

## Revisiting Limitations on Claims Trading: Enron Decision May Permit the “Washing” of Tainted Claims in Bankruptcy Cases

A recent appellate decision by the United States District Court for the Southern District of New York, addressing a decision in the Enron bankruptcy case, may have significant implications for all creditors, particularly parties to claims transfers. If the decision is followed, creditors could see a reduction in recoveries on their claims because transferred claims formerly subject to challenge may be allowed, thereby increasing the overall amount of claims against the estate. Lenders may no longer be deterred from taking aggressive positions with distressed companies because of the ability to “wash” their claims in bankruptcy by transferring them to a third party. Parties to claims transfers may be insulated from liability against challenges to transferred claims based on the transferor’s conduct, and should carefully consider structuring transfers to take advantage of the potential protections afforded by the decision.

Prior to the filing of the Enron bankruptcy case, Enron borrowed \$1.7 billion under a short-term credit agreement extended by a syndicate of banks. After the filing, certain of the banks, including Citibank, N.A., transferred claims to other entities, including a \$5 million claim transferred to Springfield Associates, L.L.C. Enron sued Springfield to disallow the claim under

Bankruptcy Code section 502(d) on the grounds that Citibank was the recipient of avoidable transfers and, in the alternative, to equitably subordinate the claim under Bankruptcy Code section 510(c) because Citibank had engaged in misconduct. Springfield moved to dismiss the action on the grounds that the Bankruptcy Code does not permit disallowance or equitable subordination of a claim based on the transferor’s conduct.

The bankruptcy court denied Springfield’s motion and held the claim could be challenged based solely on Citibank’s conduct. Springfield appealed to the district court, which vacated the decision and remanded the case to the bankruptcy court.

In vacating the decision, the district court rejected Enron’s argument that limiting the ability to challenge transferred claims based on the transferor’s conduct will incentivize “tainted” creditors to transfer their claims to avoid liability. The district court concluded that conduct giving rise to disallowance and equitable subordination attaches to the claimant and not the claim. When a claim is *sold* to a bona fide purchaser, the claim may be transferred free of any limitation to the claim in the hands of the seller caused by the seller’s conduct. When the claim is *assigned*, the assignee steps into the

shoes of the assignor and any such limitation is inherited by the assignee, unless the assignee is a holder in due course or the doctrine of latent equities applies. Other than to imply that the transferee's ability to negotiate indemnity rights from the transferor may be indicative of an assignment, the district court offers no further insight into the factors that could render a particular claim transfer a sale or an assignment.

If followed, the district court's holding could have far reaching implications. The decision may impact all creditors because it could result in more allowed claims against the estate, thereby diluting overall creditor recoveries. Lenders may govern their actions with distressed debtors immune from the prospect that their claims will be challenged under Bankruptcy Code sections 502(d) and 510(c). Parties to claims transfers will likely attempt to structure their transactions to reduce the likelihood that their claims will be challenged based on the transferor's conduct. If such efforts are successful, the decision has the potential to significantly expand the secondary market for bankruptcy claims.

**For more information please contact:**

**James S. Carr**  
(212) 808-7955  
jcarr@kelleydrye.com

**Eric R. Wilson**  
(212) 808-5087  
ewilson@kelleydrye.com

**Craig A. Wolfe**  
(212) 808-5073  
cwolfe@kelleydrye.com