

August 8, 2007

MEMORANDUM TO: Clients and Friends of the Firm

FROM: Jon Kibbe
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RE: Enron Update: District Court Holds Hearing in Appeal of
Bankruptcy Court Decision that Equitable Subordination
Risk Travels with the Claim

We write to update you on a hearing held in an appeal that is currently pending before the United States District Court for the Southern District of New York that is important to the secondary claims trading markets. The appeal arises out of United States Bankruptcy Judge Arthur Gonzalez's rulings in the *Enron Corp.* bankruptcy proceeding. As we reported previously, the issues on appeal are: 1) whether equitable subordination risk "travels" with the claim if the claim would have been subject to subordination in the hands of the transferor, and 2) whether a disallowance defense to the payment of a claim similarly "travels" with the claim if the claim would have been subject to disallowance in the hands of the transferor.

On August 7, 2007, the district court heard oral argument in the appeal. We summarize the history of the appeal and the oral argument below.

A. The Bankruptcy Court's Decisions

As we reported last year¹, in two decisions with wide-reaching implications for trading in all distressed markets, Judge Gonzalez held that bankruptcy claims in the hands of innocent buyers may be equitably subordinated or disallowed 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)).

In the first decision, the bankruptcy court concluded that equitable subordination risk does travel with the claim, even if the claim is subsequently transferred to an innocent transferee. In subordinating the buyers' claims, the bankruptcy court rejected the buyers' arguments that

¹ The relevant memoranda are available on our website at
http://www.rkollp.com/2006/09/memorandum_to_clients_secondar.php
http://www.rkollp.com/2006/03/equitable_subordination_risk_f.php and
http://www.rkollp.com/2007/05/enron_update_district_court_af.php.

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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.

Similarly, in the second decision relating to whether such a claim may be disallowed based on conduct of the transferor, the bankruptcy court held that a claim that was subject to disallowance when held by the original creditor remains subject to disallowance even after such claim is transferred to an innocent third party, holding that a claim “should be disallowed to the same extent that such claim would be subject to disallowance in the hands of the transferor.” The court reasoned that a transferee – merely by purchasing claims in a bankruptcy proceeding – should not obtain any greater rights than the transferor had regarding those claims. Rather, “the risks inherent in bankruptcy proceedings are merely shifted to another who stands in the shoes of the original or previous claimant.”

B. The Appeals of those Decisions

Following the bankruptcy court’s decisions, a number of defendant banks in the *Enron* bankruptcy proceeding and intervenors (including transferees of the defendant banks’ claims) (collectively, “appellants”) filed motions with the district court for permission to file interlocutory appeals with respect to the bankruptcy court’s decisions. Although such mid-trial appeals are generally disfavored because they are perceived as interfering with the province of the trial court and the progress of the ongoing case, United States District Court Judge Shira Scheindlin granted appellants the right to appeal the bankruptcy court’s decisions as described below. Opinion and Order dated September 5, 2006, *In re Enron Corp., et al.*, No. 01-16034 (Jointly Administered) (S.D.N.Y. Sept. 5, 2006); Opinion and Order dated February 1, 2007, *In re Enron Corp., et al.*, 2007 WL 313470 (S.D.N.Y. Feb. 1, 2007).

In September 2006, the district court granted the right to appeal the bankruptcy court’s first decision which held that equitable subordination risk travels with the claim and denied transferees the good faith purchaser defense. Then, in February 2007, in considering a motion to appeal Judge Gonzalez’s second decision (that a claim subject to disallowance in the hands of the transferor remains subject to disallowance to the same extent in the hands of a transferee), the district court reversed, in part, its earlier grant of appeal.

Judge Scheindlin concluded that an appeal was appropriate on the issue whether defenses to the payment of a claim can be applied to claims held by a transferee to the same extent they would be applied to claims if they were still held by the transferor based on alleged acts or omissions on the part of the transferor, rejecting an argument by Enron that the determination of that issue turned on questions of fact.

