The Cautionary Tale Continues: Debt Acquired from Recipient of Voidable Transfer Subject to Disallowance under Section 502(d)

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In the January/February 2006 edition of *Business Restructuring Review* (vol. 5, no. 1), we reported on a highly controversial ruling handed down by the New York bankruptcy court overseeing the chapter 11 cases of embattled energy broker Enron Corporation and its affiliates. The court held that a claim is subject to equitable subordination under section 510(c) of the Bankruptcy Code even if it is assigned to a third-party transferee who was not involved in any misconduct committed by the original holder of the debt.

The ruling had players in the distressed securities market scrambling to devise better ways to limit their exposure by building stronger indemnification clauses into claims transfer agreements. The “buyer beware” approach articulated by Bankruptcy Judge Arthur J. Gonzalez has been greeted by a storm of criticism from lenders and traders alike, including the Loan Syndications and Trading Association (“LSTA”), the Securities Industry Association, the International Swaps and Derivatives Association, Inc. and the Bond Market Association. According to these groups, if *caveat emptor* is the prevailing rule of law, claims held by a bona fide purchaser can be equitably subordinated even though it may be impossible for the acquirer to know, even after conducting rigorous due diligence, that it was buying loans from a “bad actor.”

Judge Gonzalez recently expanded the scope of his cautionary tale to encompass not only subordination of a transferred claim, but disallowance of the claim altogether. In *In re Enron Corp.*, he ruled that a transferred claim should be disallowed under section 502(d) of the Bankruptcy Code unless and until the transferor returns payments to the estate that are allegedly preferential. Judge Gonzalez also held that the safe harbor for good faith recipients of avoidable transfers does not apply to the assignee of a claim, and that, even if it did, an assignee cannot qualify for the defense because it is presumed to have knowledge at the time it acquires a claim of both the debtor's precarious financial circumstances or bankruptcy filing and the likelihood that an investigation will be conducted into possible grounds for disallowance of the claim.

Allowance and Disallowance of Claims in Bankruptcy

Whether a creditor's claim is allowed or disallowed in a bankruptcy case is governed by the procedures contained in section 502 of the Bankruptcy Code. Section 502(a) provides that a filed proof of claim is deemed allowed unless a party-in-interest files a written objection with the court. If an objection is filed, section 502(b) directs the bankruptcy court to determine the allowed amount of the claim after notice and a hearing in accordance with certain restrictions and limitations specified in the statute (*e.g.*, disallowing claims for unmatured interest and capping landlord claims for future rent).

Section 502(c) of the Bankruptcy Code mandates the estimation of almost any contingent or unliquidated claim if the failure to do so "would unduly delay the administration of the case." Thus, for example, if litigation is pending against the debtor when it files for bankruptcy, but has not yet gone to trial, the bankruptcy court can estimate the debtor's liability to the plaintiffs in lieu of modifying the automatic stay to allow the action to proceed until judgment.

The Bankruptcy Code also provides for the temporary estimation of a claim. Under Rule 3018(a) of the Federal Rules of Bankruptcy Procedure, a bankruptcy court "may temporarily allow [a] claim or interest in an amount which the court deems proper for the purpose of accepting or rejecting a plan." Temporary allowance of a claim for the limited purpose of voting on a plan is appropriate because creditors whose claims are disputed would otherwise be completely disenfranchised in chapter 11 cases where the claims resolution process cannot be completed prior to voting.

The statute also creates a mechanism to penalize certain creditors who have possession of estate property on the bankruptcy petition date or are the recipients of pre- or post-bankruptcy asset transfers that can be recovered because they are fraudulent, preferential, unauthorized or otherwise subject to forfeiture by operation of a bankruptcy trustee's avoidance powers. Section 502(d) of the Bankruptcy Code provides that the court shall disallow any claim asserted by a creditor who falls into one of these categories, "unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable." The purpose of the provision is to facilitate pro rata distribution of the bankruptcy estate among all creditors and to coerce payment of judgments obtained by the trustee. Most courts take the approach that the underlying avoidance claims must be adjudicated fully before a claim can be disallowed under section 502(d). Some courts, noting that the statute refers to property that is "recoverable" or a transfer that is "avoidable," find that colorable allegations to that effect are sufficient to trigger temporary disallowance for certain purposes (*e.g.*, voting on a plan of reorganization or to receive distributions of estate property) subject to later reconsideration.

