

Article

Claims Trading: New York District Court Gets Bullish on Bankruptcy Claims Market

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On August 27, 2007, in connection with the poignant, seemingly interminable story of the Enron bankruptcy case, the United States District Court for the Southern District of New York rendered an opinion that will have significant implications for creditors and parties looking to purchase bankruptcy claims. In vacating a prior decision by the Bankruptcy Court, the District Court held that inequitable conduct of a creditor may not necessarily provide a basis to equitably subordinate or disallow a claim held by the creditor once that claim has been sold to an innocent third party. Several amicus curiae, including the Securities Industry and Financial Markets Association, the International Swaps and Derivatives Association, Inc., the Loan Syndications and Trading Association, the Bond Market Association, and the International Swaps and Derivatives Association, Inc., joined the appeal in support of overturning the Bankruptcy Court's decision due to its perceived impact on the claims trading market.

At issue in the appeal was a claim against Enron which was transferred by a bank alleged to have engaged in inequitable conduct and received avoidable transfers from Enron. Enron filed an action against the bank seeking to recover compensatory and punitive damages and to equitably subordinate each of the bank's claims. Prior to the commencement of this action by Enron, the bank transferred one of its claims against Enron. Enron commenced a separate proceeding against the transferee seeking (i) equitable subordination of the transferred claim under section 510(c) of the Bankruptcy Code based solely on the alleged misconduct of the transferor (i.e., the bank), and (ii) disallowance of the transferred claim under section 502(d) of the Bankruptcy Code based solely on the allegation that the transferor received and failed to repay avoidable transfers. No allegation was made by Enron that the transferee itself engaged in any inequitable conduct. The transferee moved to dismiss the complaint filed by Enron on the grounds that neither equitable subordination under section 510(c) nor disallowance under section 502(d) apply to a claim held by transferee when the action is based solely on the alleged misconduct of the transferor. The Bankruptcy Court denied the dismissal motion, holding that a claim subject to equitable subordination or disallowance in the hands of a transferor remains subject to equitable subordination or disallowance in the hands of a transferee. Thus, the Bankruptcy Court held that a claim may be equitably subordinated or disallowed even though it was now held by an innocent purchaser.

The District Court disagreed with the Bankruptcy Court's analysis, and – discounting arguments that a contrary ruling would promote claims washing by encouraging bad actors to convey their claims to good faith purchasers (at the expense of creditors of the bankruptcy estate) – found that a claim transferred to a good faith purchaser may potentially be insulated from equitable subordination or disallowance.

The District Court based its decision on two fundamental points. First, the District Court rejected Enron's argument that all rights among competing claims are fixed and determined as of the bankruptcy petition date. Enron argued that, under basic principles of bankruptcy law, if the claim was subject to equitable subordination or disallowance as of the petition date, it remained so notwithstanding its transfer. Among other reasons, the District Court rejected this argument because post-petition court action was a prerequisite to either equitably subordinate a claim under section 510(c) or disallow a claim under section 502(d), and because both equitable subordination or disallowance can be ordered based on post-petition conduct. Since post-petition events

impacted whether relief would be granted under these two sections of the Bankruptcy Code, the District Court concluded that equitable subordination and disallowance are not fixed as of the petition date.

Next, the District Court addressed the question of whether equitable subordination and disallowance are attributes of a claim or, instead, are personal disabilities of a particular claimant. If the former, they travel with the claim regardless of the form of transfer to the transferee. If it is the latter, their application depends on whether the claim was conveyed to the transferee by assignment or by sale. The District Court explained that, in the case of an assignment, the law is well settled that the assignee steps into the shoes of its assignor. This means that the assignee is generally held to be subject to the same defenses and limitations to the claim to which the assignor was subject. In other words, the assignor cannot give more than it has. Conversely, according to the District Court, this doctrine does not typically apply in the case of a sale. Rather, a good faith purchaser in a sale, without knowledge of the specific defect or defense, often can purchase an asset free and clear of competing interests and other defects impairing its value in the hands of the seller. Thus, a claim purchaser with actual knowledge of the seller's inequitable conduct or receipt of an avoidable transfer may be subject to equitable subordination for its own misconduct.

