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District Court Rejects Enron "Tainted Debt" Theory

On August 27, 2007, Judge Scheindlin of the Southern District of New York reversed two significant decisions by the Bankruptcy Court in the Enron case[1] that had impacted on the distressed debt market. The prior Enron rulings[2] had allowed Enron to challenge and potentially subordinate or disallow claims held by "innocent" open market purchasers of Enron bank debt based on the alleged bad acts of the original lender or holder. Judge Scheindlin's decision is particularly critical in concluding that allegations of wrongful conduct against an upstream transferor of claims does not "taint" the claims sold because the disability of the wrongful conduct is personal to the alleged wrongdoer.

In the ruling, Judge Scheindlin said bankruptcy-law provisions covering equitable subordination or disallowance of bankruptcy claims were not intended to penalize "innocent" purchasers of claims: "purchasers are protected from being subjected to the personal disabilities of their sellers." Opinion at p. 36. An important policy rationale supporting the ruling was that "the unnecessary breadth of the bankruptcy court's decisions threatened to wreak havoc on the markets for distressed debt. That result has now been avoided." Opinion at p. 52.

Judge Scheindlin said however that "bad-faith" claims buyers who are actually aware of the seller's misconduct would enjoy no protection under her ruling, as such buyers' claims could be reduced or disallowed "based on their own misconduct." Opinion at p. 37.

The Enron decisions on appeal arose from two rulings by Bankruptcy Judge Arthur Gonzalez. In those decisions, Judge Gonzalez declined to dismiss claims for equitable subordination and disallowance by Enron against downstream post-petition purchasers of Enron bank debt solely on the ground that Enron had alleged bad acts by the holder of the bank claims at the petition date.

Enron had obtained a $1.75 billion syndicated loan from Citibank and other banks prior to its Chapter 11 filing on Dec. 2, 2001. In February 2002, Citibank sold a claim of roughly $5 million to Deutsche Bank which then sold that claim in May 2002 to lead appellant Springfield Associates LLC.[3]

Enron sued Citibank and other lenders two years later within its bankruptcy for allegedly engaging in inequitable conduct and aiding and abetting fraud and breaches of fiduciary duty. In January 2005, Enron also sued Springfield Associates and other purchasers of the Enron debt on the grounds that claims that they had acquired from Citibank and other alleged "bad actor" banks could be disallowed or subordinated due to alleged misconduct by the prior holders of those claims.

Judge Gonzalez ruled in Enron's favor, essentially holding that the subordination or disallowance of claims due to alleged wrongful conduct by Citibank and other alleged "bad actor" banks could be extended to otherwise innocent buyers of those claims. By the time the appeal was briefed and argued, the other banks had settled with Enron, leaving Citibank and Springfield Associates LLC as the sole appellants.

Judge Scheindlin accepted interlocutory appeal of these decisions to decide the question of first impression as to whether equitable subordination and disallowance may be applied to transferees to the same extent as if the claims were still held by the transferor based on alleged bad acts by the transferor. Judge Scheindlin reviewed the statutory basis of equitable subordination and disallowance and reaffirmed existing case law by noting that the equitable subordination doctrine is remedial, not penal, and should be applied only to the extent necessary to offset "specific harm that creditors have suffered on account of inequitable conduct." Opinion at p. 18. The Court also emphasized that "Equitable Subordination is a remedy that belongs to the *creditors* — not the debtor ... Indeed, a [solvent] debtor acting on its own behalf lacks standing to bring an action for equitable subordination." Opinion at p. 35. Additionally, Judge Scheindlin noted that the Second Circuit has "recognized that the appropriate focus is on the claimant, [whose conduct is questioned,] not the claim." Opinion at p. 33.[4]

Section 502(d) of the Bankruptcy Code requires that the Court disallow a claim if the claimant has not paid to the Bankruptcy Estate a voidable preference or transfer. Judge Scheindlin who also ruled that section 502(d) disallowance cannot be applied to an innocent transferee who purchased a claim and was not the recipient of the otherwise avoidable transfer, noted that section 502(d) was not "intended to punish, but 'rather to give *creditors* an option to keep *their* transfer (and hope for no action by the trustee) or to surrender *their* transfers and *their* advantages and share equally with other creditors.'" Opinion at p. 40.

Ultimately, Judge Scheindlin ruled that claims are not immutably fixed on the petition date, thereby rejecting a basis for Enron's "tainted debt" theory. The Court further ruled that equitable subordination and disallowance were not applicable based upon attributes of a claim itself but are instead to be applied only as personal disabilities of the particular claimants against whom wrongdoing is alleged. This was the argument raised by transferor Citibank in the appellate briefing, and means that the alleged bad acts of the original creditor do not necessarily "taint" the transferred claims. Judge Scheindlin went further and held that because equitable subordination and disallowance exposure are personal to the transferor, the question of whether these actions can be applied to downstream transferees turns on whether the transfers were effected by a sale or by a pure assignment (where the transferee actually steps into the shoes of the transferor). If the transfers were by a pure assignment such as pursuant to a receivership, or by operation of law or subrogation, then the personal disability is also transferred and the claims may be subject to subordination or disallowance, subject to whether the transferee may maintain any defenses. In contrast, if the transfers were by sale, then the good faith transferee takes clear of these actions.

While remanding for a factual determination as to whether the subject agreements were sales or assignments, Judge Scheindlin clearly stated such factual determination will not always be necessary. "Sales of claims on the open markets are indisputably sales and subrogation of a surety to the rights under a claim is indisputably an assignment." Opinion at p. 45. Thus, according to Judge Scheindlin, equitable subordination of claims shouldn't be applied to open market sales. This distinction "is particularly imperative in the distressed debt market, where sellers are often anonymous and purchasers have no way of ascertaining whether the seller (or a transferee up the line) has acted inequitably or received a voidable preference. No amount of due diligence on [the buyer's] part will reveal that information and it is unclear how the market would price such unknowable risk. Parties to true assignments, by contrast, can easily contract around the risk of equitable subordination or disallowance by entering into indemnity agreements to protect the assignee." Opinion at p. 36.

While it is virtually certain that the ruling will be appealed to the Second Circuit Court of Appeals, this ruling does provide a degree of comfort to distressed claims buyers and the market, based on the strong and unequivocal language that Judge Scheindlin used in determining that the Bankruptcy Court had overreached in its ruling.

1 06 Civ. 7828 (SAS) and 07 Civ. 1957 (SAS).

2 *See Enron Corp. v. Sprinfield Assocs., L.L.. (In re Enron Corp.)* ("Subordination Order"), Nos.01-16034, 05-01025, 333 B.R. 205 (Bankr. S.D.N.Y. Nov. 28, 2005), and *Enron Corp. v. Avenue Special Situations Fund II, LP* (*In re Enron Corp.*) ("Disallowance Order"), 340 B.R. 180 (Bankr. S.D.N.Y. 2006).

3 Generally, the transfers were accomplished by purchase and sale agreements and assignment and acceptance agreements, and contained warranties and indemnities against any acts of the transferor that might reduce the value of the claim.

4 Thus, a bad "actor" may have even an unrelated claim subordinated.

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