Caveat Emptor: Claim in Innocent Transferee's Hands Can Be Equitably Subordinated Based Upon Transferor's Misconduct

January/February 2006

Paul D. Leake and Mark G. Douglas

The power of a bankruptcy court to adjust the relative priority of claims against a debtor based upon the claimant's misconduct is widely recognized. By means of "equitable subordination," a bankruptcy court can remedy conduct that harms other creditors by relegating the offending creditor's claim to the lowest priority of payment or disallowance. Still, whether or not equitable subordination of a claim is warranted in the absence of creditor misconduct continues to be a subject of debate. Moreover, even where misconduct is present, it is unclear whether there must be a nexus between the misconduct and the claim to justify subordination. The New York bankruptcy court overseeing the chapter 11 cases of Enron Corporation and its affiliates addressed both of these issues in a recent ruling. In *Enron Corp. v. Avenue Special Situations Fund II, LP (In re Enron Corp.),* the court held that a transferred claim can be equitably subordinated even though the transferee is blameless and a creditor's misconduct need not be related to a claim to justify its subordination.

Subordination in Bankruptcy

A bankruptcy court's ability to reorder the relative priority of claims or debts under appropriate circumstances is derived from its broad powers as a court of equity. The statutory vehicle for applying these powers in a bankruptcy case is section 510 of the Bankruptcy Code.

Section 510 authorizes involuntary subordination — *i.e.*, subordination under circumstances not involving the voluntary undertakings of two or more parties to a contract — in two cases. First, section 510(b) automatically subordinates any claim for damages arising from the rescission of a purchase or sale of a debtor-company's securities to the claims of ordinary creditors. Its purpose is to prevent the bootstrapping of equity interests into claims that are on a par with other creditor claims, consistent with the Bankruptcy Code's "absolute priority" rule.

Second, misconduct that results in injury to other creditors can warrant the "equitable" subordination of a claim under section 510(c). The statute does not specify what kind or degree of misconduct justifies application of the remedy, providing merely that the bankruptcy court may "under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim." Nor does section 510(c) specify whether the misconduct must be somehow related to the claim. It has been left to the courts to develop criteria for applying the remedy.

In 1977, the Fifth Circuit Court of Appeals in *In re Mobile Steel Co.* articulated what has become the most commonly accepted standard for equitably subordinating a claim. Under the *Mobile Steel* test, a claim can be subordinated if the claimant engaged in some type of inequitable conduct that resulted in injury to creditors (or conferred an unfair advantage on the claimant), and if equitable subordination of the claim is consistent with the provisions of the Bankruptcy Code. Courts have since refined the test to account for special circumstances. For example, many make a distinction between insiders (*e.g.*, corporate fiduciaries) and non-insiders in assessing the level of misconduct necessary to warrant subordination. In addition, although subordination is most often invoked in cases where misconduct is related to a claim, the remedy has been applied when no such nexus exists. Regardless of the standard applied, two principles are clear under the *Mobile Steel* test: equitable subordination requires some kind of misconduct and a claim or interest will be subordinated only to the extent necessary to redress it.

The majority of courts follow the *Mobile Steel* approach. Still, some courts have taken issue with the principle that subordination of non-shareholder claims requires a showing of misconduct that injures other creditors. In many cases, their reasoning derives from decisions and policies that pre-date enactment of the Bankruptcy Code in 1978. They also rely on statements in the legislative history of section 510(c) indicating that pre-Code decisions can assist in determining the priority of claims under the Bankruptcy Code. For example, a long line of cases in the First Circuit once stood for the proposition that stock redemption claims should be categorically subordinated even though such claims may not fall within the scope of present-day section 510(b).

