

**‘Taint Clear: “Purchased” Claims are Not Subject to Equitable Subordination or Disallowance Based Solely on Seller’s Conduct, but Purchaser’s Knowledge of the Seller’s Conduct May Be Fatal**

**Robin Phelan  
Judy Elkin  
Frances Smith  
Haynes and Boone, LLP  
USA**

On August 27, 2007, a United States district judge in New York, acting as an appellate court, overturned the Enron bankruptcy court’s ruling on equitable subordination and claims disallowance that had drawn harsh criticism from economists and distressed-debt traders. The ruling provides protection to domestic and international good-faith “purchasers” of claims in U.S. bankruptcy cases, but the ruling also leaves several pitfalls for those unwary of the details.

First, a brief background on equitable subordination and claim disallowance. Section 510(c) of the Bankruptcy Code allows an American bankruptcy court, “under principles of equitable subordination, [to] subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim ...” 11 U.S.C. § 510(c). Under developed case law, the traditional requirements for equitable subordination are (a) inequitable conduct by a creditor; (b) the inequitable conduct harmed other creditors or conferred an unfair advantage to the inequitable creditor; and (c) the subordination cannot be inconsistent with the Bankruptcy Code. The purpose of equitable subordination is not to punish the inequitable creditor, but instead to undo the harm to other creditors.

Section 502(d) of the Bankruptcy Code empowers a bankruptcy court to disallow the claim of any creditor who received, prior to the bankruptcy filing, an avoidable transfer (such as a fraudulent transfer or preferential transfer), unless that creditor returns the transferred property back to the debtor’s bankruptcy estate. The statute serves two purposes: First, it promotes equality of distributions to creditors because it disallows any remaining claims of a creditor who received preferential payments prior to the bankruptcy filing. Second, it coerces compliance with a bankruptcy court order to return the avoidable transfer.

The court ruling on these two Bankruptcy Code sections arose out of a suit by Enron against distressed-debt traders who acquired bank-facility claims from banks that allegedly committed inequitable conduct or received avoidable transfers in connection with transactions unrelated to the credit facility. Certain of those traders filed motions to dismiss, arguing that their claims were not subject to subordination or disallowance because the traders did not act inequitably or receive avoidable transfers.

In denying the motions to dismiss, the bankruptcy court ruled that equitable subordination under section 510(c) and disallowance under section 502(d) can be applied, as a matter of law, to claims acquired by a transferee based solely on the alleged bad actions of the seller—in other words, claims held by a “tainted” seller who committed bad acts or received

avoidable transfers are fixed as of the bankruptcy petition date and cannot be “cleansed” by transferring the claims to a new holder.

Noting that the bankruptcy court’s decision “threatened to wreak havoc on the markets for distressed debt,” Judge Shira Scheindlin reversed and remanded. The district court first noted that the purpose of equitable subordination under section 510(c) is to undo wrongdoing by an individual creditor in the interest of the other creditors. Likewise, section 502(d) was intended to force the recipient of an avoidable transfer to return the transferred property. It was undisputed that the Springfield Associates, LLC, the transferee in this case, was not alleged to have acted inequitably or to have received any avoidable transfer that would subject its claims to equitable subordination or disallowance.

Enron argued for equitable subordination and disallowance despite Springfield’s lack of wrongdoing on the grounds that (1) the Bankruptcy Code fixed the priority and nature of the banks’ claims on the bankruptcy petition date, and (2) under principles of assignment law, a transferee can have no greater claim than a transferor would have. Therefore, according to Enron, Springfield’s claims were “forever tainted.” The district court disagreed.

*Equitable subordination and disallowance are not fixed as of petition date.* According to the district court, while some priorities become fixed and immutable on the petition date, claims of equitable subordination and disallowance do not. Equitable subordination under section 510(c) is not fixed as of the bankruptcy petition date because the remedy (a) requires court action; (b) is permissive, not mandatory; (c) may be based on post-petition conduct; and (d) is not available to creditors who have suffered no injury, so creditors who acquired their claims post-petition, after the alleged misconduct, may not be entitled to the remedy.

Similarly, according to the district court, claim disallowance under section 502(d) is not fixed as of the petition date because (a) again, court action is required; (b) disallowance is contingent on the refusal or failure to return the recipient's avoidable transfer; and (c) disallowance could be premised upon receipt of an unauthorized postpetition transfer under Bankruptcy Code section 549. These circumstances cannot be determined on the petition date.

*Equitable subordination and disallowance are "personal disabilities" of the claimant that travel with the claim only when the claim is assigned, not when it is sold.* The court next addressed whether equitable subordination under section 510(c) and disallowance under section 502(d) are attributes of a claim or personal disabilities of a particular claimant. If they are attributes of the claim, the court reasoned, "they will travel with the claim regardless of the method of transfer, whereas if they are personal disabilities, their application to transferees depends on whether the transfer was by way of a sale or an assignment."

