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# Buyer beware: your new claim may carry hidden baggage

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Two recent decisions issued in the bankruptcy proceedings of Enron Corp., *et al.,* highlight – and threaten to expand considerably – the risks facing purchasers of claims against a debtor. These include (i) the risk that the claims held by an innocent third party purchaser will be subordinated under Section 510(c) of the Bankruptcy Code (the 'Code') and (ii) the risk that such claims will be disallowed under Section 502(d) of the Code. In both situations, the risks are present even if the alleged wrongdoing giving rise to the subordination, or the avoidance proceedings resulting in the disallowance, is unrelated to the transferred claim or the transferee.

In the first decision (the '510(c) Decision'), the Bankruptcy Court held that a claim in the hands of an innocent purchaser may be subordinated on account of the transferor's misconduct. *In re Enron Corp*., 333 B.R. 205, 331 (Bankr. S.D.N.Y. 2005). The second decision held that a claim that has been purchased by an innocent third party after commencement of the bankruptcy case may be disallowed under Section 502(d) of the Code to the same extent that such claim could have been disallowed under Section 502(d) had it remained in the hands of the seller. *In re Enron Corp*. 340 B.R. 180 (Bankr. S.D.N.Y. 2006) (the '502(d) Opinion').

This article will focus on the second decision. In the 502(d) Opinion, Judge Arthur J. Gonzalez held that a transferred bankruptcy claim is subject to disallowance if, prior to the transfer of the claim, the seller received an avoidable transfer (i.e., a preference or a fraudulent conveyance) or held property that the debtor could recover pursuant to its statutory avoidance powers. The claim could be disallowed, the Bankruptcy Court found, even if (i) the avoidable transfer or recoverable property in question is entirely unrelated to the transferred claim, (ii) the purchaser did not itself receive an avoidable transfer or any recoverable property or otherwise engage in misconduct, and (iii) the purchaser is a 'good faith' purchaser, under Section 550(b) of the Code, without actual knowledge of the potential challenge to the seller's claim. In short, the Bankruptcy Court's decision extends the reach of Section 502(d) far beyond its traditional target – culpable creditors, who have themselves received an avoidable transfer or hold recoverable property – to innocent purchasers of claims. And, in a footnote, the Bankruptcy Court went so far as to suggest that the same result would apply even to purchasers of publicly traded debt. Participants in the bankruptcy claims market – particularly buyers of bond debt – must pay careful attention to this new counterparty risk.

**Factual background**

The basic facts underpinning the Bankruptcy Court's ruling are simple. Prior to the commencement of its bankruptcy proceedings (the 'Petition Date'), Enron was party to a $1.25bn long term revolving credit facility and a $1.75bn short term revolving credit facility (collectively, the 'Loans') with a number of banks. After the Petition Date, one of those banks – Fleet National Bank ('Fleet') – sold its claims under the Loans (the 'Claims') to various parties. The Claims ultimately came to rest in the hands of the defendants (the 'Defendants') named in the adversary proceeding (the 'Adversary Proceeding') that is the subject of the 502(d) Opinion.

On 23 September 2003, Enron commenced an adversary proceeding (the 'MegaClaim Action') against various banks and other defendants alleging, among other things, that their claims should be equitably subordinated or disallowed because they engaged in inequitable conduct and/or received avoidable transfers. Fleet was originally not even named as a defendant in the MegaClaim Action. It was only in the fourth amended complaint, filed on 10 January 2005, that Enron alleged that Fleet received avoidable transfers in connection with two series of prepaid forward transactions (the 'Forward Transactions'), which transactions were entirely unrelated to the Loans.

Importantly, there were no allegations in the MegaClaim Action that there was any 'fraudulent or unlawful conduct' with respect to the Loans, that any payments made with respect to the Loans constituted avoidable transfers, or that the Defendants had themselves received any avoidable transfers or had otherwise engaged in any misconduct. Nevertheless, on 12 January 2005, Enron commenced the Adversary Proceeding (separate and apart from the MegaClaim Action) against the Defendants seeking, *inter alia,* the disallowance of the Claims pursuant to Code Section 502(d) on the ground that Fleet had received avoidable transfers in connection with the Forward Transactions – transactions that were, as noted above, entirely unrelated to the Loans and the Claims.

Code Section 502(d) provides that: "[t]he court shall disallow any claim *of any entity from which property is recoverable* under section 542, 543, 550 or 553 of this title *or that is a transferee of a transfer avoidable* under section 522(f), 522(h), 544, 545, 547, 548, 549 or 724(a) of this title unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable under section 522(i), 542, 543, 550 or 553 of this title." (emphasis added.)

In their motion to dismiss, the Defendants argued that because they were not (i) an "entity from which property is recoverable" or (ii) a "transferee of a transfer avoidable" under the respective enumerated sections of the Code, Section 502(d) was plainly inapplicable to the Claims in their hands.