The District Court proceeded to hold that equitable subordination and disallowance are personal disabilities that do not inhere in the claim. Thus, according to the District Court, whether the claim at issue can be equitably subordinated or disallowed depends on the nature of the transfer. If the claim was transferred by way of assignment, then the Bankruptcy Court's decision would essentially have been correct - the claim would be subject to equitable subordination or disallowance just as the claim would have been in the hands of the assigning bank. If, however, the claim was transferred by sale, then it was possible that the purchaser would not be subject to the same defenses and limitations as the seller.

The District Court concluded its opinion by addressing policy implications of its ruling. One particular concern expressed by Enron was that a ruling reversing the Bankruptcy Court's holding would encourage "claim washing" by a creditor potentially subject to an action for equitable subordination and/or disallowance. That is, a creditor, whom either knows or suspects that the debtor will assert a cause of action against the creditor thereby putting the allowance of the claim in jeopardy, will transfer its claim against the debtor in order to receive some value for the claim and thus prevent an action for equitable subordination and/or disallowance. Accordingly, if the claim is allowed to be "washed," Enron asserted that the creditor body will be harmed because the ultimate dividend paid to creditors as a whole will be reduced. In response to this concern, the District Court acknowledged that a claim may be effectively "washed" to the detriment of other creditors in the bankruptcy case, but concluded that the likelihood of that happening was limited and that the risk of a claim being "washed" was outweighed by the countervailing policy of protecting a bona fide purchaser of the claim. Further, the District Court noted that the "unnecessary breadth of the Bankruptcy Court's decision threatened to wreak havoc on the markets for distressed debt," which the District Court said would be avoided with its ruling. In the District Court's eyes, its legal analysis struck a fair balance between two groups of innocents: the creditors as a whole and the transferee.

The District Court's holding is fraught with uncertainty, and thus has left a degree of uncertainty in the claims trading market. First, prior to this ruling by the District Court, participants in the claims trading market did not clearly differentiate in claims transfer documents whether the transaction was a sale or an assignment. Practically speaking, the participants considered those terms synonymous. Thus, reviewing the transfer documents to determine the intent of the parties may not end the inquiry. Second, the District Court failed to provide clear guidance as to what constitutes a sale or an assignment. Until such guidance is developed, uncertainty will continue in the claims trading market as to how transfers will be treated with respect to this substantial issue. Third, clarifying the standard is no small feat, because the determination of whether a given transaction constitutes a sale or some type of assignment is a question of state law. The precise standards and considerations to be used by the courts in making the distinction will vary with the laws of the particular states.

This story may not be complete. Because the Bankruptcy Court did not determine whether the claim at issue was transferred by way of sale or by way of pure assignment, the District Court remanded the proceeding back to the Bankruptcy Court with instructions for it to determine the nature of the transfer. The claim holder and its supporting amicus curiae attempted to avoid the remand by requesting the District Court to permit them to appeal the District Court's ruling to the Second Circuit Court of Appeals, arguing that the District Court's opinion was, by itself, insufficient to quell uncertainty in financial markets. Ironically, among the arguments raised by these parties in support of the justification for appealing the District Court's favorable ruling is that the parties all appear to agree that whether a claim is conveyed by sale or assignment is not relevant to the resolution of the issues. The District Court denied this request for interlocutory appeal on September 24, 2007. The matter is now back before the Bankruptcy Court on remand for a factual determination as to whether the claim at issue was transferred by way of an assignment or a sale. Following this determination, it is possible there could be a global appeal at the conclusion of this matter in the Bankruptcy Court. Regardless of the outcome, claim purchasers should carefully review the language used in the transfer documents and structure the transaction to reduce the likelihood the claim will be attacked based on the misconduct of the transferor.

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