies.").

Moreover, time is of the essence. The need for a Chapter 11 trustee is acute in that the Debtors are ultimately owned by an individual who is the principal target of the Criminal Investigation. Moreover, the Debtors had a full and fair opportunity to bring about a successful sale of their assets. To date, the sale process has not borne fruit. The longer that the Debtors remain in control of these cases, the greater the concern that these cases will not have a successful outcome.

In any case, any delay in the appointment of a Chapter 11 trustee will inexorably lead to yet another basis for the appointment of a Chapter 11 trustee. Courts have included a debtor's failure to commence avoidance or preference actions among the grounds for relief under Section 1104(a)(2). *William H. Vaughan & Co.*, 40 B.R. at 526 ("debtor's failure to commence proceedings for the avoidance of the transfer" is grounds for appointment of a trustee under section 1104(a)(2); *In re Microwave Products of America, Inc.*, 102 B.R. 666, 676 (Bankr. W.D. Tenn. 1989) ("failure of the debtor to investigate potential avoidable or preferential transfers weigh heavily in favor of appointing a trustee" under section 1104(a)(2).) Because Modi cannot be expected to bring an action against himself or the entities he controls, allowing the Debtors to remain in possession at this time will inevitably lead to a situation later in the case where the Court must find that the Debtors have failed to commence actions against Modi, the Modi entities, or Bhansali.

Accordingly, it is in the interest of creditors at this juncture to put these cases into the hands of an independent fiduciary who can (1) assume control of the Debtors' assets, (2) bring potential actions against Modi, the Modi entities, and/or Bhansali, (3) sell the Debtors' businesses, and (4) formulate a viable Chapter 11 plan.

B. Legal Authority – Conversion to Chapter 7

Section 1112(b)(1) and (2) provide, in pertinent part, as follows:

> (b)(1) Except as provided in paragraph (2) and subsection (c), on request of a party in interest, and after notice and a hearing, the court shall convert a case under this chapter to a case under chapter 7 or dismiss a case under this chapter,[9] whichever is in the best interests of creditors and the estate, for cause unless the court determines that the appointment under section 1104(a) of a trustee or an examiner is in the best interests of creditors and the estate.
>
> (2) The court may not convert a case under this chapter to a case under chapter 7 or dismiss a case under this chapter if the court finds and specifically identifies unusual circumstances establishing that converting or dismissing the case is not in the best interests of creditors and the estate, and the debtor or any other party in interest establishes that—
>
> (A) there is a reasonable likelihood that a plan will be confirmed within . . . a reasonable period of time; and
>
> (B) the grounds for converting or dismissing the case include an act or omission of the debtor other than under paragraph (4)(A)—
> (i) for which there exists a reasonable justification for the act or omission; and
> (ii) that will be cured within a reasonable period of time fixed by the court.

11 U.S.C. § 1112(b)(1) and (2).

Courts focus on whether "cause" exists for conversion, and the best interests of the parties-in-interest. *Andover Covered Bridge*, 553 B.R. 162, 171 (1st Cir. BAP 2016). Although

[9] The United States Trustee does not believe that dismissal of these cases under 1112(b) would be appropriate under these circumstances.

the initial burden is on the movant to establish cause, once the movant meets that burden, the debtor then bears the burden to "demonstrate 'unusual circumstances' establishing that conversion or dismissal is not in the [parties'] best interests. . . ." *Id.* at 172. A motion brought pursuant to Section 1112(b) should be granted if conversion or dismissal "is in the best interests of both the creditors and the estate." *In re BH S & B Holdings, LLC, et al*., 439 B.R. 342, 346 (Bankr. S.D.N.Y. 2010); *see also In re FRGR Managing Member LLC,* 419 B.R. 576, 580 (Bankr. S.D.N.Y. 2009) (same). Although specific grounds for conversion to chapter 7 are listed in the statute, that list is not "exhaustive." *See In re C-TC 9th Avenue Partnership*, 113 F.3d 1304, 1311 (2d Cir. 1997); *BH S & B*, 439 B.R. at 346; *In re Tornheim*, 181 B.R. 161, 163 (Bankr. S.D.N.Y. 1995), *appeal dismissed*, 1996 WL 79333 (S.D.N.Y., Feb. 23, 1996).

F. Cause Exists for Conversion to Chapter 7

Here, at least two grounds exist under Section 1112(b)(4) to convert the case to chapter 7. First, conversion is appropriate where there has been "substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation." 11 U.S.C. § 1112(b)(4)(A). *FRGR Managing Member* 419 B.R. at 581. Second, cause for conversion to chapter 7 exists in these cases in the form of gross mismanagement of the estate. *See* 11 U.S.C. § 1112(b)(4)(F).

Likelihood of Rehabilitation

The Debtors' ability to rehabilitate its business was made especially difficult because of the events leading up to the filing of the chapter 11 petitions. Not only was there a shadow cast over the Debtors' operations by the scandal in India, but also, as a result of the investigation in India, the companies that supplied the Debtors with inventory were shuttered. That action forced the Debtors to sell their assets in a relatively short time frame.

Consequently, the success of these chapter 11 cases depended entirely on the success of the sale process. That process, as it turned out, has resulted not in success, but rather in failure. First, the Debtors postponed the sale hearing insofar as it concerned the assets of FDI and FI; then, though they did conduct what appeared to be a successful auction with respect to the AJI assets, the Notice of Withdrawal of the Sale Motion announced to the parties-in-interest and to the Court that the sale of the AJI assets had fallen through.

