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Equitable Subordination: Good-Faith Transferees Beware

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Editor's Note: *Paul, Weiss represents a party in the matter.*

In a recent decision in the *Enron* chapter 11 case, *Enron Corp. v. Avenue Special Situations Fund II L.P.* (the "Enron Opinion"), Judge **Arthur Gonzales** of the U.S. Bankruptcy Court for the Southern District of New York ruled that bank claims held by post-petition transferees may be equitably subordinated pursuant to §510(c) of the Bankruptcy Code, 11 U.S.C. §§101, *et seq.,* on the basis that the transferors engaged in inequitable pre-petition conduct. This is an unprecedented expansion of the doctrine of equitable subordination, and the decision's significance extends beyond *Enron* and threatens serious disruption to the distressed debt-trading markets.

Background

Prior to filing for chapter 11 protection, Enron borrowed $3 billion under short- and long-term credit agreements from a consortium of banks, including Fleet National Bank. Subsequent to Enron's filing, Fleet transferred 100 percent of its claims against Enron, pursuant to these credit agreements (the "claims"), to various entities; some of these claims were subsequently transferred to other purchasers.

Almost two years after Enron's chapter 11 filing, Enron commenced an adversary proceeding against various banks, including Fleet. In that action, Enron alleged, among other things, that Fleet and other named bank defendants (1) received preferential and fraudulent transfers, and (2) participated in pre-petition inequitable misconduct with respect to Enron, which injured Enron's creditors and gave an unfair advantage to Fleet and the other named defendants. Fleet and the other bank defendants have vigorously contested these allegations, which have yet to be adjudicated by the bankruptcy court.

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Feature

In early 2005, Enron commenced an adversary proceeding against the purchasers of the claims (collectively, the "defendants") in which it sought, among other things, equitable subordination of the claims based on the alleged misconduct of Fleet. The defendants moved to dismiss the adversary proceeding asserting that they, unlike Fleet, were not alleged to have engaged in any inequitable conduct. The defendants argued that their claims cannot be equitably subordinated because §510(c) of the Code requires inequitable conduct by the party holding the subject claims. On Nov. 17, 2005, the bankruptcy court denied the defendants' motion to dismiss.

Bankruptcy Court's Decision

In its decision, the bankruptcy court first examined the language of §510(c) and found that its purpose is to advance equitable distribution among creditors.[1] The bankruptcy court then analyzed the controlling three-part test for determining if a claim should be equitably subordinated, which was first articulated in *Benjamin v. Diamond (In re Mobile Steel Co.),* 563 F.2d 692 (5th. Cir. 1977).[2] The bankruptcy court next considered whether §510(c) grants a court authority to equitably subordinate claims unrelated to any misconduct, but that are held by a creditor alleged to have engaged in inequitable conduct regarding the debtor. The bankruptcy court ruled that it has such authority, citing as support the pronouncement in *Mobile Steel* that "[i]mproper acts unconnected with the acquisition or assertion of a particular claim have frequently formed at least a part of the basis for the subordination of that claim." *Enron Opinion,* p. 23.

Next, the bankruptcy court considered whether claims that could have been equitably subordinated in the hands of the original transferor remain subject to subordination in the hands of a transferee. Commenting that "[t]here is no basis to

1 Section 510(c) of the Code provides, in relevant part: "Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may...(1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim...." 11 U.S.C. §510(c).

2 The *Mobile Steel* test provides that a claim may be subordinated upon three essential findings:
1. The claimant must have engaged in some type of inequitable conduct.
2. The misconduct must have resulted in injury to the creditors...or conferred an unfair advantage on the claimant.
3. Equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Act. *In re Mobile Steel,* 563 F.2d at 700 (citations omitted).

find or infer that transferees should enjoy greater rights than the transferror," the bankruptcy court concluded that §510(c) permits a court to subordinate a claim held by an innocent transferee based solely on the misconduct of a predecessor-in-interest. *Enron Opinion,* p. 29. In reaching this conclusion, the bankruptcy court relied on case law dealing with the law of assignments and addressing transferees of priority wage claims. In particular, the bankruptcy court focused on a decision in *Shropshire, Woodlife & Co. v. Bush,* 204 U.S. 186 (1907), a case involving the priority of assigned wage claims.

In *Shropshire,* the U.S. Supreme Court found that an assignment of a wage claim, voluntarily assigned pre-petition, does not affect the statutory priority afforded to that claim. The *Shropshire* court reasoned that because the statutory priority attached to the wage claim as the debt was incurred, the right to such priority is not altered simply because it is asserted by an assignee. The bankruptcy court analogized the circumstances in *Shropshire* to those in the present case and found that a transferee steps into the shoes of the transferor at the time of the transfer.

