Daily Deal: Enron claims trading reversal is timely

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HEADLINE: Enron claims trading reversal is timely

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HIGHLIGHT:

A federal judge's ruling in bankruptcy court could create hope for distressed debt.

BODY:

With more distressed debt likely to come on the market as more mortgage lenders implode, the buyers of such assets may have received a key legal shot in the arm in their pursuit of them.

On Monday, Aug. 27, a federal appeals judge overturned a bankruptcy court ruling in the Enron Corp. case that had sent shivers through the $500 billion U.S. distressed debt market.

Judge Shira Scheindlin of U.S. District Court for the Southern District of New York in Manhattan ruled that improper conduct by a claims seller doesn't necessarily carry over to the buyer.

"Scheindlin's decision is critically important because the bankruptcy court's ruling threatened to choke off distressed debt trading since it would have been impossible to price trades," said the lawyer for several of the appellants in the Enron case, Craig Goldblatt of Wilmer Cutler Pickering Hale and Dorr LLP in Washington. "The bankruptcy court ruling would have imposed a huge burden on claims buyers to do due diligence on the possibility that the seller was a bad actor."

The appeal is tied to a $1.75 billion syndicated loan that Citigroup Inc.'s Citibank unit and other banks made to Enron prior to its Chapter 11 filing on Dec. 2, 2001. In May 2002, Citibank sold a claim of roughly $5 million to lead appellant Springfield Associates LLC.

Enron sued Citibank and other lenders two years later within its bankruptcy for allegedly engaging in fraud that aided the former energy trader's spectacular collapse. In January 2005, Enron also sued Springfield Associates and others in its petition on grounds that claims that they had acquired from Citibank could be disallowed or subordinated due to alleged misconduct by the claims seller.

On March 31, 2006, Judge Arthur Gonzalez in U.S. Bankruptcy Court for the Southern District of New York in Manhattan ruled in Enron's favor in both instances, essentially blessing the notion that the subordination of claims due to wrongful conduct by the seller is extended to their buyer.

By so doing, Goldblatt noted, "The bankruptcy court ruling created a huge cloud that was hovering over distressed debt because it threatened to dampen an otherwise robust market."

Scheindlin's decision, however, essentially protects buyers of distressed debt in bankruptcy cases from the personal acts of the sellers of the claims, according to the 53-page ruling.

"In order to ensure that untenable distinctions and unreasonable results are avoided, it is proper to consider the effect that the [bankruptcy] court's interpretation would have on the markets," Scheindlin ruled. "The unnecessary breadth of the bankruptcy court's decisions threatened to wreak havoc on the markets for distressed debt."

Scheindlin then remanded the dismiss motion back to bankruptcy court.

Scheindlin made a distinction between claims sales and pure assignments where a surety that pays a claim is subject by law to the rights of the original buyer.

"The claims on the open market are indisputably sales," Scheindlin ruled, and equitable subordination of claims, or their reduction in payment priority to other 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 has acted inequitably or received a voidable preference, Scheindlin ruled. "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."

Springfield Associates and others appealed Gonzalez's decision on Sept. 29, 2006. Bond Market Association, International Swaps and Derivatives Association, Loan Syndications and Trading Association and Securities Industry and Financial Markets Association all filed briefs challenging the bankruptcy court decision.

Industry officials argued that the Gonzalez ruling would chill otherwise vibrant markets.

They asserted that demand for distressed debt could languish, dampening the credit markets and putting a big dent in the secondary claims market by making it more difficult for lenders to cash out their claims.

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