

District Court Reverses Controversial Claims-Trading Rulings in *Enron*

In a decision that is important to debt traders, claims purchasers, and others, District Judge Shira A. Scheindlin of the Southern District of New York has reversed two controversial decisions by Bankruptcy Judge Arthur Gonzalez in connection with the *Enron Corp.* bankruptcy, in which he subordinated (under section 510(c) of the Bankruptcy Code) and disallowed (under section 502(d) of the Bankruptcy Code) the claims held by a “claims purchaser” *qua* transferee.¹

Judge Gonzalez had ruled, in two separate and widely discussed opinions, that if the original claims were “tainted” in the hands of the transferor due to the misconduct of the transferor or the transferor’s receipt of a preference, the taint traveled with the claims into the hands of the purchaser/transferee, thus enabling the debtor to equitably subordinate and/or disallow the claims held by the purchaser/transferee.² In other words, according to Judge Gonzalez’s rulings in the bankruptcy court, the debtor (or, where applicable, a trustee) could assert against the claims purchaser the same bankruptcy remedies that the debtor (or, where applicable, the trustee) would have had against the original creditor/transferor, the same as if the claims were still held by the original wrongdoer.

Thus, if the transferor had engaged in misconduct, the claim in the hands of the claims purchaser would be subject to equitable subordination under section 510(c); and if the transferor had received a preferential payment within 90 days of bankruptcy, until that payment was recovered, section 502(d) would block any distribution on account of the claim that was now in the hands of the claims purchaser. The Bankruptcy Court rulings had roiled the claims-trading markets.

In a fifty-three page opinion, District Judge Scheindlin reversed the rulings of Judge Gonzalez and held that the “defects” relied upon by Enron Corp. to disallow the claims held by the claims purchaser did not “inhere in the claim” that had been transferred to the purchaser. The defects, and likewise the debtor’s remedies, were found by Judge Scheindlin to be personal to the transferor

“Thus, unless there was a pure assignment (or other basis for the transferee to step in the shoes of the transferor), as opposed to a sale of the claim, the claim in the hands of the transferee is not subject to equitable subordination or disallowance based solely on the conduct of the transferor.”

and did not infect the claim of the innocent transferee. Judge Scheindlin paid attention to the disruptive effect of the lower court’s ruling on the credit- and claims-trading markets. She also felt the lower court’s reading of the statute was overly technical and led to a result that was not supported by the legislative history of sections 510(c) and 502(d) or by prior case law.

Judge Scheindlin handled the subordination issue by drawing a distinction between an assignment (where the assignee steps into the shoes of the assignor) and a market purchase by a good faith purchaser without notice of the defects, and

held that an innocent buyer in the marketplace does not step into the bad actor's shoes. The issue for the District Court was simple: "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*."³ Judge Scheindlin concluded that both equitable subordination under section 510(c) and disallowance under section 502(d) are *not* attributes of the claim and therefore do *not* travel with the claim regardless of the method of transfer.

Consequently, the answer to the question whether these "personal disabilities" travel with the claim will depend upon the method of transfer.⁴ As a general matter, the disability will travel to an assignee but not a purchaser. However, Judge Scheindlin left open the possibility that someone who takes a claim by purchase rather than by assignment, with knowledge of the misconduct or the preference, might still suffer the consequences of subordination under 510(c) or disallowance under 502(d). Conversely, Judge Scheindlin also left open the possibility that an assignee would not necessarily be tainted by the assignor's misconduct if, for example, the assignee was a holder in due course or able to invoke the third party latent equities doctrine.⁵

Open Issues After Enron

This case does raise some interesting issues. First, although Judge Scheindlin discussed the indemnity provisions found in many claims purchase agreements including the agreement at issue in this case, and found that the indemnity was not adequate in most cases to protect the buyer, she did not address in any detail common provisions found in many claims purchase agreements that enable the claims buyer to "put" back any disallowed claim to the seller. This unwinds the trade, repays the innocent buyer what it paid the seller for the claim, and leaves the seller holding the bag, as it should because it was the bad actor or the recipient of the preference.

Second, the exact difference between a market purchase (which arguably shields a good faith purchaser without notice of any adverse

issues) and an assignment (which arguably subjects the assignee to defects created by the assignor) is difficult to gauge. Is the linchpin use of magic words like "sell" versus "assign" or must the court delve into the circumstances of each transaction? Is every private sale an "assignment"? Is every market trade a "sale"? In this regard, Judge Scheindlin points out that the answer to the question whether a transaction is a sale or an assignment will not be driven by the use of particular words.⁶ Unfortunately, Judge Scheindlin does not give any additional guidance to future parties. The decision only states without explanation that transactions that are "pure" assignments are the ones where the assignee is at risk. But, the decision does not supply the indicia of a "pure" assignment.