To support its decision, the bankruptcy court relied heavily on policy concerns. Specifically, the court was concerned with the burden that a debtor might face if it were not permitted to subordinate the claims of innocent transferees based on the misconduct by their predecessors in interest. It found that the "necessity of collecting damages in lawsuits against each of the original or previous holders who engaged in inequitable conduct" would "delay the ultimate distribution by the debtor, which delay is contrary to the goal of the Bankruptcy Code." *Enron Opinion,* p. 36.

As for defenses, the bankruptcy court held that its construction of §510(c) affords no protection to transferees that acquire claims in good faith and for value. The bankruptcy court based its holding in part on the absence of any explicit provision in the Code establishing a defense to equitable subordination under §510(c) for good-faith transferees. The bankruptcy court further reasoned that the good-faith defense is not applicable in the context of equitable subordination because all claim transferees by definition know they are purchasing a claim against a debtor and know that any defense, including equitable subordination, may be asserted against the claim.

The Appeal

The defendants immediately appealed the decision, asserting that the bankruptcy court had erred in holding that (1) §510 of the Code permits subordination of a claim in the hands of a transferee based solely on the fact that a predecessor in interest—but not the transferee—engaged in misconduct; and (2) the defense of good faith was not available to an innocent transferee who acquired a claim in good faith and for value. The defendants also argued in the appeal that in making its decision, the bankruptcy court failed to take into account the profoundly disruptive effect its ruling will have on the distressed-debt markets. In addition to the briefs filed by the defendants, an *amici* brief was filed in support of the appeal by certain industry participants (the "*amici*"), including the Loan Syndications and Trading Association.

Principles of Equitable Subordination

On appeal, the defendants argued that in deciding that §510(c) permits a court to subordinate a claim held by an innocent transferee based solely on the misconduct of a predecessor in interest, the bankruptcy court disregarded the legislative history of §510(c), which in their view demonstrates Congress' intent that misconduct by the holder of a claim be an essential element in equitably subordinating a claim. The defendants further assert that the bankruptcy court's holding contradicts the clear language of *Mobile Steel*'s controlling three-part test for determining if a claim can be equitably subordinated. The first of the three essential elements is that there must be a finding of misconduct on the part of the particular claimant holding the claim. The defendants contend that the bankruptcy court's holding "contort[s] the definition of 'claimant' to mean 'the claimant or any party that previously asserted the claim,'" a construction that plainly contradicts the clear language of *Mobile Steel* and its progeny. Appeal Brief, p. 13.

The Appeal Brief also highlights the bankruptcy court's failure to offer any authority for the proposition that principles of equitable subordination permit the subordination of claims held by an innocent, for-value transferee based solely on the misconduct by a transferor. The bankruptcy court instead attempts to justify its holding on "two inapposite areas of the law: the law of assignments and case law addressing transferees of priority wage claims." *Appeal Brief,* p. 14. The defendants were especially troubled by the bankruptcy court's reliance on *Shropshire* as authority for its holding because, in the defendants' view, *Shropshire* is inapplicable in the context of the equitable subordination of transferred claims. The defendants contend that the "statutory priority of wage claims derives from the 'character' of the claim itself" and that "the character of the claim, *i.e.,* a claim for wages, does not change upon its assignment." *Appeal Brief,* p. 16. By invoking the holding in *Shropshire,* the defendants assert that the bankruptcy court erroneously concluded that the priority adjustment of a claim due to equitable subordination derives from the "character" of the claim, when in fact, the priority adjustment of a claim derives from a particular claimant's misconduct. The defendants insist that the principles of equitable subordination offer no support for the bankruptcy court's finding that "the adjustment of priority of a claim resulting from subordination is attached to such claim and it travels with any subsequent transfer." *Appeal Brief,* p. 16 (*quoting Enron Opinion,* p.33).

Protection for Good Faith, Value Transferees

Both the *amici* and the defendants argue in their respective briefs that the bankruptcy court failed to apply the well-established equitable principle that affords protection to transferees that acquire claims in good faith and for value. The defendants note that several sections of the Code provide protection for innocent transferees. Specifically, the Code states that while §550(b)(1) provides that a trustee may sue to recover transferred property or its value from a subsequent transferee, it also provides a defense for "a transferee that takes for value...and without knowledge of the viability of the transfer avoided." The defendants contend that the inclusion of a good-faith defense in §550(b)(1) demonstrates "(a) where Congress intended to impose liability on subsequent transferees, it knew how to do so (and chose not to do so in §510(c) by not referring to transferees); and (b) where Congress did create a remedy against subsequent

transferees, it provided protection to good-faith purchasers for value." *Appeal Brief,* p.17.

