August 29, 2007

MEMORANDUM TO: Clients and Friends of the Firm

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

RE: Enron Update: District Court Reverses Bankruptcy Court Decision -- Equitable Subordination Risk Does Not Travel with the "Sale" of a Claim But Does Travel with an "Assignment" of a Claim

The United States District Court for the Southern District of New York has issued a decision in an appeal that is significant to the secondary claims trading markets. The appeal arose out of United States Bankruptcy Judge Arthur Gonzalez's rulings in the *Enron Corp.* bankruptcy proceeding. As we reported previously, the issues on appeal were: 1) whether equitable subordination risk "travels" with a claim if that claim would have been subject to equitable 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.

In a decision filed on Tuesday, August 28, 2007, Judge Scheindlin of the United States District Court for the Southern District of New York reversed the bankruptcy court's decision that such defects do travel with the claim, holding that the risk of equitable subordination or disallowance is "personal" to the bad actor, and does not travel with the claim. Opinion and Order filed August 28, 2007, *In re Enron Corp.,* No. 01-16034 (S.D.N.Y. filed Aug. 28, 2007) ("Opinion and Order").

However, addressing an issue that had not been fully briefed or argued by the parties, the district court held that a transferee may nonetheless be subject to equitable subordination or disallowance if that transferee received the claim by virtue of an assignment, as opposed to by virtue of a sale. In so holding, the court relied upon traditional notions of assignment -- the assignee of a claim stands in the shoes of the assignor and, therefore, is subject to equitable subordination or disallowance to the same extent that the assignor would have been. The court distinguished an assignment from a sale, holding that a purchaser (by sale) of a claim does not stand in the shoes of the seller and, therefore, such a purchaser is not subject to the equitable subordination or disallowance risk of its seller. As we discuss below, the court provided little direct guidance about what legally distinguishes an assignment from a sale. While footnote 76 of the court's decision indicates that the court intended to hold that a traditional transfer of bank debt on customary distressed documentation constitutes a "sale", other language in the decision creates sufficient ambiguity that a subsequent court might conclude that such a transfer was an "assignment".

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A. The Bankruptcy Court's Decisions

As we previously reported[1], Judge Gonzalez held that bankruptcy claims in the hands of innocent transferees may be equitably subordinated or disallowed based on conduct of upstream transferors, which conduct need not be related to the transferred claim. *See In re Enron Corp.*, 340 B.R. 180 (S.D.N.Y. Mar. 31, 2006 (AJG)); *In re Enron Corp.*, 333 B.R. 205 (S.D.N.Y. Nov. 17, 2005 (AJG)).

B. The Appeals of those Decisions

Following the bankruptcy court's decisions, a number of defendant banks in the *Enron* bankruptcy proceeding and interveners (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. United States District Court Judge Shira Scheindlin granted appellants the right to appeal the bankruptcy court's decisions as they relate to the issues whether equitable subordination and disallowance risk travel with the claims but did not grant the right to appeal the issue whether the transferees were entitled to the good faith purchaser defense. Opinion and Order dated September 5, 2006, *In re Enron Corp.*, No. 01-16034 (Jointly Administered) (S.D.N.Y. Sept. 5, 2006); Opinion and Order dated February 1, 2007, *In re Enron Corp.*, 2007 WL 313470 (S.D.N.Y. Feb. 1, 2007). Thus, the bankruptcy court's decision denying the good faith purchaser defense to transferees remains good law.[2]

C. The District Court's Decision Reversing the Bankruptcy Court

In reversing the bankruptcy court's decision and remanding the case back to the bankruptcy court for further proceedings, Judge Scheindlin acknowledged that the issues on appeal were "complex and of first impression in this Circuit, and will have serious ramifications well beyond the parties involved in this particular appeal." Opinion and Order, p. 3.

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[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
http://www.rkollp.com/2007/05/enron_update_district_court_af.php and
http://www.rkollp.com/2007/08/enron_update_district_court_ho.php.
In addition, links to the briefs filed in the case may be found on our website at:
http://www.rkollp.com/2007/08/enron_update_district_court_ho.php.

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

1. Equitable Subordination and Disallowance are "Personal Disabilities" of the Claimant.

In addressing whether equitable subordination risk and the defense of disallowance travel with the claim, the district court analyzed the language of Sections 510(c) and 502(d) of the Bankruptcy Code, as well as the legislative history and purpose of those sections. The district court concluded that Congress intended those defects to be personal liabilities related to the claimant, not defects that would pass with the claim. Opinion and Order, pp. 30-43. Accordingly, under the court's logic, such defects relate to the wrongdoer claimant and a transferee does not suffer the equitable subordination and/or disallowance risk based on misconduct of an upstream transferor alone. However, as we describe below, the court went on to say that in the context of an assignment (as opposed to a sale), the transferee stands in the shoes of the transferor and, therefore, takes the claim subject to the personal disabilities of the transferor.

2. Assignees of a Claim Take Subject to the Personal Disabilities of Their Transferors; Purchasers of a Claim Take Free of Such Disabilities.

As discussed above, the court held that whether a particular claimant will be subject to equitable subordination or disallowance depends, in part, on whether that claimant "purchased" the claim or was "assigned" the claim. The court held "[a] personal disability that has attached to a creditor who transfers its claim will travel to the transferee if the claim is *assigned*, but will not travel to the transferee if the claim is *sold*." Opinion and Order, p. 22. That is because, according to the court, where a claim is "assigned", the assignee stands in the shoes of the assignor and, therefore, the assignee is subject to equitable subordination and disallowance to the same extent the assignor would have been.[3] In contrast, the court held that a "purchaser" of the claim does not stand in the shoes of the assignor/transferor and, therefore, because equitable subordination and disallowance are personal defects, such a purchaser takes the claim free from equitable subordination or disallowance risk based on the transferor's conduct.