Third, many potential creditors buy credit insurance, oftentimes in the form of a put. The put enables the creditor to assign the claim to the issuer if the target debtor files for bankruptcy. This is not a "market purchase," and these agreements are nominally set up as assignments. Did Judge Scheindlin intend for the "sale versus assignment" distinction to apply here?

If the Court is going to protect claims traders who purchase claims by way of "sale" in the market, the Court should also protect credit-protection assignees too. These assignees are doing the exact same thing as the claims traders, except they are paid the equivalent of an insurance premium--the put price--at the time the put is issued. The put may remain "open" for as long as a year. The price for the purchase of the claim upon the beneficiary's exercise of the put is preset at the time the put is issued. For example, a bank lender or trade vendor can pay a premium to a put issuer to buy protection today that assures it of payment of 90 cents on the dollar from the issuer if the debtor files for bankruptcy in the next 12 months. Upon exercise of the put, the beneficiary immediately is paid 90 cents on the dollar by the issuer, even if the eventual distribution to creditors in the case (perhaps years later) is only 10 cents on the dollar. Upon exercise of the put, the claim is "assigned" to the issuer and the issuer holds the claim and is paid

by the debtor at whatever time and at whatever rate claims are paid in the case.

The “assignment agreement” normally requires the assignor to repurchase the claim from the assignee (for the exercise price plus interest) if the claim is disputed or disallowed by the debtor. Hence, the issuer takes the risk of distribution but not the risk of disallowance. If the claim that has been “assigned” is not protected from an *Enron*-style attack, the beneficiary might have to repurchase the claim from the issuer. If that happens, the beneficiary ends up with the risk that the claim is only worth 10 cents on the dollar in the chapter 11 case. And the beneficiary loses the price that it paid for the put. This result would destroy or at least seriously undermine the utility and purpose of the credit protection-put transaction. This is all further complicated by the fact that the issuer of the put will “lay off” the risk to others and may sell the claim itself before or after the put is exercised.

The following questions thus arise from the *Enron* decision: What happens in a put transaction where the issuer takes the claim “by assignment” from the beneficiary and later resells the claim to a market purchaser? Can the initial transaction unravel because the transfer of the claim from the beneficiary to the issuer was an “assignment”? Can the market purchaser (who is supposedly protected under Judge Scheindlin’s opinion) put the claim back to the put issuer simply because the original trade that was made between the issuer and the beneficiary was by assignment? Can the debtor (or trustee) object to the claim in the hands of the market purchaser because the “tainted” claim was acquired from an assignee? Can the assignee “wash” the taint off the claim by selling it in the market?

In keeping with the spirit of Judge Scheindlin’s decision, perhaps the claim should be viewed as a hot potato and, therefore, the last toss will determine its fate. However, it still remains to be seen how far back up the chain the repercussions of any disallowance will travel. The ultimate answer will eventually work its way into the

provisions of the various forms of agreements that are used to document these kinds of transactions.

These technical – but important – questions are left open in Judge Scheindlin’s decision. Only time will tell how these interesting but unanswered questions will be addressed.

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¹ *Enron Corp. v. Springfield Associates, L.L.C.*, Nos. 01-16034, 05-01025 (SAS) (S.D.N.Y. Aug. 27, 2007). The purchaser in both cases was Springfield Associates, L.L.C. Judge Scheindlin pointed out that Judge Gonzalez’s two opinions expressly extended their scope to claims traders that purchase claims in the open market. Slip op. at 3 n.5.

² Equitable subordination is a common-law remedy developed in bankruptcy cases that remedies inequitable conduct by a creditor that has injured other creditors. The remedy equitably subordinates the claim of the wrongdoer to the claims of innocent creditors. The subordination is effected by redirecting the distribution that would otherwise be paid to the wrongdoer on account of the wrongdoer’s claim against the debtor and distributing it to the other creditors. Corollaries to equitable subordination provide that the remedy is remedial, not punitive, and that the subordination will be implemented only to the extent necessary to redress the harm to other creditors.

³ *Id.* at 22.

⁴ *Id.* at 29.

⁵ “Under the third party latent equities doctrine, an assignee without notice takes the property free from the latent equities of third parties other than the debtor.” *Id.* at 24. However, this doctrine does not ordinarily apply to transfers of choses in action, and claims are considered to be choses in action. *Id.*

⁶ *Id.* at 20.