The *Enron* Court, citing Judge Robert D. Drain's decision in *In re Metiom* ("the claim

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and the defense to the claim under section 502(d) cannot be altered by the claimant's subsequent assignment of the claim", 310 B.R. 634, 637 (Bankr. S.D.N.Y. 2003)), rejected the Defendants' interpretation of the statute. Instead, the Bankruptcy Court held that the 'identity of the holder of a claim' is irrelevant, and, as a result, if the claims were subject to disallowance under Section 502(d) in the hands of Fleet, they would be equally subject to disallowance under Section 502(d) in the hands of the Defendants (who, as noted above, were not alleged to be anything other than innocent transferees). In addition, the Bankruptcy Court in *Enron* made clear that the fact that the claim is 'disallowable' even if not finally disallowed, is sufficient under Section 502(d) to prevent the transferee from receiving a distribution, pending the adjudication of the underlying avoidance action against the transferor.

**The impact of the 502(d) opinion**

As a result of the Bankruptcy Court's decisions, prospective purchasers of bankruptcy claims must be ever more vigilant in protecting their interests. That means, for example, conducting more in-depth due diligence with respect to the dealings between the seller (and, if necessary, prior holders of the claim) and the debtor (in order to identify any possible bases for the debtor to challenge the allowance of the claim), and discounting offer prices accordingly.

Unfortunately, the cost of such an investigation may be prohibitive if the claim-transferor has had extensive dealings with the debtor – which is quite common in the case of loan claims originating with large financial institutions (such as the ones at issue in the Adversary Proceeding). This limitation can be illustrated by the experience of traders in the bankruptcy proceedings of Refco Inc., *et al*. ('Refco'), in which the secondary market for claims that had been held at one time by one of Refco's lenders reportedly came to a virtual standstill after rumors of misconduct on the part of the lender began to circulate.[1] As this example demonstrates, even sophisticated parties may have difficulty quantifying counterparty risk with the precision necessary to accurately price potentially tainted debt.

Refco also suggests that prior to purchasing a debtor's publicly traded debt, traders should carefully scrutinise any payments made by the debtor on account of that debt during the 90 day period preceding the bankruptcy filing (the 'Preference Period'). In Refco, the bondholders received a substantial redemption payment during the Preference Period. As the Refco disclosure statement highlights, the debtors and other parties-in-interest asserted, among many other theories, that the claims of the then-current holders of the bonds, most of whom likely purchased their bonds during the pendency of the bankruptcy case and did not receive any portion of the redemption payment, should be disallowed pursuant to Section 502(d) of the Code based on, among other things, Judge Gonzalez's holding in the 502(d) Opinion. While the Refco plan contemplates a settlement of all claims that may have been asserted against the bondholders, the 502(d) Opinion may have factored into the bondholders' ultimate recovery in Refco.

Purchasers of claims in bankruptcy should also consider negotiating even stronger indemnity rights, and fact-specific representations, in the relevant transfer documents. The *Enron* Bankruptcy Court noted in the 502(d) Opinion that the claims trading industry has already "promulgated standardized provisions relating to transferred rights, assumed obligations, and buyer's rights and remedies." Of course, even apart from the collection costs involved, indemnity rights are only valuable if the indemnitor is solvent and capable of making the indemnitee whole if called upon to do so. So, prospective purchasers must also now consider how to investigate the financial status and potential liabilities of any counterparty.

Moreover, certain categories of debt, such as publicly issued bonds, are traded anonymously. As a result, purchasers of these types of claims will not have the opportunity to negotiate for and obtain indemnities. Seen in this light, it is particularly troubling that the Bankruptcy Court saw 'no legal or policy basis' to treat this category of debt any differently than the transferred loan claims at issue in the Adversary Proceeding. Rather, the Bankruptcy Court indicated its belief that market pricing is the appropriate mechanism to account for counterparty risk. However, as discussed above in connection with the Refco proceedings, even sophisticated parties may lack the ability to account fully for counterparty risk and price potentially tainted debt with any degree of confidence. And, courts have long held that transfers of publicly-traded securities are regulated independently of the Code.

Finally, purchasers of publicly traded debt may also be able to rely on the protections afforded by Section 546(e) of the Code to 'settlement payments'. However, as other decisions in the *Enron* case have demonstrated, that protection may only be available to payments "commonly used in the securities trade". Compare, for example, *In re Enron Corp*., 325 B.R. 671 (Bankr. S.D.N.Y.), holding that a trial would be necessary to determine whether certain prepayments of commercial paper constituted 'settlement payments', with *In re Enron Corp*., 341 B.R. 451 (Bankr. S.D.N.Y. 2006), dismissing a fraudulent conveyance challenge, based on the Section 546(e) 'safe harbor' provision, where Enron executed market purchases of certain notes issued by a related trust.

In any event, a district court recently agreed to consider the appeals of several related *Enron* decisions, including the Defendants' interlocutory appeals of the Bankruptcy Court's 502(d) Opinion and 510(c) Decision. In so doing, the district court cited a "substantial ground for a difference of opinion on a difficult issue of first impression in this circuit." As the quoted language indicates, the Bankruptcy Court's 502(d) Opinion may well be reversed or limited on appeal. Nevertheless, in light of the risks identified above, pending the outcome of the appellate process and the development of subsequent case law interpreting and clarifying the scope of the 502(d) Opinion, prospective purchasers would be well advised to carefully consider counterparty risk and to consult with counsel before entering into significant transactions in the bankruptcy claims market. ■

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