[3] The court noted two exceptions to this rule. First, where the assignee is a holder in due course of a negotiable instrument. However, it is unlikely that bank loans would be deemed to be negotiable instruments, a requirement of the holder in due course doctrine. In addition, the court noted that a purchaser of debt during the post-petition period will never be a holder in due course because it cannot take the instrument "without notice that it is overdue". Opinion and Order, p. 23 n.63. Second, under the third party latent equities doctrine, an assignee without notice takes the property free form the latent equities of third parties other than the debtor. However, the court noted that many states, including New York, do not recognize the doctrine of latent equities in the context of transfers of choses in action. Opinion and Order, p. 24.

3. Is the Transfer of Bank Debt an Assignment or a Sale?

Unfortunately, it is not entirely clear from the court's decision how to determine whether a claim has been acquired through an assignment or a sale. The distinction between a claim that has been "assigned" and a claim that has been "purchased" was not fully briefed or argued by the parties to the appeal. On one end of the spectrum, it seems clear from the decision that the court views the transfer of bonds, for example, to be a "sale", not an assignment. *See* Opinion and Order, p. 3 n.5, p. 45 n.104. On the other end of the spectrum, "subrogation of a surety to the rights under a claim is indisputably an assignment." Opinion and Order, p. 45 n.104. However, in between those extremes, there may be some ambiguity whether the transfer of bank debt is a "sale" and therefore (with the exception discussed below) free of equitable subordination or disallowance risk based on conduct of the transferor, or an "assignment" subject to such risk, under the court's decision. The ambiguity whether the transfer of bank loans constitutes an assignment or sale is important because Judge Scheindlin declined to decide whether the debt at issue on appeal was assigned or sold, leaving that issue for the bankruptcy court to decide on remand.

Judge Scheindlin's decision, however, provides ammunition for both sides on this question. There is language in the decision from which one could conclude that Judge Scheindlin considers the transfer of bank debt to be a sale (and, therefore, that equitable subordination risk should not travel with the bank debt claim). For example, the court implied that a purchase of bank debt is a sale by describing how "the concerns raised by Industry Amici with respect to the effects of the Bankruptcy Court's ruling on the markets for distressed debt are no longer present" as a result of the court's ruling. *See* Opinion and Order, p. 30 n.76. In that key footnote, the court cited those pages of Industry Amici's brief that argued that Judge Gonzalez's decision would have a decidedly negative impact on the distressed markets, including the market for distressed loans. It stands to reason that if the court intended that transactions involving such loans were assignments, rather than sales, then the concerns raised by Industry Amici would remain present, and in fact be realized, following the district court's decision. In addition, the court seemed to distinguish between an assignment, through which an assignee might passively "receiv[e]" a claim through subrogation, by operation of law, or otherwise, and a sale through which a purchaser purchases its claim. Opinion and Order, p. 36.

There is also language in the opinion, however, from which a subsequent court might conclude that Judge Scheindlin believed that a "sale" may only occur in an anonymous "open market" transaction where the counterparties do not have the opportunity to negotiate representations, warranties and indemnities. Opinion and Order, p. 41. This state of affairs would not appear to characterize the current distressed bank loan market. For example, the court distinguished between an assignment and a sale by describing a sale as a scenario "in the distressed debt market context, where sellers are often anonymous and purchasers have no way of ascertaining whether the seller (or a transferee up the line) has 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."[4] Opinion and Order, pp. 36-37. The court contrasted that scenario from an assignment in which, "by contrast, [the parties] can easily contract around the risk of equitable subordination or disallowance by entering into indemnity agreements to protect the assignee." Opinion and Order, pp. 36-37. *See also* Opinion and Order, p. 41. This characterization is arguably a more accurate view of the current distressed bank loan market.

Ultimately, the court remanded the issue of whether the *Enron* debt at issue on appeal was "assigned", and therefore subject to equitable subordination, or "sold", and therefore not subject to equitable subordination based on conduct of the upstream transferors. Accordingly, we will not likely get any further guidance on the sale vs. assignment issue unless and until the bankruptcy court addresses the issue on remand or one of the parties appeals Judge Scheindlin's decision.

4. Exception to the Safe Harbor Provided by a "Sale" of a Claim.

It is important to note that, even if the transfer of bank debt is found to be a sale and therefore not subject to equitable subordination based on the conduct of an upstream seller, the court's decision raises the specter that, if the purchaser of the claim has actual notice of the inequitable conduct of the seller, the purchaser may nevertheless be subject to equitable subordination because such knowledge may be viewed as its own misconduct. Opinion and Order, p. 37. *See also* Opinion and Order, p. 44 & 48 n.111.

D. Next Steps

It is not clear when, if ever, the market will get further guidance on this issue. Currently, trial against Citibank on the *Enron Corp.* bankruptcy estate's claims in the Megacomplaint is scheduled for early 2008 but the claims against Citibank may be settled before trial. In the event that those claims are settled before the bankruptcy court reaches a decision whether the debt was an assignment or a sale[5], there may not be further guidance on these issues until they are addressed by subsequent courts in other litigation. In addition, it is possible that Enron might appeal the district court's decision, further delaying any resolution of these issues.

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[4] Although one could read this language to apply to transfers of bank loans because it is often difficult or impossible to diligence whether a transferee up the line has acted inequitably, the court's reference to "anonymous" sellers (which does not characterize traditional bank loan transfers) may lead a subsequent court to conclude that such transfers are assignments.

[5] Notably, the district court indicated in its opinion that "the issue may have to be decided at a later stage of the adversary proceeding", Opinion and Order at p. 45, anticipating that the bankruptcy court might not resolve this issue immediately following remand.

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.

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