Enron Redux: Round Two Goes to Claims Purchasers/Traders

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In previous editions of the *Business Restructuring Review*, we reported on a pair of highly controversial rulings handed down in late 2005 and early 2006 by the New York bankruptcy court overseeing the chapter 11 cases of embattled energy broker Enron Corporation and its affiliates. In the first, Bankruptcy Judge Arthur J. Gonzalez 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. In the second, Judge Gonzalez broadened the scope of his cautionary tale, ruling 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.

Although immediately appealed, the rulings 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. Their "buyer beware" approach, moreover, was greeted by a storm of criticism from lenders and traders alike, including the Loan Syndications and Trading Association, 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 acquiror to know, even after conducting rigorous due diligence, that it was buying loans from a "bad actor."

An enormous amount of attention was focused on the appeals, with industry groups, legal commentators, Enron creditors, distressed investors, academics and other interested parties seeking the appellate court's leave to register their views on the issues involved and the impact of the rulings on the multi billion-dollar market for distressed claims and securities. The vigil ended on August 27, 2007. In a carefully reasoned 53-page opinion, District Judge Shira A. Scheindlin vacated both of Judge Gonzalez's rulings, holding that "equitable subordination under section 510(c) and disallowance under section 502(d) are personal disabilities that are not fixed as of the petition date and do not inhere in the claim."

Statutory Provisions Involved

The Bankruptcy Code creates a mechanism to deal with 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 promote the pro rata distribution of the bankruptcy estate among all creditors and to coerce payment of judgments obtained by the trustee.

Equitable subordination is a common-law doctrine predating the enactment of the Bankruptcy Code designed to remedy misconduct that causes injury to creditors (or shareholders) or confers an unfair advantage on a single creditor at the expense of others. The remedy is now codified in section 510(c) of the Bankruptcy Code, which provides that "the 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 or all or part of an allowed interest to all or part of another allowed interest." The statute, however, does not define the circumstances under which subordination is warranted, leaving the development of such criteria to the courts.

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.

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. Citibank N.A. and Chase Manhattan Bank served as co-administrative agents. Citibank later filed a proof of 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 again to other acquirors. The claims ultimately came to be held by five separate distressed-investment funds (collectively referred to as the "transferees"), 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 constructively 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 even though the claims had been transferred to the transferees. The transferees moved to dismiss the proceedings.

The Bankruptcy Court's Rulings

The bankruptcy court denied the motion to dismiss Enron's equitable subordination claims. Observing 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 bankruptcy court gave short shrift to the transferees' 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 for which, in fact, they specifically account 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 by neither the Bankruptcy Code nor case law interpreting it.

In a separate opinion, the court addressed dismissal of Enron's causes of action against the transferees 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.

The bankruptcy court rejected the transferees' 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 transferees' claims were subject to the same defenses that applied to them when the claims were held by Fleet.

Both rulings were appealed by the transferees, all but one of which settled before the district court issued its ruling.

The District Court's Ruling: Key Distinction Between Assignment and Sale

Noting that the issue before it "is complex and of first impression in this Circuit," the district court commenced its analysis by examining the important distinction between the legal concepts of "sale" and "assignment." Although each is a form of transfer, the court explained, the terms are not synonymous and have very different legal consequences for the transferee:

> With respect to assignments, "[a]n assignee stands in the shoes of the assignor and subject to all equities against the assignor." In other words, "an assignee of a claim takes with it whatever limitations it had in the hands of the assignor . . . . By contrast, these assignment law principles do not apply to sales. A purchaser does not stand in the shoes of the seller and, as a result, can obtain more than the transferor had in certain circumstances.
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> These distinctions apply with the same force to transfers of debt and claims. An assignee of a claim takes no more than the assignor had to give. A purchaser of a claim may take more. Although characteristics that inhere in a claim may travel with the claim regardless of the mode of transfer, the same cannot be said for personal disabilities of claimants. A personal disability that has attached to a creditor who transfers its claim will travel to the transferee if the claim is *assigned*, but it will not travel to the transferee if the claim is *sold*.

The court then discussed certain exceptions to the general rule that an assignor cannot give more than he has. The first exists for holders in due course of negotiable instruments who, to qualify for that status, must take an instrument for value in good faith and without notice that the instrument is overdue, has been dishonored or is subject to any defense or claim. Any holder in

due course will take an instrument free from all competing claims to it and, with certain exceptions, all defenses of any party to the instrument with whom the holder has not dealt. A post-petition assignee of a claim, however, cannot qualify as a holder in due course because it cannot take the instrument "without notice that it is overdue."

