District Court Holds that Bankruptcy Claims Purchased in Good Faith Are Not Subject to Equitable Subordination Claims

October 1, 2007

Organizations that acquire claims in bankruptcy should acquire such claims by a sale without knowledge of the debtors' claims against the original holder or prior transferees, and obtain an indemnification from the transferor of such claims.

On August 27, 2007, the U.S. District Court for the Southern District of New York issued an important ruling relating to the chapter 11 cases of Enron Corporation, *et al*. The Court vacated a decision of the U.S. Bankruptcy Court for the Southern District of New York and held that a claim purchased in good faith in a bankruptcy proceeding is not subject to the debtors' equitable subordination claims against the transferor based on the transferor's bad conduct. This decision is significant because the prior Bankruptcy Court ruling had surprised many distressed debt investors and injected uncertainty into the market for distressed claims.

Background

On May 18, 2000, and May 14, 2001, Enron entered into two financing agreements, pursuant to which it borrowed $1.75 billion under a short-term revolving credit agreement and $1.25 billion under a long-term revolving credit agreement with Citibank and other lenders. Beginning December 2, 2001, the debtors commenced their chapter 11 cases in the Bankruptcy Court.

On October 15, 2002, Citibank filed two proofs of claim against the debtors in the amounts of $30 million (related to the short-term agreement) and $5 million (related to the long-term agreement). The $30 million claim was transferred to Westpac Banking Corporation and the $5 million claim was transferred to Springfield Associates, L.L.C.

On September 23, 2003, the debtors commenced an adversary proceeding against the lenders, in which the debtors alleged that Citibank engaged in and benefited from inequitable conduct that injured Enron's creditors and conferred an unfair advantage on Citibank. On January 10, 2005, the debtors commenced an adversary proceeding against Springfield and Westpac, seeking to subordinate their respective claims under section 510(c) of the Bankruptcy Code and disallow such claims under section 502(d) of the Bankruptcy Code. Springfield was not alleged to have acted inequitably or received any preference that would subject its claims to equitable subordination or disallowance.

On April 1, 2005, Springfield filed a motion to dismiss, on the basis that its claim was not subject to equitable subordination because Citibank's alleged conduct related to the short-term agreement and was unrelated to the Springfield claim. Springfield argued that equitable subordination applies personally to the entity that acted inequitably (*i.e.*, it is a personal disability), not to the claim itself (*i.e.*, it is not a claim attribute). In response, the debtors argued that any claim that was subject to subordination as of the petition date should remain subject to subordination thereafter. The debtors argued that any other holding would improperly encourage a wrongdoer, at the expense of other innocent creditors, to cleanse its claims (by transferring them) in order to escape equitable subordination.

Equitable Subordination and Disallowance

Equitable subordination is a common law doctrine that was recognized and incorporated into the Bankruptcy Code. Equitable subordination permits the court to subordinate a creditor’s claim if the creditor’s inequitable conduct harmed other creditors or shareholders. Section 510(c) of Bankruptcy Code provides that the court may, after notice and a hearing, "under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of allowed interest to all or part of another allowed interest."

Disallowance is addressed in section 502(d) of the Bankruptcy Code, which provides, in relevant part, that "the court shall disallow any claim of any entity from which property is recoverable under . . . this title or that is a transferee of a transfer avoidable under . . . this title, unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable."

The Bankruptcy Court Decision

On November 28, 2005, the Bankruptcy Court ruled on Springfield’s motion to dismiss and concluded that the Springfield claim was subject to equitable subordination. First, the Bankruptcy Court held that equitable subordination applies broadly in bankruptcy, potentially reaching any claim held by a claimant. Citing *Pepper v. Litton*, the Bankruptcy Court determined that it had broad authority to "sift the circumstances surrounding a claim to see that injustice or unfairness is not done in administration of a bankruptcy estate," holding that this rationale applied irrespective of whether the alleged misconduct related to the claim at issue. The court ruled that equitable subordination could reach any claim necessary to effectuate the remedy set forth in section 510(c) of the Bankruptcy Code.

Second, the Bankruptcy Court held that the Springfield claim was not free from subordination because it was in the hands of a transferee. It found that there was no basis to find that transferees should enjoy greater rights than the transferor. The Bankruptcy Court also found that policy considerations supported its holding. It observed that the estate should not have to be burdened by collecting damages from a wrongdoer when it could just subordinate the wrongdoer’s claim. Further, the Bankruptcy Court dismissed the concern that the claims market would be negatively affected. It found that such risks must be assessed and borne by the purchasers. In any event, standardized provisions already existed in distressed debt trade documents to protect the purchaser. Accordingly, the Bankruptcy Court determined that the Springfield claim remained subject to the same equitable relief as if the claim was still held by Citibank.

Finally, the Bankruptcy Court held that the asserted "good faith" defense was not available to Springfield. First, it found that there was no good faith defense to an equitable subordination claim available under the Bankruptcy Code. Next, it concluded that even if that defense was available, Springfield knew or should have known that the debtors, consistent with their fiduciary duties, could assert a claim based on the wrongful conduct of the transferor. Accordingly, Springfield could not shield itself with a good faith defense.

