T O O U R F R I E N D S A N D C L I E N T S

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Reversal of Enron Ruling on Claims Transfers - Reevaluating the Risks of Equitable Subordination

In a decision in *In re Enron Corp., et al.*, 2007 U.S. Dist. LEXIS 63129, No. 05-01025 (S.D.N.Y. August 27, 2007), the Honorable Shira Scheindlin, United States District Judge for the Southern District of New York, held that the sale of a claim that is subject to equitable subordination under section 510(c) or disallowance under section 502(d) of the Bankruptcy Code may insulate the claim from subordination and disallowance when asserted against the buyer of the claim. At first blush the decision may be, and has been, read by some to offer relief and clarity to distressed debt investors. However, study and review of the decision raises and leaves unanswered critical questions for the distressed debt market. All may be vetted further in the context of an appeal to the Second Circuit. However, any appeal to the Second Circuit will have to wait for another day. The District Court denied a motion for leave to appeal the interlocutory order to the Second Circuit. *In re Enron Corp., et al.,* Nos. 01-16034, 05-01025, slip op. (S.D.N.Y. Sept. 24, 2007).

Judge Scheindlin overturned two decisions rendered in *Enron* by the Honorable Arthur J. Gonzalez, United States Bankruptcy Judge. In one decision, Judge Gonzalez held that the transfer of a claim subject to equitable subordination will not free the claim from subordination in the hands of the ultimate holder. *Enron Corp. v. Springfield Assocs., L.L.C.*, 2005 WL 3873893, Nos. 01-16034, 05-01025, slip op. (Bankr. S.D.N.Y. Nov. 28, 2005). In the second decision, Judge Gonzalez held that where a claim is not allowable because the creditor had not returned a preference or other avoidable transfer, a transferee of the claim takes subject to disallowance on the same ground. *Enron Corp. v. Avenue Special Situations Fund II, LP*, 340 B.R. 180 (Bankr. S.D.N.Y. 2006). The District Court noted that the "unnecessary breadth of the bankruptcy court's decisions threatened to wreak havoc on the markets for distressed debt." The District Court reasoned that legal precedent providing "consistent protection of bona fide purchasers for value" outweighs the harm to other creditors in the context of a "sale" of a claim. However, the District Court made a distinction between the legal effect of a "sale" of a claim and the legal effect of an "assignment," stating that in the case of an assignment, the assignee takes the claim subject to the risks of equitable subordination or disallowance based on conduct of a prior holder of the claim. The decision

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of the District Court neither articulated the distinction between a sale and an assignment, nor set forth criteria that a court should use to determine whether a particular transfer is a sale or an assignment. Absent a clear distinction between a sale and an assignment, the decision of the District Court raises troubling questions that may affect trading in the distressed debt market.

Background

Prior to filing a bankruptcy petition on December 2, 2001 (the "Petition Date"), Enron entered into a $1.75 billion short-term credit agreement with a syndicate of banks, including Citibank. After the Petition Date, Citibank and other syndicate banks transferred portions of their claims under the Credit Agreement (the "Claims") to various third parties. In one instance, Citibank transferred its interest in a $5 million claim to Deutsche Bank (previously Bankers Trust Company). Deutsche Bank subsequently transferred the claim to Springfield Associates, L.L.C. Both transfers of the $5 million claim -- between Citibank and Deutsche Bank and Deutsche Bank and Springfield, respectively -- were transferred pursuant to a Purchase and Sale Agreement as well as an Assignment and Acceptance.

After the transfer of the Claims, on September 24, 2003, Enron filed an adversary proceeding against Citibank and the other syndicate banks for equitable subordination, disallowance and compensatory and punitive damages based on allegations that the syndicate banks engaged in inequitable conduct, failed to repay certain avoidable transfers, aided and abetted fraud and engaged in an unlawful civil conspiracy with insiders that resulted in injury to Enron's creditors.

Based on these same allegations, on January 10, 2005, Enron also commenced a series of adversary proceedings against the transferees of the Claims, including Springfield, seeking to equitably subordinate and disallow the transferred Claims based solely on the alleged misconduct of the syndicate banks. The Bankruptcy Court held that the transfer of a claim that is subject to equitable subordination will not free such claim from subordination in the hands of the ultimate holder and thus, based on the conduct of the syndicate banks, including Citibank, Springfield's claim would be subordinated and disallowed. On appeal, Judge Scheindlin reversed Judge Gonzalez's decisions, and remanded the dispute back to the Bankruptcy Court for a determination of whether the nature of the transfers between Citibank, Deutsche Bank and Springfield constituted an assignment or a sale.