The defendants and the *amici* continue their criticism by asserting that the bankruptcy court's holding prevents a transferee from ever establishing the prerequisite of a good-faith defense. According to the bankruptcy court's opinion, because all claims transferees, by definition, know they are purchasing a claim against a debtor and are on notice that a fiduciary is charged with investigating each claim and asserting any defense, including equitable subordination, all claims transferees are on notice of the risk of equitable subordination. The defendants and the *amici* argue that this interpretation of "good faith" is unprecedented and untenable. Notice of a debtor's bankruptcy at the time a claim is purchased is not an element of an equitable subordination action; by adopting such a test, the bankruptcy court is, in essence, defining away the good-faith defense as "any purchaser of a bankruptcy claim must, by definition, be on notice of the debtor's bankruptcy." *Appeal Brief,* p. 20

Decision's Effect on Distressed Markets

The defendants and the *amici* further assert that although the bankruptcy court devoted much of its opinion to a series of "policy arguments" as justification for its decision, it ignored the crippling effect this decision will have on the entire claims trading market.

The bankruptcy court's policy justifications for its decision focus on the burden a debtor might bear if it was not permitted to subordinate the claims of innocent transferees based on the misconduct of their predecessors in interest. The potential burdens the bankruptcy court was concerned about include the administrative burden of collecting damages in lawsuits against previous holders who engaged in misconduct, and the uncertainty and delay attendant to litigation. The defendants and *amici* argue, however, that the bankruptcy court's reasoning ignores the fact that before a debtor can subordinate a claim, it must first establish the misconduct of the claim's original holder. This requirement means that the debtor must still engage in time-consuming and uncertain litigation, and thus the burden or delay will not be appreciably different. In addition, the defendants and *amici* contend that equitable subordination is merely a supplemental remedy to the primary form of relief: the right to sue an alleged wrongdoer for damages resulting from the alleged inequitable conduct. Accordingly, the defendants and *amici* argue that facilitating the use of this supplemental remedy, plus any purported incremental "administrative burden" on a debtor unable to assert an equitable subordination claim against an innocent transferee, cannot justify the disruptive effect the decision will have on the claims-trading market and the unfair burden it imposes on innocent transferees.

The defendants and *amici* argue that the bankruptcy court downplayed the effect its decision would have in that market and erred in citing secondary sources to justify its holding, rather than relying on the views of actual market participants (such as the *amici*).

It is the *amici*'s position that this decision will have profound effects on the market for bankruptcy claims and could decrease liquidity in what is otherwise an efficient, healthy market. One such effect is that claim buyers, in order to analyze their increased risk, will require more extensive due diligence into the actions of all previous claim owners—slowing the claims-trading process and increasing costs.

Other effects may include the requirement of indemnities from sellers in order to minimize the new risk of equitable subordination. As indemnities are only as valuable as the financial condition of the indemnifying party, the claims purchaser will require more extensive due diligence on the creditworthiness of the seller. In addition, there is a potential for a stream of litigation up the chain of title when claims are bought and sold multiple times. For example, if a debtor brings an equitable subordination suit against the ultimate buyer of a claim, the buyer would bear the cost and expense of such litigation, plus any litigation necessary to enforce any indemnification rights it may have against the transferor of that claim. In turn, the transferor, if it is not the wrongdoer, would most likely bring suit against its respective transferor and, where a claim has been transferred multiple times, so on up the chain of title until the litigation reaches the transferor who engaged in inequitable conduct. These additional risks of litigation will have to be considered by any claims buyer, who may discount their bids accordingly. The *amici* argue that the bankruptcy court's analysis, with its myopic focus on the supposed benefits its decision would provide to debtors, fails to account for the tremendous burdens its decision places on market participants and the judicial system. The defendants and *amici* contend that the decreased liquidity in the bankruptcy claims market, due to higher risk premiums and fewer claims buyers, will result in higher credit costs for borrowers. A primary mechanism for a lender to stem its losses if a borrower defaults is its ability to sell its claims, and the viability of this exit strategy is dependent on the availability of a liquid market for claims trading. If "exit-by-sale" becomes a less-attractive option for lenders due to claim buyer's demand for greater discounts, the result will be that lenders will demand more stringent terms, which could price many distressed borrowers out of credit markets and increase the number of bankruptcies.

Conclusion

The bankruptcy court's holding in *Enron Corp. v. Avenue Special Situations Fund II L.P.* disregarded traditional principles of equitable subordination, centuries of precedent with regard to good-faith purchasers and the serious potential disruption to the distressed claims-trading market that will result if the bankruptcy court's opinion remains law. It is bad law for distressed companies, traders of distressed debt and the distressed-debt markets as a whole, and should be overturned on appeal. ■

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