September 12, 2006

MEMORANDUM TO: Clients and Friends of the Firm

FROM: Jon Kibbe
Paul Haskel
Michael Friedman
Patricia O'Prey

RE: Secondary Loan Purchasers Challenge Enron and Win an Extraordinary Appeal: Does Equitable Subordination Risk Travel with the Loan?

Earlier this year, United States Bankruptcy Judge Arthur Gonzalez ruled in the Enron bankruptcy proceeding that bankruptcy claims in the hands of innocent buyers may be equitably subordinated based on conduct of upstream sellers, which conduct need not be related to the transferred claim. *See In re Enron Corp.*, 340 B.R. 180 (S.D.N.Y. March 31, 2006 (AJG)); *In re Enron Corp.*, 333 B.R. 205, (S.D.N.Y. Nov. 17, 2005 (AJG)). The bankruptcy court issued substantially similar opinions in a number of related adversary proceedings brought by Enron, in which Enron sought to equitably subordinate claims in the hands of secondary market loan buyers based on inequitable conduct of the seller banks. The sellers' alleged inequitable conduct was unrelated to the loans that Enron sought to subordinate. In the adversary proceedings, Enron argued that the buyers' claims should be subject to equitable subordination under section 510(c) of the Bankruptcy Code to the same extent that they would be subject to equitable subordination if they had not been transferred. As an initial matter, the bankruptcy court concluded that the equitable subordination remedy may be applied to any claim held by an accused bad actor, whether or not the misconduct related to the specific claim at issue.[1] The bankruptcy court concluded further that equitable subordination travels with the claim, even if the claim is subsequently transferred to an innocent transferee.[2] In subordinating the buyers' claims, the bankruptcy court rejected the buyers' arguments that they were nonetheless entitled to a "good faith" defense because they had no knowledge of any allegations against the original sellers when they purchased the claims.[3]

Following the bankruptcy court's decision, a number of defendant banks in the *Enron* bankruptcy proceeding and intervenors (including transferees of the defendant banks' claims) (collectively, "appellants") filed a motion for permission to file an interlocutory appeal. In order to appeal the bankruptcy court's decision, appellants needed permission from the United States District Court. However, such mid-trial appeals are generally disfavored because they are perceived to interfere with the province of the trial court and the progress of ongoing cases.

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[1] *In re Enron*, 333 B.R. at 222.
[2] *In re Enron*, 333 B.R. at 231.
[3] *In re Enron*, 333 B.R. at 222.

Last week, on September 5, 2006, United States District Court Judge Shira Scheindlin granted appellants permission to appeal the bankruptcy court's decision. Opinion and Order dated September 5, 2006, *In re Enron Corp., et al.*, No. 01-16034 (Jointly Administered) ("District Court Opinion and Order"). The district court's grant of an interlocutory appeal in the *Enron* case is an extraordinary remedy because interlocutory appeals are disfavored and allowed only in "exceptional circumstances" where (i) the issue presented involves exclusively a question of law, (ii) substantial ground for difference of opinion arises out of a genuine doubt as to whether the bankruptcy court applied the correct legal standard (*i.e.*, there is conflicting authority on the issue or the issue is particularly difficult and one of first impression for the Second Circuit), and (iii) an appeal will advance the time for trial.[4]

With respect to the second factor, in order to determine that substantial ground for difference of opinion exists, the district court must "analyze the strength of the arguments in opposition to the challenged ruling" and implicitly determine not necessarily that they will prevail, but that there is sufficient merit to the arguments that they ought to be considered.[5]

In addition to the mere fact of granting the appeal, and thus implicitly deciding that appellants' arguments are at least worthy of consideration, the district court expressed skepticism regarding the basis of the bankruptcy court's decision in a number of statements throughout its decision. This is important because Judge Scheindlin, the judge that granted the appeal, will also hear and decide the appeal.

First, while the district court characterized the bankruptcy court's decision as involving two rulings of first impression in the Second Circuit (one, that a claim in the hands of a transferee is subject to the same equitable relief as it would be were it still held by the transferor, and, two, that the policy underlying the good faith defense does not warrant extension to the purchasers of claims), it subsequently described the first issue as having been addressed by two other district courts (including one southern district bankruptcy court decision which was discussed at length and relied on, apparently erroneously in the eyes of the district court, by the bankruptcy court in reaching its decision) which reached the opposite conclusions.[6]

Second, with respect to the bankruptcy court's interpretation of the language of section 510(c) which allows courts to apply equitable subordination, the district court described as "substantial and facially persuasive" the appellants' argument that the language of section 510(c) and its legislative history, as well as case law, indicate that the principles of equitable subordination should not be applied to innocent claim holders.[7] The district court then raised the

[4] District Court Opinion and Order, pp. 10-11.
[5] District Court Opinion and Order, pp. 13-14.
[6] District Court Opinion and Order, pp. 9-10, n.18.
[7] District Court Opinion and Order, pp. 19-21.

issue whether the bankruptcy court, in its opinion, had "impermissibly operated at 'the level of policy choice' which is reserved for Congress" in interpreting section 510(c).[8]

Neither the district court's grant of the interlocutory appeal nor its language in the Opinion and Order point with certainty to the ultimate outcome of the appeal. Judge Gonzalez's initial decision has been duly noted and widely debated by participants in the secondary bank loan market. For example, after the decision, trading in the Refco bankruptcy slowed when participants tried to analyze potential recourse against Bawag Group, which, in addition to being a potential upstream holder and "bad actor", was in uncertain financial condition. If, prior to Judge Gonzalez's decision, every transferee knew about the theoretical risk of equitable subordination in the abstract, then, after the decision, every market participant started applying the theory to concrete trading situations. Despite the strong contractual protections in the distressed documentation, no one wanted to "buy a lawsuit" or be forced to actually use those contractual protections. Potential gaps in secondary market documentation conventions also surfaced -- while distressed documentation protects a buyer from the bad acts of upstream sellers in the chain of title, the documentation used to transfer par loans does not contain such protections. Judge Gonzalez's decision has been read to put par loans and all claims, not just distressed bank debt, at risk for equitable subordination, even if held by innocent transferees.

If the district court now reverses the bankruptcy court's decision, the impact of Judge Gonzalez's decision will likely be dissipated and liquidity will continue to increase in the claims market. If the district court upholds the bankruptcy court's decision, buyers of claims will be faced with an impossible task -- trying to review the conduct of prior holders, and guessing at potential sources of dispute based on past acts committed by a third party. In all cases it will continue to be prudent for buyers of claims to negotiate for "acts and omissions" protection, similar in structure to the existing LSTA distressed documentation, which has been designed to protect buyers in this situation.

Whatever the outcome on appeal, the district court indicated that it intends to act with some speed in deciding the appeal by ordering the parties to submit a proposed expedited briefing schedule this week. Following the district court's decision, we can all expect greater clarity on the rights of a transferee of bankruptcy claims.

If you have any questions on the foregoing, please feel free to call us at 212 530 1800.

J.K.
P.B.H.
M.F.
P.C.O.

[8] District Court Opinion and Order, p. 21.