The final blow to the Debtors' chances of rehabilitation was the departure of Bhansali. Now, the only people in control of the Debtors are the independent board member and the CRO, both of whom were selected by Bhansali. Under these circumstances, it is highly unlikely that the Debtors will be able to rehabilitate themselves. *See Andover Covered Bridge*, 553 B.R. at 175 (courts examine "the prospect of reestablishment of a business").[10]

Gross Mismanagement of the Estate

Given the fraud allegations in India, the Debtors' management was under an unusually high level of scrutiny in these cases from the beginning of these chapter 11 cases. That, after all, is why they retained a CRO and brought in a new board member. However, instead of assuring parties-in-interest that the management of the Debtors was improving, the Debtors' actions in these cases turned out to be causes for even greater concern. As noted above, the sale process failed, and Bhansali, under pressure to assure the Court that he was not in communication with Modi, simply left the company. This was an act that inspired further suspicion, not confidence. Bhansali has left in his wake a CRO and a director of his choosing, and Modi, the ultimate majority shareholder, still lurks in the background. Current management, fresh off the collapse

[10] To the extent that the Debtors argue that, were they to remain as debtors-in-possession, they would liquidate the assets themselves, this would be no argument against a motion to convert the cases. *See Andover Covered Bridge*, 553 B. R. at 175 ("rehabilitation for purposes of § 1112(b) does not include liquidation").

of the sale process, cannot be expected to see these cases through to confirmation. Under the circumstances, these cases should be converted pursuant to 11 U.S.C. § 1112(b)(4)(B).

IV. CONCLUSION

WHEREFORE, the United States Trustee respectfully requests that the Court appoint a Chapter 11 trustee or grant such other and further relief as may be deemed just and proper.

Dated: New York, New York
May 24, 2018

Respectfully submitted,

WILLIAM K. HARRINGTON
UNITED STATES TRUSTEE, Region 2

By: */s/ Richard C. Morrissey*
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UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK
----------x

In re	Chapter 11
FIRESTAR DIAMOND, INC., *et al.*,	Case No. 18-10509 (SHL)
Debtors.	(Jointly Administered)

----------x

DECLARATION OF RICHARD C. MORRISSEY IN SUPPORT OF THE UNITED STATES TRUSTEE'S MOTION FOR AN ORDER FOR THE APPOINTMENT OF A CHAPTER 11 TRUSTEE PURSUANT TO SECTION 1104 OF THE BANKRUPTCY CODE OR, ALTERNATIVELY, FOR CONVERSION OF THESE CASES TO CHAPTER 7

I am a Trial Attorney for movant, William K. Harrington, the United States Trustee for Region 2 (the "United States Trustee"). Within his Office, I am responsible for monitoring this chapter 11 case captioned above on her behalf. I make this declaration based on personal knowledge, information and belief formed from records of the Office of the United States Trustee, kept in the ordinary course of its business, and my personal review earlier today of the docket of this case on the PACER information system. If called, I would testify to the following:

1. On February 26, 2018 (the "Petition Date"), Firestar Diamond, Inc. ("**FDI**"), Fantasy, Inc. ("**FI**"), and A. Jaffe, Inc. ("**AJI")** (collectively, the "**Debtors**") each commenced a voluntary case under Chapter 11 of the Bankruptcy Code. *See* Voluntary Petitions, SDNY Case Nos. 18-10509 (SHL), 18-10510 (SHL), 18-10511 (SHL), ECF Doc. No. 1. The Debtors continue to operate their businesses and manage their properties as debtors-in-possession pursuant to sections 1107(a) and 1108 of the Bankruptcy Code.

2. By Order entered on March 9, 2018, the Court directed that these cases be jointly

administered. ECF Doc. No. 24.

3. To date, the United States Trustee has been unable to appoint an official committee of unsecured creditors in the Debtors' cases.

4. On March 4, 2018, the Debtors filed a Motion for an Order authorizing them to retain Getzler Henrich & Associates LLC to Provide Mark Samson as Chief Restructuring Officer (the "**CRO**") and Related Services, *nunc pro tunc* to the Petition Date. ECF Doc. No. 10.

5. By Order entered on March 29, 2018, this Court approved the Debtors' retention of the CRO on a final basis. ECF Doc. No. 80.

6. Upon information and belief, after the Petition Date, the debtors named an independent director, Neil Bivona, to serve alongside Mihir Bhansali, the debtors' principal, in that capacity. Subsequently, Mr. Bhansali resigned from the board, leaving Mr. Bivona as the sole board member.

7. After the Court held a hearing on the Debtors' motion to sell AJI's assets, the Debtors announced that Mr. Bhansali had resigned from his position as President of the Debtors.

I declare under penalty of perjury that the information contained in this Declaration is true and correct.

Dated: New York, New York
May 24, 2018

/s/ Richard C. Morrissey
RICHARD C. MORRISSEY

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK
----------x

In re	Chapter 11
FIRESTAR DIAMOND, INC., *et al.*,	Case No. 18-10509 (SHL)
Debtors.	(Jointly Administered)

----------x

CERTIFICATE OF SERVICE

Richard C. Morrissey affirms under penalty of perjury that the following is true and correct:

1. I am a trial attorney with the Office of the United States Trustee for Region 2.

2. On May 24, 2018, I caused true and correct copies of (1) the Notice of Motion, (2) the Memorandum of Law in Support of the Motion of the United States Trustee for an Order to Appoint a Chapter 11 Trustee pursuant to 11 U.S.C. § 1104 or, Alternatively, for an Order Converting these Cases to Chapter 7, and (3) the Declaration of Richard C. Morrissey in Support of the Motion, to be served by email upon the parties listed in the annexed **Schedule A**, and by first-class mail upon the parties listed on the annexed **Schedule B** by depositing true copies of same in sealed envelopes, with postage pre-paid thereon, in an official depository of the U.S. Postal Service within the City and State of New York.

Dated: New York, New York
May 24, 2018

/s/ Richard C. Morrissey
Richard C. Morrissey

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