Claims Trading

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. In most cases, however, an assigned claim is also 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.

Only a handful of courts have considered the application of section 502(d) to a claim that has been assigned by a creditor who allegedly falls within the scope of the statute. The New York bankruptcy court was the latest to address the question in *Enron*.

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.

Enron sued the banks in 2003 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 or transfers made or obligations incurred in connection with the agreements. Instead, Enron's allegations concerned an unrelated prepaid forward transaction involving the same lenders that took place in 2000. In a separate proceeding filed in 2005, Enron sought to subordinate and disallow Fleet's claims under the credit agreements. Enron sought to equitably subordinate the claims under section 510(c) and to disallow them under section 502(d) even though Fleet had transferred the claims to the defendants. The defendants moved to dismiss the proceeding.

The Bankruptcy Court's Ruling

As previously reported, the bankruptcy court denied the motion to dismiss Enron's equitable subordination claims, ruling that a debt can be subordinated even if assigned to a blameless transferee. In a separate opinion, the court addressed dismissal of Enron's causes of action against the defendants under section 502(d). Consistent with its previous determination, the bankruptcy court reaffirmed the principle that a transferred claim is subject to the same shortcomings, including any defenses, to which it was subject in the hands of the original holder of the obligation.

At the outset, the court examined whether entry of a judgment in the underlying avoidance action is a prerequisite to disallowance of a claim under section 502(d). It ruled that prior adjudication on the merits is unnecessary under the circumstances because, in connection with a motion to dismiss, it need only decide whether Enron's causes of action under section 502(d) are viable pending adjudication of the avoidance litigation. Even so, based upon its conclusion (discussed below) that Enron's section 502(d) claim is viable, the court held that "no distribution can be made to the Defendants with respect to the Claims pending a resolution of their disputed claims."

Next, the bankruptcy court addressed the application of section 502(d) to assigned claims. It rejected the defendants' argument that the plain language of the statute supports the position that a claim can be disallowed only if the holder of the claim can be a defendant in an avoidance or recovery proceeding. According to the court, section 502(d) clearly applies to "any claim" of an entity from whom property or its value can be recovered — it does not require that the claim be

related to an avoidable transfer or that such a transfer or other basis for liability occur after a creditor acquires a claim. Observing that "[t]he Court has not found any case law mandating that the creditor who received an avoidable transfer be the same entity that actually asserts such claim against the debtor in the bankruptcy proceeding in order for a debtor to assert a section 502(d) disallowance against the claim," the bankruptcy court ruled that the defendants' claims were subject to the same defenses that applied to them when the claims were held by Fleet.

Responding to policy concerns implicated by a ruling that might encourage "claim washing," on the one hand, or undermine confidence in the claims trading market, on the other, the bankruptcy court emphasized that the proper inquiry should focus on ensuring that the purpose of section 502(d) is not contradicted or undermined. It rejected the defendants' argument that their claims should not be subject to disallowance because Enron has a remedy against Fleet, a solvent entity that would be bound by any judgment issued by the court. According to the bankruptcy court, "[t]he solvency of an entity or creditor is not a factor or element required to be considered under section 502(d) of the Bankruptcy Code."

The allowance of a claim assigned by the recipient of a voidable transfer, the court observed, "would eviscerate the purpose of section 502(d)" because it would force a bankruptcy trustee or chapter 11 debtor-in-possession to act affirmatively to seek recovery from the original creditor rather than relying on section 502(d) as a defense that, when invoked, bars any distribution of estate funds to the holder of the claim. The bankruptcy court was unmoved by the defendants' contentions regarding an adverse impact on the claims trading market, remarking that "participants in the claims-transfer market are aware of, or should be aware of, the risks and

uncertainties inherent in the purchase of claims against the debtors, including the possibility of claims being temporarily disallowed under section 502(d) unless and until their predecessors turn over the avoidance transfers." Participants in the market, the court emphasized, assume the liabilities arising from acquired claims. According to the court, the risks associated with buying claims in a bankruptcy proceeding have been identified in the distressed debt industry for at least a decade and participants have dealt with such risks by including broad indemnification language in claims transfer agreements, such as the Standard Terms and Conditions on the Purchase and Sale Agreement for Distressed Trades published by the LSTA.

