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District Court Vacates Bankruptcy Orders that Had Roiled Distressed Debt Markets

On August 27, 2007, Judge Shira A. Schiendlin of the United States District Court for the Southern District of New York issued an Opinion and Order in the Enron bankruptcy vacating two prior Bankruptcy Court orders on equitable subordination under § 510(c) of the Bankruptcy Code and claims disallowance under § 502(d) of the Bankruptcy Code. *Springfield Associates, L.L.C. v. Enron Corp. (In re Enron Corp.)*, Nos. 06 Civ. 7828 (SAS) and 07 Civ. 1957 (SAS) (S.D.N.Y. August 28, 2007).

In the two underlying orders, the Southern District of New York Bankruptcy Court (Gonzalez, J.) had determined that: (1) when a claim against the debtor is subject to equitable subordination under § 510(c) of the Code based on the misconduct of the creditor holding the claim, all subsequent transferees of the claim, whether pre- or post-petition, whether with or without knowledge of the alleged inequitable conduct and whether in negotiated transfers or anonymously on a public market, will also be subject to equitable subordination[1]; and (2) when a claim is subject to disallowance under § 502(d) of the Code because the holder received an avoidable transfer pre-petition that it has failed to return to the debtor, that disallowance similarly follows to all subsequent transferees of the claim.[2] These two decisions had caused a great deal of concern in the debt and claims trading arenas, particularly in the anonymous markets where purchasers do not usually receive any guaranties or indemnities from the sellers against such subordination or disallowance. The appeal has, therefore, been watched closely and many groups submitted *amicus curiae* briefs on both sides of the issues.

Judge Schiendlin began her analysis by examining the reach and purpose underlying each of the two Code sections. She then turned to a discussion of transfers in general and specifically

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1 *See Enron Corp. v. Springfield Assocs., L.L.C. (In re Enron Corp.)*, Nos. 01-16034, 05-01025, slip op. (Bankr. S.D.N.Y. Nov. 28, 2005) (the "Subordination Order").

2 *See Enron Corp. v. Avenue Special Situations Fund II, LP (In re Enron Corp.)*, 340 B.R. 180 (Bankr. S.D.N.Y. 2006) (the "Disallowance Order").

the difference between a pure assignment (by contract or operation of law) and a sale. Applying traditional notions of non-bankruptcy law, Judge Schiendlin determined that an assignee, with certain exceptions, steps into the shoes of the assignor while a purchaser, again with certain exceptions, does not.

Applying these general concepts to the Code sections at issue in the case, the Court determined that both equitable subordination under § 510(c) and disallowance under § 502(d) are personal disabilities of a particular claimant and travel with the claim only when the claim is assigned, not when it is sold. In so holding, Judge Schiendlin undertook a detailed examination of the case law and legislative history on both statutes as well as the authorities and arguments put forward by Enron and the Appellant.

Rather than dismiss the case, the Court remanded to the Bankruptcy Court for further proceedings as to the true nature of the transfer at issue (sale or assignment) and whether the transferee took in good faith without knowledge of the inequitable conduct or the avoidable transfers. These questions will be fertile ground for future litigation in the Enron cases as well as other cases where similar arguments are being pursued. In the future, debtors may well raise inequitable conduct issues earlier in the bankruptcy process in an effort to cut off or limit the ability of transferees to claim that they took in good faith. In that regard, Judge Schiendlin specifically stated with respect to both equitable subordination and disallowance that knowledge on the part of the transferee of the inequitable conduct of its counterparty or the knowledge of an avoidable transfer to the counterparty would allow equitable subordination or disallowance of the claim in the hands of the transferee based on its own misconduct.

From the distressed debt market perspective, the decision adds some clarity and the Court specifically stated:

> "[T]he concerns raised by Industry Amici with respect to the effects of the Bankruptcy Court's rulings on the markets for distressed debt are no longer present. Equitable subordination and disallowance arising out of the conduct of the transferee will not be applied to good faith open market purchasers of claims."

Slip Op. at 30 n. 76 (citations omitted).

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or e-mail Kevin J. Burke at (212) 701-3843 or kburke@cahill.com or Robert Usadi at (212) 701-3700 or rusadi@cahill.com.