In 1996, the U.S. Supreme Court attempted to dispel any lingering uncertainty concerning the scope of section 510(c) in a pair of rulings. In *United States v. Noland*, the Court found that section 510(c) does not permit a court to subordinate a noncompensatory tax penalty claim of the IRS that would otherwise have been entitled to administrative expense priority. In part, the ruling was predicated on the idea that section 510(c) codifies the equitable power of the bankruptcy court to consider claims on a case-by-case basis. The subordination of tax penalty claims based on a general policy, rather than the individual claim's merits, the Court reasoned, represents an inappropriate exercise of section 510(c) in a legislative, rather than equitable, manner. The Supreme Court employed similar reasoning to invalidate subordination of an unsecured tax penalty claim in *United States v. Reorganized CF & I Fabricators of Utah, Inc.* Even so, the Supreme Court stopped short of deciding whether creditor misconduct is a prerequisite to equitable subordination in all cases.

Claims Trading

The answer to that question can be of crucial significance if a creditor sells or otherwise transfers its claim prior to or during the course of a bankruptcy case. The market for "distressed" debt is thriving and largely unregulated. Sophisticated players in the market are aware of most of the risks associated with acquiring discounted debt, but generally focus on the enforceability of the obligation in question and its probable payout or value in terms of bargaining leverage. These risks can be often assessed with reasonable accuracy by examining the underlying documentation, applicable non-bankruptcy law, the obligor's financial condition and its prospects for satisfying its obligations in whole or in part. Other types of risk may be harder to quantify. For this reason, most claim transfer agreements include a blanket indemnification clause designed to compensate the transferee if a traded claim proves to be unenforceable in whole or in part.

An assigned claim is generally enforceable by the assignee in a bankruptcy case to the same extent that it would be enforceable in the hands of the assignor. With the exception of certain priority claims for employee wages and benefits, amounts owed to farmers and fishermen, consumer deposits, alimony and support, taxes and capital maintenance obligations to federally insured banks, a transferred claim also retains its priority in the hands of the transferee. The flip side of the analysis, however, is whether a transferred claim is subject to the same defenses that the obligor could have asserted against the original holder of the claim, including limitations on the enforceability or priority of the claim based upon the pre-transfer conduct of the transferor. This was the question posed to the bankruptcy court in *Enron*.

The Court's Ruling in Enron

Enron Corporation and approximately 90 affiliated companies began filing for chapter 11 protection in December of 2001. Shortly before filing for bankruptcy, Enron borrowed $3 billion under short- and long-term credit agreements from a consortium of banks, including Fleet National Bank, and Citibank N.A. and Chase Manhattan Bank, as co-administrative agents. Citibank later filed a proof for claim for amounts due under the agreements on behalf of all participating banks, including Fleet.

During the course of Enron's bankruptcy, Fleet sold its claims against Enron to various entities, some of which later transferred the claims to other acquirors. The claims ultimately came to be held by five separate distressed investment funds (collectively referred to as the "defendants"), none of which had loaned money to Enron or had any existing relationship with the company.

In 2003, Enron sued the banks claiming, among other things, that Fleet and certain of its affiliates were the recipients of pre-bankruptcy preferential or fraudulent transfers and that Fleet aided and abetted Enron's accounting fraud, resulting in injury to Enron's creditors and conferring an unfair advantage on Fleet. None of the allegations dealt with purported misconduct related to the credit agreements. In a separate proceeding, Enron sought to subordinate and disallow Fleet's claims under the credit agreements. Enron sought equitable subordination under section 510(c) even though Fleet had transferred its claims to the defendants. The defendants moved to dismiss the subordination proceeding.

The bankruptcy court denied the motion. Framing the ultimate question before it as "whether the Claims transferred by the original holder . . . are immunized from equitable subordination," the court embarked upon a three-part analysis. First, it considered whether section 510(c) grants a court authority to subordinate claims that do not arise from misconduct, but were held initially by a creditor who engaged in misconduct unrelated to the claims. The court concluded that it does.