Key Points

- As a general rule, whether a transfer is in the form of a sale or an assignment will determine whether the transferee's claims can be subject to equitable subordination under section 510(c) or disallowance under section 502(d) based upon the transferor's misconduct.
- In most cases, purchased claims will be insulated from subordination and/or disallowance, while assigned claims will not.
- Not every purchaser of a claim will be automatically exempt from subordination exposure. Claims purchased in bad faith and claims bought by those with actual notice of the seller's misconduct who engage in misconduct themselves will still be subject to equitable subordination.
- Not all claims of assignees who take from bad actors will automatically be subject to equitable subordination. The claim of an assignee who qualifies as a holder in due course or can rely on the "doctrine of latent equities" (depending upon which state's law governs the contract) may be protected from subordination.
- Because post-petition assignees of claims, including negotiable instruments, cannot take an instrument "without notice that it is overdue," they cannot qualify as holders in due course.

The second exception to the general rule is the "third party latent equities doctrine," which provides that an assignee without notice takes property free and clear from the latent equities of

third parties other than the debtor. Many states, however, including New York, do not recognize the doctrine in the context of transfers of "choses in action," which include bankruptcy claims.

Having drawn the distinction between assignments and sales, the court proceeded to an examination of the language of sections 510(c) and 502(d) to determine whether, as Enron contended, "all rights among competing claims to a bankruptcy estate are fixed and determined" as of the bankruptcy petition date, such that the claims transferred were "forever tainted" as of that point in time. The district court concluded otherwise.

The language of section 510(c), the court explained, reveals that equitable subordination cannot be "fixed" on the petition date because: (i) a claim or interest can be subordinated only after notice and a hearing; (ii) the remedy is permissive, not mandatory; (iii) subordination can be based upon post-petition conduct; and (iv) inasmuch as *Mobile Steel* dictates that equitable subordination is not available to creditors who did not suffer injury, creditors who acquired their claims post-petition and after the alleged misconduct upon which equitable subordination is based "may not be entitled to that remedy . . . [such that] the circumstances of other creditors can become relevant post-petition and may alter the availability of equitable subordination."

Likewise with disallowance of a claim under section 502(d), the district court emphasized. The plain language of the provision indicates that: (i) court action is necessary before a claim will be disallowed; (ii) disallowance is completely contingent on the recipient's refusal or failure to return an avoidable transfer; and (iii) disallowance can be based solely on the post-petition receipt of and failure to return an avoidable transfer.

Next, the court addressed the threshold question of law before it: Are equitable subordination and disallowance under the relevant statutes "attributes of a claim or are they personal disabilities of particular claimants?" If attributes, the court explained, they will travel with the claim regardless of the method of transfer, whereas if they are personal disabilities, their application to transferees "depends on whether the transfer was by way of sale or assignment."

Examining the language, history and application of equitable subordination, and noting the absence of any precedent on point, the district court concluded that Congress "intended to create a personal disability" when it enacted section 510(c). Relevant case law and the provision's legislative history, the court emphasized, focus on misconduct committed by the holder of the claim or, stated differently, focus on the "claimant rather than the claim." In fact, the court explained, Congress expressly rejected a broader wording of the provision that would have provided for subordination "on equitable grounds," opting instead for a version that actually limits the scope of the remedy. The court viewed the absence of any precedent equitably subordinating the claim of a transferee based upon the conduct of the transferor as a testament to the validity of its conclusion.

According to the district court, by expressly extending its rulings to all transfers of bankruptcy claims, the bankruptcy court "ignored the distinctions between assignments and sales and never addressed whether equitable subordination travels with the claim or is a personal disability." If a claimant purchases its claim, as opposed to taking it by assignment, operation of law, or subrogation, the court explained, "assignment law principles have no application with respect to

personal disabilities of claimants . . . [and] purchasers are protected from being subject to the personal disabilities of their sellers." This distinction, the court observed, is "particularly imperative" in the distressed-debt market, where sellers are frequently anonymous and buyers have no way of knowing whether the seller (or any preceding transferee) has engaged in misconduct or received an avoidable transfer. According to the district court, it is unclear how such "unknowable risk" could be priced by the market. By contrast, the court explained, parties to true assignments can readily contract around the risk of subordination or disallowance by means of indemnification clauses drafted to protect the assignee.

The district court reached a similar conclusion regarding section 502(d): the "language and structure of the statute is plain and requires the entity that is asserting the claim be the same entity (*i.e.*, 'such entity') that is liable for receipt of a failure to return property." This result, the court emphasized, comports with one of the provision's primary purposes in coercing the return of assets obtained by means of an avoidable transfer. This goal would not be served if a claim could be disallowed in the hands of an entity that is not the recipient of an avoidable transfer and could therefore not be compelled to return the assets conveyed. Such a result, the court reasoned, would also be inconsistent with the statute's coercive, rather than punitive, nature. Applying section 502(d) to purchasers of claims would be punitive "because they have no option to surrender something they do not have."

