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Memorandum

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Enron Update: District Court Affirms In Part and Reverses In Part Earlier Ruling Granting Appeal of Bankruptcy Court Decision that Equitable Subordination Risk Travels with the Claim

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We write to update you on issues raised by a case currently pending before the United States District Court for the Southern District of New York that are important to the secondary claims trading markets. These issues are the subject of a pending appeal arising out of United States Bankruptcy Judge Arthur Gonzalez's rulings in the *Enron Corp*. bankruptcy proceeding. As we reported previously, the issues 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, 2) whether transferees of such a claim are entitled to the "good faith purchaser" defense, and 3) 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.

The latest development in the case is that the district court, on appeal, recently reversed its previous grant of appeal relating to whether the "good faith purchaser" defense would be available to such a transferee, concluding that the determination of that issue involved disputed issues of fact. Accordingly, Judge Gonzalez's earlier decision denying the transferees the good faith defense remains good law.

At the same time, the district court upheld its right to decide the issues of whether equitable subordination and other defenses to the payment of a claim "travel" and can be used against claims held by a transferee to the same extent they would be applied to claims in the hands of the transferor. Those issues remain pending on appeal and we look forward to a final resolution of those issues by the district court this year.

We summarize the status of the recent proceedings further below.

THE BANKRUPTCY COURT'S DECISION

As we reported last year,[1] 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*

1 The relevant memoranda are available on our website at http://www.rkollp.com/newsroom-publications-69.html and http://www.rkollp.com/newsroom-publications-190.html

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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 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."

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]

IMPLICATIONS

As a result of Judge Scheindlin's recent ruling, the interlocutory appeals related to the issue of whether equitable subordination under section 510(c) and disallowance under section 502(d) apply to claims held

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

by a transferee will go forward. However, there remains no certainty regarding the ultimate outcome of this issue.

The bankruptcy court's decision was greeted critically by lenders and traders, including the Loan Syndications and Trading Association ("LSTA"), the Securities Industry Association, the International Swaps and Derivatives Association, Inc. and the Bond Market Association.[3] If, prior to the bankruptcy court's decision, every transferee knew about the theoretical risk of equitable subordination in the abstract, after the decision, every market participant started applying the theory to concrete trading situations. Parties endeavored to build stronger contractual protections in the distressed documentation through stronger indemnification provisions and potential gaps in secondary market documentation conventions 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.

It will continue to be prudent for buyers of claims to negotiate for distressed representations and warranties of the type included in the existing form LSTA distressed documentation, which has been designed to protect buyers in this situation. In addition, if the bankruptcy court's decision is upheld on appeal, it may be prudent, where possible, to conduct greater due diligence of a transferor's credit worthiness when trading claims. Whatever the final outcome of the appeals and litigation, the market can expect greater clarity on the rights of transferees of bankruptcy claims.

QUESTIONS

If you have questions regarding the matters discussed in this memorandum, please call your usual contact at Richards Kibbe & Orbe LLP or one of the persons listed below.

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3 Indeed, one commentator recently suggested that the *Enron Corp.* decisions may have implications in broader capital markets, including the markets for credit default swaps (*e.g.*, if a loan held by a "bad actor" is physically delivered to a protection seller after a credit event) and par loan participations (*e.g.*, the general form of par participation documentation does not contain a "no bad actor" indemnity). *See* Adam J. Levitin, *Finding Nemo: Rediscovering the Virtues of Negotiability in the Wake of Enron*, 2007 Colum. Bus. L. Rev. 83, 155 (2007).