For support, it relied upon the Fifth Circuit's pronouncement in *Mobile Steel* that "[i]mproper acts unconnected with the acquisition or assertion of a particular claim have frequently formed at least a part of the basis for the subordination of that claim." No federal court, the court observed, has since ruled to the contrary, and the Fifth Circuit reaffirmed the vitality of the principle in 1987 in *In re Missionary Baptist Foundation*, where it noted that a claim could conceivably be subordinated even though the claimant "himself committed no overt acts of misconduct" because the claimant's partner did act inequitably.

The bankruptcy court also looked to a ruling handed down by the Ninth Circuit Court of Appeals in *Tone v. Smith (In re Westgate-California Corp.)*. There, a bankruptcy court initially subordinated claims that related to a creditor's misconduct as well as claims that did not, based upon evidence of pervasive misconduct on the part of the creditor throughout the course of her relationship with the debtor. It later modified this ruling to limit subordination only to those claims related to misconduct. On appeal, the district court reinstated subordination of all of the creditor's claims. The Ninth Circuit reversed that determination, concluding that because the harm caused by the creditor could be remedied by subordinating claims related to inequitable conduct, subordination of all of the creditor's claims was punitive.

Despite reversal of the underlying order subordinating claims unrelated to misconduct, the Ninth Circuit's ruling did not go so far as to condemn such a remedy in an appropriate case — *i.e.*, where the measure of harm or unfair advantage exceeds the value of claims directly tainted by misconduct. The bankruptcy court in *Enron* relied upon the Ninth Circuit's underlying rationale, consistent with subordination's purpose in ensuring a just and fair distribution of the bankruptcy estate, to conclude that section 510(c)'s scope is not limited to claims directly related to misconduct.

Next, the bankruptcy court considered whether claims that could have been subordinated in the hands of the original creditor remain subject to equitable subordination in the hands of a transferee. Remarking that "[t]here is no basis to find or infer that transferees should enjoy greater rights than the transferor," the court concluded that transferred claims are still subject to equitable subordination in the hands of a blameless transferee.

The court refused to speculate on the extent to which a contrary ruling would encourage creditors who have engaged in misconduct to "wash" their claims by selling them to innocent transferees. Instead, it focussed on the added burden borne by debtors forced to expend estate assets in an effort to collect damages from a tainted claim's original holder rather than simply equitably subordinating the claim. According to the court, "[b]urdening of the estate with the necessity of collecting damages to effectuate the remedy of equitable subordination would undermine the remedy itself."

The bankruptcy court gave short shrift to the defendant's contention that subordination of an assigned claim in the hands of a blameless transferee would adversely impact the claims trading market. The risk of equitable subordination, the court emphasized, is a danger of which potential acquirors are well aware, and in fact, specifically account for by incorporating indemnifying language in any transfer agreement. Eliminating such risks by providing special protection to purchasers of claims subject to subordination, the bankruptcy court explained, "would create a 'special' class of claimholders," a concept that is supported neither by the Bankruptcy Code nor caselaw interpreting it.

Finally, the bankruptcy court considered whether the defendants could rely upon a "good faith" defense to insulate their assigned claims from subordination. It concluded that they could not. The court rejected the defendants' contention that provisions in the Bankruptcy Code protecting good faith transferees from liability for otherwise avoidable transfers suggest that Congress intended to provide the same kind of safe harbor in the context of section 510(c). According to the court, the statute's protection of good faith transferees is limited to avoidance actions, and had Congress intended to include subordination actions within the scope of the safe harbor, it would have done so specifically. Moreover, the court emphasized, even if such a safe harbor existed, the defendants could not qualify for it because they "knew or should have known the risks associated with the purchase of a debtor's distressed debt," including the risk of equitable subordination.

Based upon its findings, the bankruptcy court denied the defendants' motion to dismiss Enron's equitable subordination proceeding.

Outlook

The defendants in *Enron* immediately appealed the bankruptcy court's decision. The ruling has been greeted by a storm of criticism from players in the distressed debt market, including the Loan Syndications and Trading Association ("LSTA"). According to the LSTA, if the decision stands, the claims held by a bona fide purchaser would be equitably subordinated even though it might be impossible for the acquiror to know, even after conducting rigorous due diligence, that it was purchasing loans from a “bad actor.”