Relying on indemnity agreements to ameliorate the risk of disallowance, the court explained, would be problematic for two reasons: (i) standardized indemnity agreements did not come into use until years after the enactment of section 502(d), so that it is doubtful at best that lawmakers

intended reliance on such agreements as a means to protect claims purchasers from having their purchased claims disallowed; and (ii) such agreements do not exist in a substantial portion of the market, which involves anonymous trading in distressed debt. According to the court, the handful of existing decisions that have found section 502(d) liability to ride along with a transferred claim are flawed because they fail to distinguish between claims that are sold and claims that are merely assigned.

Having concluded that Congress intended sections 510(c) and 502(d) to create personal, rather than portable, liabilities, the district court refused to tailor its ruling to account for any policy concerns articulated by either the litigants or other interested parties. Even so, the court briefly discussed policy concerns regarding the possibility that claims tainted by misconduct can be "washed" simply by transferring them to innocent transferees.

Acknowledging that the availability of a direct action against the transferor "is not a perfect substitute" due to burden of proof and time value of money issues, the court downplayed the magnitude of any added burden associated with the unavailability of recourse to the transferor, observing that it is unlikely that transferors "will routinely be able to immunize themselves through sales" and characterizing the potential for protracted and costly litigation above and beyond what would be required to subordinate or disallow a claim as "somewhat exaggerated." So too, the court emphasized, "[i]nsolvency of the transferor is not of grave concern in the big picture." According to the court, the "more likely scenario" is that a lender in financial trouble who is anxious to sell its claims would be compelled to do so by means of an assignment that

includes representations, warranties, and indemnities — circumstances under which "there is no concern of loss to the estate because the transferee's claim *would* be disallowed."

Even so, the district court acknowledged, claim "washing" may be possible in some cases:

> At the end of the day, however, there can be no dispute that in limited circumstances, a bad faith transferor may be able to sell its claim to a bona fide purchaser for value, effectively "wash" its claim in the hands of the purchaser, take the proceeds and run, to the detriment of other creditors. However, the risk of that scenario is outweighed by the countervailing policy at issue, namely the law's consistent protection of bona fide purchasers for value . . . . This Court finds that the balance struck by the foregoing legal analysis is fair: the burden and risk is better carried by creditors as a whole in favor of the bona fide purchaser in the context of a sale, but better carried by the assignee in favor of the creditors in the context of an assignment, particularly given the ability of parties to an assignment to obtain indemnities and warranties.

Finally, addressing the effect that its interpretation of the statute would have on the market, the district court stated that "the two opinions below unnecessarily reached beyond the facts of the cases before the court" because none of the transferees at issue acquired its claim in the distressed debt market. According to the court, "[t]hat overreaching resulted in the outcry from commentators and *amici curiae*, who have expressed great concern that the effect of these opinions will wreak havoc in the markets for distressed debt." That result, the court concluded, "has now been avoided."

Outlook

District Judge Scheindlin's ruling in *Enron* is not the end of the story for either the litigants involved or players in the distressed-debt market. In addition to vacating Bankruptcy Judge Gonzalez's rulings, Judge Scheindlin remanded the cases below to determine whether the transfers involved were in the form of an assignment or a sale. The nature of the transaction will

determine whether the remaining non-settling transferee's claims can be subject to equitable subordination and/or disallowance based upon the transferor's alleged misconduct. If Judge Gonzalez finds that the transfer was via sale, the transferee's claims will be protected from subordination or disallowance. Otherwise, it will have to rely upon its indemnity agreement with the transferor because, as a post-petition transferee, it cannot be a holder in due course, and New York law, which governs the transfer agreements, does not recognize the doctrine of latent equities.

The message borne by *Enron* is undoubtedly a welcome one for players in the distressed-claims and securities-trading markets. Consistent with the district court's ruling, transferors should try to structure a transaction as a sale rather than an assignment to limit potential exposure. In cases where assignment is the only option, a carefully drafted indemnity agreement may be the only recourse. Finally, whether *Enron* will withstand additional appellate review remains to be seen at this juncture. On September 24, 2007, Judge Scheindlin denied a request by Springfield Associates LLC, which had purchased claims against Enron after it filed for chapter 11 protection, for leave to appeal her ruling. In doing so, the judge stated that an early appeal of the ruling could postpone litigation against Enron's lenders scheduled to commence in March of 2008.

In re Enron Corp., 2007 WL 2446498 (S.D.N.Y. Aug. 27, 2007).