After considering the plain language of the statute, the legislative history, and the case law, the district court concluded that equitable subordination under section 510(c) and disallowance under section 502(d) are personal disabilities. Congress intended equitable subordination to be specific to the individual who acted inequitably. "Congress did not intend 510(c) to be applied to the transferee of the claim—who has not acted inequitably—merely because that claim was transferred, directly or indirectly, by a bad actor." Likewise, the plain language of section 502(d) focuses on the claimant rather than the claim, and the purpose of section 502(d) is to coerce the return of assets obtained by an avoidable transfer. The purpose would not be served where the claimant never received the avoidable transfer. Because subordination and disallowance are both personal disabilities of the seller, the outcome of the case depended on whether Springfield received its claim by way of sale, or instead, by assignment.

According to the district court, "[s]ales and assignments can have very different consequences for the transferee." The assignee stands in the shoes of the assignor and is subject "to all equities against the assignor." The "assignee of a claim takes with it whatever limitations it had in the hands of the assignor" because "an assignor cannot give more than he has." These principles of assignment law do not apply to sales. The purchaser does not stand in the shoes of the seller and may, under certain circumstances (such as when the purchaser is a holder in due course), obtain more than the transferor had.

The court criticized the bankruptcy court for its failure to distinguish between assignments and sales. To Judge Scheindlin, this distinction was especially important in the distressed debt market, where, she stated, sellers are often anonymous and purchasers have no way of knowing whether that seller has acted inequitably and no amount of due diligence would reveal the information. In contrast, the court stated that parties to “true assignments” can easily contract around the risk of equitable subordination by executing indemnity agreements. The district court therefore remanded the case back to Bankruptcy Judge Gonzalez so that he could determine, among other things, whether Springfield was a purchaser or an assignee.

While the court’s analysis would apply to good-faith purchasers without knowledge of the seller’s inequitable conduct, other purchasers may not be so fortunate: “Indeed, purchasers of claims with actual notice of the inequitable conduct of the seller may be subject to equitable subordination based on their own misconduct.” What must the trader know to commit this misconduct? Knowledge that an original seller is rumored to have participated in a fraud? Knowledge that the debtor or creditors’ committee is investigating the original seller’s conduct? Knowledge that a lawsuit based on allegations of fraud or similar misconduct is imminent or has been filed against the original seller? The district court gives little guidance to Judge Gonzalez (or to the claims-trading market) on this issue. The impact of this lack of direction will be increased litigation, especially since allegations of bad acts by lenders have almost become *de rigueur* in large chapter 11 cases and the factual nature of the inquiry will eliminate the availability of pre-trial summary resolution.

Judge Gonzalez must also grapple with the issue of whether a sale or a “true assignment” was involved in the Springfield acquisition. What is required for a true assignment? What is required for a sale? The district court suggests the following potentially distinguishing factors: (i) whether there is a fully negotiated contract containing representations, warranties and/or indemnities provided by the assignor, or instead whether there is a plain-vanilla agreement without such bells and whistles; (ii) whether there is an anonymous seller and a purchaser who has no opportunity to conduct due diligence, or instead whether there are face-to-face negotiations and lots of due diligence; and (iii) whether there is a potentially insolvent or financially troubled assignor. Are any of these factors controlling? Are there other factors? What if the instrument is a hybrid and is not clearly a “true assignment” or a clear sale agreement? Again, Judge Gonzalez and the claims-trading market have little guidance from the district court. It is hard to come up with examples of something that is an “assignment” under applicable U.S. law but not a sale. While the standard forms used to trade bank debt will surely be modified to attempt to adapt to the decision, the issue of substance over form will continue to be litigated.

Finally, even if there is a true assignment, Judge Scheindlin suggests that the assignee still might take the claim free of the seller’s personal disabilities under certain circumstances, such as when the assignee is a holder in due course or when controlling state law provides the doctrine of third-party latent equities. Here again, the need for a knowledge based inquiry will increase litigation.

On September 7, 2007, Springfield filed a motion to modify Judge Scheindlin's order and to certify the opinion and order for interlocutory appeal. Enron opposed that motion. On September 24, 2007, Judge Scheindlin entered an order denying the motion to certify for interlocutory appeal, thus clearing the way for a trial on the merits before Judge Gonzalez.

In short, the district court opinion provides protection to domestic and international good-faith "purchasers" of claims in U.S. bankruptcy cases, but is less than clear regarding what constitutes a protected transaction. Stay tuned for further updates on how Judge Gonzalez determines which parties are protected and how this issue is handled by other courts soon to face it in other large chapter 11 cases.