Purchaser of Debt on the Secondary Market Takes Free from Taint on Account of Seller's Alleged Improper Conduct

2007-08-30

On August 27, 2007, District Judge Shira A. Scheindlin of the US District Court for the Southern District of New York reversed a bankruptcy court decision that had caused widespread concern in the secondary markets for trading bank debt, bond debt and other claims against a debtor in bankruptcy.[1] Recognizing that the decision would have "serious ramifications well beyond the parties involved," the district court held that equitable subordination and disallowance are "personal disabilities" that do not transfer with claims when they are sold to good faith purchasers on the open market.[2]

The case arose out of a secondary market purchase by Springfield Associates, L.L.C. (Springfield) of $5 million of Enron bank debt originally held by Citibank. Enron sued Springfield seeking to (i) equitably subordinate Springfield's claim based solely on Citibank's alleged inequitable conduct; and (ii) disallow Springfield's claim pursuant to Section 502(d) of the Bankruptcy Code based on Citibank's receipt of avoidable transfers. Enron did not allege that Springfield itself engaged in any improper conduct or received any avoidable transfer. Enron had separately sued Citibank seeking damages for the same alleged misconduct and seeking to recover the same alleged avoidable transfers.

The Enron bankruptcy court accepted Enron's argument, issuing decisions holding that improper conduct or receipt of an avoidable transfer by a prior holder of a claim taints the claim itself. Purchasers of a "tainted" claim thus take subject to risks of equitable subordination based on the prior holder's bad acts and disallowance based on the prior holder's receipt of an avoidable transfer. Those "taints" can render the claim essentially worthless in the hands of a subsequent—and a wholly innocent—holder.

The District Court's Opinion

The district court began by recognizing that a purchaser of a claim may take more rights than the seller of that claim held. Specifically, while a seller of a claim may be subject to "personal disabilities" that impede the seller's ability to collect its claim, a purchaser buys the claim free of those personal disabilities. The district court then proceeded to determine whether equitable subordination and disallowance based on receipt of an avoidable transfer were personal disabilities of the seller that did not travel with the claim to the purchaser.[3]

With regard to equitable subordination,[4] the district court determined that while the plain language of the Bankruptcy Code did not directly address the question, both the case law and the legislative history demonstrated that Congress intended to create a personal disability. First, the legislative history refers to misconduct on the part of a "holder" of the claim, showing that Congress intended equitable subordination to be specific to the bad actor. Second, at the time of enactment of section 510(c) of the Bankruptcy Code—the section that incorporates principles of equitable subordination—courts required misconduct on the part of the creditor asserting the claim before they would apply equitable subordination. The district court thus held that equitable subordination does not apply to a transferee of a claim who has not acted inequitably "merely because that claim was transferred, directly or indirectly, by a bad actor."[5]

Turning to disallowance, the district court focused on the statutory text.[6] The language and structure of Section 502(d) requires "that the entity that is asserting the claim be the same entity . . . that is liable for receipt of and failure to return property."[7] Because the language at issue focuses on the claimant as opposed to the claim, disallowance under Section 502(d) creates "a personal disability of the claimant, not an attribute of the claim."[8]

Caveats

For the reasons described above, the district court held that when the holder of a claim sells that claim to a third party, the buyer of the claim is not subject to the "personal disabilities" that would have run against the seller. At the same time, however, the district court distinguished a "sale" from an "assignment" stating that an assignee may be subject to the equities against the assignor[9] The district court made clear, however, that except in cases of a "pure assignment"—such as when a surety that pays a claim is subrogated by operation of law to the rights of an original obligee—a transferee of a claim generally will not be subject to the personal disabilities of a seller. The district court thus stressed that "sales of claims on the open markets are indisputably sales."[10]

In addition, the district court explained that a purchaser with "actual notice" of the seller's receipt of an avoidable transfer may be subject to equitable subordination for its own misconduct.[11]

The district court thus remanded the matter to the bankruptcy court to determine whether any of these caveats come into play in the transfer at issue.

Policy Concerns

The district court also addressed certain policy concerns in reaching its decision. In some instances, a bad actor may indeed by able to "wash" its claim by selling it to a good faith purchaser, and, as the district court stated, "take the money and run, to the detriment of other creditors."[12]

Following the policy arguments of the amici trade associations,[13] the district court recognized that the question became one of "allocating the burden and risk of pursing the bad actor transferor between two groups of innocents: the creditors as a whole or the transferee."[14] It concluded that the balance struck by its decision fairly allocated the risk to the creditors as a whole, rather than a single good faith, innocent purchaser. Moreover, the bankruptcy court's decision threatened to "wreak havoc on the markets for distress debt"—a result that has now been avoided.[15]

The Bottom Line

Good faith open market purchasers of distressed claims—whether bank debt, bond debt, trade debt or derivatives—should take free of any risk of equitable subordination or disallowance based solely on the conduct of a prior holder of that claim. Moreover, the timing of the petition date of the debtor's bankruptcy filing has no relevance to this analysis. However, transferees that take with knowledge of personal disabilities may nevertheless be subject to equitable subordination based on their own conduct in participating in potential "claims washing." And finally, those transferees that take by something other than a good faith sale—the district court often spoke of "assignments" rather than sales—risk taking subject to personal disabilities of the transferor.

----

[1] See *Enron Corp. v. Springfield Assocs.*, L.L.C. (In re Enron Corp.), 06 Civ. 7828 (S.D.N.Y. August 27, 2007).

[2] Id., slip op. at 3,52.

[3] The district court first rejected Enron's argument that equitable subordination and disallowance are fixed as of the petition date. See id., slip op. at 25-29.

[4] "'Under the doctrine of equitable subordination . . . a bankruptcy court may subordinate a particular claim if it finds that the creditor's claim[], while not lacking a lawful basis nonetheless results from inequitable behavior on the part of that creditor.'" Id., slip op. at 14 (quoting *Musso v. Ostashko*, 468 F.3d 99, 109 (2d Cir. 2006)).

[5] Id., slip op. at 32.

[6] Section 502(d) requires disallowance of "any claim of any entity from which property is recoverable . . . or that is a transferee of a transfer avoidable . . . unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable." Id., at 38-39 (quoting Section 502(d) of the Bankruptcy Code).

[7] Id., slip op. at 39.

[8] Id.

[9] Id. at 21. The district court went on, however, to indicate that even under the law of assignment, there were circumstances in which an assignee would not be subject to those personal disabilities—such as when the assignee was the holder in due course of a negotiable instrument, or when state law would provide that an assignee takes free of latent equities of third parties. Id. at 23-24. This suggestion—that whether a claim is subject to equitable subordination under Section 510(c) of the Bankruptcy Code turns on state law—is at least in some tension with statements by the Supreme Court indicating that the meaning of the Bankruptcy Code should not turn on variations in the laws of individual jurisdictions. See *Field v. Mans*, 516 U.S. 59, 70 n.9 (1995) ("We construe the terms in § 523(a)(2)(A) to incorporate the general common law of torts, the dominant consensus of common-law jurisdictions, rather than the law of any particular State.").

[10] Id. at 45 n.104.

[11] Id., slip op. at 37.

[12] Id., slip op. at 51.

[13] WilmerHale represented the Loan Syndications and Trading Association (LSTA), the Securities Industry and Financial Markets Association (SIFMA) and the International Swaps and Derivatives Association (ISDA), all leading securities industry trade associations, as *amici curiae* in this appeal.

[14] Id.

[15] Id., slip op. at 52.