Finally, the bankruptcy court turned to the defendants' claim that, as "innocent" transferees, they are entitled to assert a "good faith" defense. The court explained that section 550 of the Bankruptcy Code, which is incorporated into section 502(d), provides that, even if a transfer is avoidable as a preference, fraudulent conveyance or otherwise, the bankruptcy trustee may not recover the property or its value from any transferee "who takes for value, . . . in good faith, and without knowledge of the voidability of the transfer avoided." According to the defendants, the "good faith" defense should be extended to purchasers of claims, and because they had no knowledge of any of the allegations asserted in Enron's suit against Fleet when they purchased their claims, the claims should not be disallowed under section 502(d).

The bankruptcy court ruled that section 550(b) does not apply to claims transferees, and that, even if it did apply, the defendants could not establish that they were entitled to rely on the good faith defense. Section 550(b), the court explained, on its face and by intention, protects only good faith purchasers of estate property — there is no authority to support the proposition that its

scope extends to purchasers of claims against the estate. Moreover, the court emphasized, even if the scope of the statute were broad enough to protect transferees of claims, the defendants could not successfully invoke the good faith defense because "a purchaser of a claim, by definition, knows that it is purchasing a claim against a debtor and is on notice that any defense or right of the debtor may be asserted against that claim."

According to the court, the criteria for determining whether a transferee acted in good faith in purchasing a claim "does not solely rely upon such transferee's actual knowledge of whether the claims would be challenged." Instead, the bankruptcy court explained, a claims transferee cannot rely on section 550(b) if it has either (i) knowledge of the debtor's possible insolvency or unfavorable financial condition at the time of the transfer or (ii) notice that the transfer may be recovered by the trustee. Applying these criteria, the court concluded that the defendants clearly were not "without knowledge of the voidability of the transfer" as required by section 550(b). It accordingly denied the defendants' motion to dismiss Enron's causes of action under section 502(d).

Outlook

Enron is not the first decision to address the disallowance of assigned claims under section 502(d) or its predecessor. The Eighth Circuit Court of Appeals confronted the issue over a century ago in *Swarts v. Siegel*, disallowing an assigned claim under section 57g of the Bankruptcy Act of 1898 because the original holder had received a preference and remarking that "[t]he 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." More recently, Judge Robert D. Drain of the United States

Bankruptcy Court for the Southern District of New York reached the same conclusion under the current statute in *In re Metiom, Inc.*, characterizing the attempted destruction of a section 502(d) claim defense by means of assignment of the claim as "a pernicious result" and observing that "[t]he assignment should not, and does not, affect the debtor's rights vis-à-vis the claim; it is incumbent, instead, on prospective assignees to take into account possible claim defenses when they negotiate the terms of their assignments."

The defendants in *Enron* relied on an unpublished opinion issued by a Texas district court in *Section 1102(A)(1) Comm. of Unsecured Creditors v. Williams Patterson, Inc.(In re Wood & Locker, Inc.)* as support for the proposition that a claim in the hands of a transferee can be disallowed only if the transferee is subject to avoidance liability. In that case, the creditors' committee commenced preference litigation against a creditor that had assigned its claim to a bank. The bank was permitted to intervene in the avoidance action, and later commenced a separate adversary proceeding seeking a declaratory judgment that it was not subject to preference liability under sections 547 and 550, and that its assigned claim could not be disallowed under section 502(d), so that it was entitled to receive distributions under the debtor's chapter 11 plan. The bankruptcy court granted summary judgment in the bank's favor on these issues.

On appeal, the district court explained that, under the former Bankruptcy Act, a creditor had the option of retaining a preference and forgoing any distribution from the estate or seeking recovery from the estate by filing a proof of claim. The trustee could invoke section 57g as a defense only in the latter case. "Such is not the case under the modern Code," the district court observed,

emphasizing that "[t]he analytical tool to unlock the mysteries of Sec. 502(d) is to examine the enumerated sections to determine whether the transferee has liability. Where there is no liability under those sections, Sec. 502(d) is not triggered."

In *Enron*, Judge Gonzalez found *Wood* to be unpersuasive. He explained that the district court cited no authority for its interpretation of section 502(d) from either relevant caselaw or the provision's legislative history, which indicates that the focus of sections 57g and 502(d) is the same, and that both provisions concern not the holder of a claim, but the claim itself. Judge Gonzalez also faulted the court in *Wood* for dismissing *Swarts* and other decisions interpreting section 57g as inapposite because they "involved sureties who had received provable and traceable direct benefits by the payment of the preferences," whereas no funds were traceable to the bank/transferee in *Wood*. According to Judge Gonzalez, "although there were factual differences between *Swarts* and *Wood*, those factual differences do not undermine the legal principle that 'the 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 by another, until the preference is surrendered.'"