Beyond its possible impact on the claims trading market, the decision represents a departure from the typical equitable subordination paradigm. To be sure, all of the precedents relied upon by the bankruptcy court clearly articulate the proposition that misconduct need not be directly related to the claim that is being subordinated. Still, none of these cases involved claims asserted by an "innocent" transferee. In *Missionary Baptist*, the Fifth Circuit reversed the bankruptcy court's decision to subordinate claims asserted by the partner of a creditor that engaged in misconduct because the Court of Appeals could not determine from the lower court's decision the basis for its ruling. The Court's observation that the absence of any misconduct on the part of the claimant-partner would not preclude subordination was based upon the "peculiar" circumstance that the claimant, as the partner of an individual who did engage in misconduct, was "intimately familiar with the transactions that gave rise to the notes subordinated by the bankruptcy court." Moreover, the Fifth Circuit cautioned that its ruling should not be relied upon as a blanket mandate for subordinating claims in the hands of "innocent" transferees:

> [W]e do not express an opinion on a hypothetical case in which a note is in some way passed by an inequitable actor to an innocent, uninvolved bystander. In that hypothetical situation, one which is not presented in this case, there might be reasons to find that subordination of a note would be contrary to the principles of equitable subordination as they have developed in the courts.

Westgate-California similarly does not provide unequivocal support for the proposition that the claims of blameless transferees can be equitably subordinated based upon misconduct committed by the transferor unrelated to the assigned claim. Beyond the fact that the Ninth Circuit in that case reversed the determination below to subordinate both claims that were related to misconduct and those that were not, the case involved a single creditor holding both kinds of claims rather than an innocent transferee.

In the absence of solid precedent for equitably subordinating assigned claims on the basis of a transferee's unrelated misconduct, we are left to consider whether such a rule comports with the purpose of the remedy and its role in the pantheon of a bankruptcy court's equitable powers. On one hand, a rule that, once tainted, a claim remains tainted no matter who asserts it is consistent with section 510(c)'s purpose in compensating injured creditors. Absent subordination of a tainted claim, the estate's only recourse would be to sue the original transferor for damages. Section 510(c), like provisions in the statute disallowing claims asserted by the recipients of avoidable transfers, was designed in part to relieve the estate of this burden.

On the other hand, subordinating the claim of a blameless transferee based upon the original holder's misconduct, particularly where it is totally unrelated to the claim itself, may impose an unreasonable burden of inquiry on potential transferees. The practical ramifications of *caveat emptor* as the prevailing rule of law on this issue will likely cause traders to build greater protections into loan/claim transfer agreements and focus far more attention on the indemnities commonly given in distressed trades. Adoption of the rule announced in *Enron* could potentially might also increase the due diligence obligations for these trades. A transferor's creditworthiness, for example, may figure more prominently in an acquiror's calculus of the risks. Also, significant expense could be involved in litigation seeking indemnification.

Finally, the viability of *Enron* in cases involving securities or claims other than bank debt is not clear. In this context, non-bankruptcy law may insulate from attack securities held by a holder in due course or good faith purchaser.

Enron Corp. v. Avenue Special Situations Fund II, LP (In re Enron Corp.), 333 B.R. 205 (Bankr. S.D.N.Y. 2005).

Benjamin v. Diamond (In re Mobile Steel Co.), 563 F.2d 692 (5th Cir. 1977).

United States v. Noland, 517 U.S. 535 (1996).

United States v. Reorganized CF & I Fabricators of Utah, Inc., 518 U.S. 213 (1996).

Wilson v. Huffman (In re Missionary Baptist Foundation), 818 F.2d 1135 (5th Cir. 1987).

Trone v. Smith (In re Westgate-California Corp.), 642 F.2d 1174 (9th Cir. 1981).