The District Court Decision

On appeal, the Court vacated the Bankruptcy Court's decision and held that equitable subordination and disallowance are personal disabilities that do not inhere in a claim. Accordingly, the Court held that "unless there was a pure assignment of the claim (or other basis for the transferee to step into the shoes of the transferor), as opposed to a sale of the claim, the claim in the hands of a transferee is not subject to equitable subordination or disallowance based solely on the conduct of the transferor."

The Court noted that the issue presented was one of first impression and would have serious ramifications well beyond the parties involved in the appeal. The Court acknowledged the high level of commercial interest in the case, manifested by its receipt of hundreds of pages of briefs from the parties and from *amici curiae*, including the Securities Industry and Financial Markets Association, the International Swaps and Derivatives Association, the Loan Syndications and Trading Association (each in support of Springfield's position) and certain of Enron's creditors, including Abrams Capital, LLC; Blavin & Company, Inc.; and Citadel Investment Group, L.L.C. (each in support of the debtors' position).

The Court analyzed the law of assignments and sales, and observed that under an assignment, the assignee stands in the shoes of the assignor and takes subject to all equities against the assignor. Therefore, the assignee takes the claim with whatever limitations it had in the hands of the assignor. Those assignment provisions, however, do not apply to sales. Citing New York's Uniform Commercial Code § 8-202(d), the District Court observed that a purchaser does not stand in the shoes of the seller and therefore can obtain more than the transferor, where such purchaser takes "for value . . . without notice of the particular defense." Accordingly, it held that equitable subordination and disallowance are personal disabilities of the claimant and travel with the claim only when the claim is assigned, not when it is sold. This distinction is particularly imperative in the distressed debt market, where sellers are often anonymous and purchasers have no way of knowing whether a seller or prior transferee has acted inequitably. Parties to true assignments, on the other hand, can easily contract around such risks through the use of indemnity agreements. The Court observed that "[t]he unnecessary breadth of the Bankruptcy Court's decision threatened to wreak havoc on the markets for distressed debt. That result has now been avoided."

The Court stressed that its decision did not apply to bad faith purchasers. It noted that a bad faith purchaser of a claim may be subject to equitable subordination based on its own misconduct. Conversely, an assignee may qualify as a holder in due course and take free of defenses of any party to the instrument with whom that holder has not dealt.

The District Court vacated the Bankruptcy Court's decision and remanded for a finding of whether the Springfield claim was transferred by sale or by assignment. On September 7, 2007, Springfield filed a motion seeking an order certifying the Court's decision for an interlocutory appeal to the U.S. Court of Appeals for the 2nd Circuit. The appeal was endorsed by several Wall Street trade associations.

In its motion for authority to appeal, Springfield argued that the transfer was a sale and that it should not be required to prove that issue in the Bankruptcy Court. Springfield stated the two issues on appeal as follows:

- Whether equitable subordination under section 510(c) of the Bankruptcy Code and disallowance under section 502(d) of the Bankruptcy Code can be applied, as a matter of law, to claims held by a transferee to the same extent as they would be applied to such claims if they were still held by the transferor, based solely on alleged acts or omissions on the part of the transferor, where no such acts or omissions on the part of the transferee have been alleged.
- If so, whether potential equitable subordination and/or disallowance turn on the distinction between a claim transferred by sale and a claim transferred by assignment.

On September 24, 2007, the District Court denied Springfield's request for an interlocutory appeal. The Court held that "exceptional circumstances" did not exist to overcome the general policy against "piecemeal litigation." In sum, the Court found that, contrary to the Bankruptcy Court's ruling, its ruling was significantly narrower in scope and ensured that the financial markets would not be disturbed. The Court emphasized that there was no substantial ground for a difference of opinion regarding whether an assignment is distinct from a sale, or an assignee stands in the shoes of the assignor. Further, there was no pure question of law that a reviewing court could decide quickly and cleanly. Rather, it would be necessary to study the case record to determine if the transfer was by assignment or sale. Finally, in this case, an interlocutory appeal would not accelerate the termination of the litigation. Instead, an interlocutory appeal would likely delay the already protracted underlying action against Citibank and others by more than a year. Accordingly, the Court determined that an interlocutory appeal was not justified.

Conclusions

Purchasers and sellers of claims should be familiar with the District Court's decision. Although this issue is not yet resolved, it is clear from the Court's decision that those who acquire claims in bankruptcy, whether from the original holder of those claims or from prior transferees, should acquire such claims by a sale (rather than an assignment) without knowledge of the debtors' claims against such original holder or prior transferees. Further, it would be advisable to obtain an indemnification from the transferor of such claims regardless of the mode of transfer. Sellers who suspect that they may become a target of a disallowance or equitable subordination action may consider selling their claim before such an action is commenced (upon which a purchaser may be considered to take with knowledge of such claim). In light of the Court's decision, consultation with counsel experienced in claims trading is advisable prior to finalizing the terms of significant claims purchases or sales.