The defendants in Enron also relied on *Maxwell Communication Corp. PLC v. Société Générale PLC (In re Maxwell Communication Corp.)* as authority for the principle that section 502(d) disallows only claims asserted by entities that have received voidable transfers. In *Maxwell*, the debtor, a U.K. corporation, sold certain U.S. assets and used the proceeds to pay obligations owed to three different U.K. banks shortly before filing for chapter 11 protection in the U.S. and

filing a petition in the High Court of Justice in London for an administration order under the U.K. Insolvency Act of 1986.

After the banks filed their claims with the English Court, the debtor commenced litigation in the U.S. bankruptcy court to avoid the payments to the banks as preferential and to disallow their claims under section 502(d). The U.K. banks moved to dismiss, arguing that an English court should adjudicate the preference claims applying English law because the debtor was a U.K. corporation, the recipients were U.K. banks and the transfers were made overseas. The bankruptcy court agreed.

On appeal to the district court, the debtor contended, among other things, that even if the transfers could not be avoided under section 547, the claims filed by the banks in the U.K. should be disallowed under section 502(d). The district court rejected this argument:

> In order for a transferee's claim to be disallowed under § 502(d), however, it must have received a "transfer avoidable" under § 547. Obviously, the Banks have not received a "transfer avoidable" under § 547 because that section does not apply to the payments to the Banks. In addition, § 502 only applies to the allowance and disallowance of claims filed under 11 U.S.C. § 501. *See Durham v. SMI Indus Corp.*, 882 F.2d 881, 883 (4th Cir. 1989) ("Since a court can only disallow a claim after one has been filed under [section 501(a)], "claim" in § 502(d) includes only one for which a proof has been filed."). As discussed above, the Banks have lodged a Notice of Claim in the English court but have not filed a Proof of Claim under § 501 and thereby submitted to the equitable jurisdiction of the U.S. court. Accordingly, there are no "claims" to disallow under § 502(d), and the appellants are therefore not entitled to the relief they seek.

The *Enron* court distinguished *Maxwell* because the entities asserting the claims in the case were the recipients of voidable transfers rather than purchasers of claims against the debtor. It also faulted the court's reasoning concerning the submission of a proof of claim as a condition to disallowance under section 502(d), observing that "[i]t is well established that 'section 502(d)

does not deal with proofs of claim.'" The bankruptcy estate, the court emphasized, "can demand a creditor to surrender any avoidable transfers even in a circumstance where such creditor does not file a proof of claim against the debtor and thereby waives any distribution from the estate."

Even if *Enron* is not the first ruling on this issue, it may have greater repercussions in terms of its impact on the claims trading market. 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 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.

The viability of *Enron* in cases involving securities or claims other than bank debt is not clear. In *dicta*, Judge Gonzalez suggested that the same rule should apply to traded claims based upon bonds or notes because the "post-petition purchaser of such debt instruments either knows or should know that the issuer of these securities is a debtor, so the prices of these transfers would reflect the attendant risks that the claims would be subordinated [sic]." He presumably intended to say "disallowed," rather than "subordinated" given the circumstances. Even so, the judge did not hazard an opinion on whether a different rule would apply if a note or bond is traded before the debtor files for bankruptcy, when the purchaser has no reason to be aware of anything other than the possibility that the obligor may file a bankruptcy case. Finally, in other contexts, non-

bankruptcy law may insulate from attack certain kinds of claims held by a holder in due course or good faith purchaser.

In re Enron Corp., 340 B.R. 180 (Bankr. S.D.N.Y. 2006).

Swarts v. Siegel, 117 F. 13 (8th Cir. 1902).

In re Metiom, Inc., 301 B.R. 634 (Bankr. S.D.N.Y 2003).

Section 1102(A)(1) Comm. of Unsecured Creditors v. Williams Patterson, Inc.(In re Wood & Locker, Inc.), 1988 U.S. Dist. LEXIS 19501 (D. Tex. 1988).

Maxwell Communication Corp. PLC v. Société Générale PLC (In re Maxwell Communication Corp.), 186 B.R. 807 (S.D.N.Y. 1995).