However, Judge Scheindlin reversed her earlier grant of an appeal of the bankruptcy court’s decision that transferees were not entitled to the good faith purchaser defense, concluding

that resolution of that issue turned on issues of disputed fact – whether the transferees were *in fact* good faith purchasers for value. As a result, Judge Scheindlin denied the right to appeal that issue and reversed her earlier decision to the extent it granted such a right. Thus, for now, the bankruptcy court’s decision denying the good faith purchaser defense to transferees remains good law.²

C. Oral Argument

On Tuesday, August 7, 2008, Judge Scheindlin held oral argument on the pending appeal. Judge Scheindlin did not reveal how she is inclined to rule on the issues on appeal and subjected both counsel for Citibank, N.A. (“Citibank”)³, the appellant, and counsel for Enron, the appellee, to difficult questioning. At times, the Court revealed her familiarity with the case law and the parties’ briefs by quoting the relevant portions of those cases and briefs to the parties. During the hearing, the parties were forced to admit to the Court that there were no cases, other than Judge Gonzalez’s decision in the *Enron Corp.* bankruptcy, directly on point. Thus, Judge Scheindlin views the issue before her as one on which no prior court has spoken.

In general, the Court seemed particularly concerned with the prospect that a reversal of the bankruptcy court’s decision would gut the equitable subordination statute – effectively allowing claims washing. She acknowledged the danger that bad actors would simply transfer their claims in order to reap the rewards of such a sale in the near term, subjecting the debtor and/or other creditors to the burden of years of litigation against that bad actor in order to attempt to recover the amounts at issue. Counsel for Citibank argued that the debtor and/or creditors would be faced with the same burden of litigation regardless of whether they were able to pursue transferees under the equitable subordination statute or were only able to pursue transferors in that civil litigation. Enron rebutted this argument by indicating that a civil action and an action for equitable subordination are not substitutes – different defenses may be available in an equitable subordination action.

Counsel for several industry organizations, including the Loan Syndications and Trading Association (“LSTA”), the Securities Industry and Financial Markets Association, and the International Swaps and Derivatives Association, Inc. (collectively, “Industry Amici”), spoke briefly at the hearing on behalf of those parties. Counsel for Industry Amici argued that the bankruptcy court’s decision, if not reversed, would have a dramatic, and negative, impact on the markets and on liquidity. Counsel pointed to the recent example of the Refco bankruptcy where trading slowed while investors tried to analyze potential misconduct by the Bawag group which, in addition to being a potential upstream holder and bad actor, was in questionable financial

² There remains the possibility that this issue could be appealed following the conclusion of the *Enron Corp.* bankruptcy proceeding.

³ Citibank is pursuing the appeal on behalf of the transferee of the Citibank debt at issue, Springfield Associates, L.L.C.

condition. In addition, counsel for Industry Amici pointed out that in light of the current market conditions in which defaults are at a particularly low point – less than 1% until the past few weeks – the true impact of the bankruptcy court's decision on the market will be felt when default rates rise and trading in bank debt increases. Under the case law cited by the parties, whether she chooses to exercise it, Judge Scheindlin has the legal authority to consider the impact of the bankruptcy court's decision on the financial markets in rendering her decision.

Finally, while it is never clear what will happen between oral argument and the issuance of a final decision, there were some indications that the bankruptcy court's decision as it relates to disallowance of claims may be reversed. Although neither the parties nor the Court spent much time arguing the issue whether a claim that is subject to disallowance in the hands of the transferor would be subject to disallowance to the same extent in the hands of the transferee, focusing on the language of the statute, the court indicated that such a claim would be subject to disallowance in the hands of the transferee only if there were a "merger" between the transferor and the transferee by operation of law. Because the statute is silent on that issue, it is unlikely that Judge Scheindlin would impose such a merger "by operation of law."

D. Next Steps

Following the hearing, there remains no certainty regarding the ultimate outcome of the issues on appeal. Currently, trial against Citibank on the *Enron Corp.* bankruptcy estate's claims in the Megacomplaint is scheduled for early 2008. Some in the industry have speculated that the claims against Citibank will be settled before that date. Thus, whatever decision the Court reaches, it may be the final decision in this appeal. The Court did not indicate any timeline for issuing a decision. However, we will continue to monitor the appeal and will update you further on any developments.

If you have any questions on the foregoing, please feel free to call us at 212-530-1800. This memorandum was prepared as a service to clients and other friends of RK&O to report on recent developments that may be of interest to them. The information in it is therefore general, and should not be considered or relied on as legal advice.

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