Equitable Subordination and Disallowance

The District Court concluded that principles of equitable subordination and disallowance, as applied to claims, are personal disabilities of the claimants and not attributes of a claim. The District Court held that "purchasers are protected from being subject to the personal disabilities of their sellers." In this context,

the Court made a distinction between the legal effect of a sale of a claim and the legal effect of an assignment of a claim, noting that while personal disabilities of claimants do not travel with the claim if it is sold, if a claim is assigned, a personal disability of the claimant does transfer from claimant to assignee.

The District Court noted, however, that a sale of a claim does not always insulate a buyer from equitable subordination or disallowance based on wrongful conduct of the seller or the seller's receipt of a preference. In particular, if the buyer of the claim knew or had reason to know of the seller's wrongful conduct, this may result in equitable subordination of the claim in the hands of a transferee even if such transfer was deemed a sale, rather than an assignment. While this raises questions as to the extent of the knowledge that a purchaser has or should have had about the conduct of an original claim holder, purchasers who buy their claims from anonymous sellers on the open market should find comfort in the ruling of the District Court. Indeed, the District Court noted that, in the distressed debt market, "sellers are often anonymous and purchasers have no way of ascertaining whether the seller (or a transferor up the line) acted inequitably or received a preference. No amount of due diligence on their part will reveal that information, and it is unclear how the market would price such unknowable risk."

In contrast to its views about sales, the District Court held that usually an assignment of a claim will not insulate the transferee from adverse consequences caused by conduct of the transferor or a prior holder (unless, for example, the assignee is a holder in due course of a negotiable promissory note). The Judge noted that those who are "[p]arties to true assignments … can easily contract around the risk of equitable subordination or disallowance by entering into indemnity agreements to protect the assignee." In this case, Springfield had an indemnity agreement with Deutsche Bank, and the Court observed that Springfield had already availed itself of its remedies pursuant to its indemnity agreement with Deutsche Bank. It remains to be seen, however, whether the presence of the indemnity clause between Springfield and Deutsche Bank is viewed as an indicia of an assignment and how, on remand, the same will affect the Bankruptcy Court's determination of whether the subject transfer was an assignment or a sale.

Assignment vs. Sale of Claims

In focusing on the distinction between the rights and burdens that attach to a sale and the rights and burdens that attach to an assignment, the District Court did not provide detailed guidance with respect to the legal and practical distinctions between sales and assignments. The decision offers no cases on point where a prior court has analyzed a distinction between a sale and an assignment. Instead, the Court relies on *Feder v. Goetz*, 264 F. 619, 624-25 (2d Cir. 1920), a case that compares an assignment for the benefit of creditors for no consideration with a sale for consideration (rather than comparing a traditional assignment for consideration and a sale for consideration). The District Court also relies on *Corpus Juris Secundum*, a legal encyclopedia, for the proposition that "[w]hether or not a particular

transfer is an assignment or a sale or some other transaction depends on the terms of the transfer." 6A *C.J.S. Assignments* §5. While the Court relies on this sentence to support the Court's suggestion that there is a clear division between an assignment and a sale, neither *Corpus Juris Secundum* nor the Court's decision articulates the differences.

Perhaps sensitive to the thin reed at hand and leaving all to remand, the District Court cautioned that even the presence of a contract between a transferor and transferee that uses either "sale" or "assignment" terminology may not be conclusive on the issue of whether the transfer was an assignment or a sale because "a court must look to the economic substance of the transaction and not its form." *Int'l Trade Admin v. Rensselaer Polytechnic Inst.*, 936 F.2d 744, 748 (2d Cir. 1991). In that regard, the Court did note that a transfer on an open market, including the sale of publicly traded bonds through a broker, is a "sale." Left unclear by the District Court decision is the precise meaning of "open market."

Effect on Claims Trading and the Distressed Debt Market

The District Court was not unmindful of the practical effects of its decision, commenting "it is proper to consider the effect that the court's interpretation would have on the markets," and, as noted above, having stated that the Bankruptcy Court decision "threatened to wreak havoc on the markets for distressed debt." The District Court based its decision on other policy concerns as well, noting that "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."

Though it would be a best practice for a buyer of a claim to use a form of agreement that has language of sale ("buyer" and "seller") as opposed to language of assignment ("assignor" and "assignee"), by reason of Judge Scheindlin's ruling, courts may feel compelled to focus on the economic substance of the transaction and not merely the labels that are placed on it in determining whether a transfer is a sale or an assignment. It is, therefore, important to see how, on remand, the Bankruptcy Court will draw the line between an assignment and a sale when determining the status of the claim transferred between Citibank, Deutsche Bank, and Springfield, and how other courts in future cases make that distinction.

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If you would like to discuss these or related matters, please do not hesitate to contact any of the individuals below.

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