DISTRICT COURT VACATES BANKRUPTCY COURT'S ENRON DECISIONS REGARDING EQUITABLE SUBORDINATION AND DISALLOWANCE

In a recent opinion in the *Enron* chapter 11 cases, Judge Shira A. Scheindlin of the United States District Court for the Southern District of New York (the Court) delivered a significant ruling (i) vacating the Bankruptcy Court's decision which confirmed a debtor's ability to pursue equitable subordination under section 510(c) of title 11 of the United States Code (the Bankruptcy Code) and claim disallowance under section 502(d) against claims held by claims transferees and (ii) remanding the matter to the Bankruptcy Court for further proceedings consistent with the Court's opinion.

The question presented before the Court on appeal from the Bankruptcy Court decisions was whether equitable subordination under section 510(c) of the Bankruptcy Code and disallowance under 502(d) can be applied, as a matter of law, to claims held by a transferee to the same extent that they would be applied to the claims if they were still held by the transferor based on alleged acts or omissions on the part of the transferor. As a threshold issue, the Court analyzed whether equitable subordination under section 510(c) of the Bankruptcy Code and disallowance under section 502(d) are constituent elements of a claim itself or personal disabilities of particular claimants. In connection with equitable subordination, the Court determined that the legislative history demonstrates (*i.e.*, there are various references to the requirement of misconduct on the part of the "holder" of the claim) and case law supports (*i.e.*, courts, including the Second Circuit, consistently have focused on the claimant, rather than the claim, for purposes of applying equitable subordination) the view that Congress intended for equitable subordination under section 510(c) to create a personal disability for the person who acted inequitably and not to be an attribute of the claim of the transferring creditor. Congress did not intend that section 510(c) be applied to a transferee of a claim – who has not acted inequitably – merely because that claim was transferred, directly or indirectly, by a bad actor.

Regarding disallowance, the Court considered the plain language of section 502(d) of the Bankruptcy Code and found that the statute focuses on the claimant as opposed to the claim, thereby leading to the inexorable conclusion that disallowance is a personal disability of a claimant, not an attribute of the claim. This result comports with one of the main purposes of section 502(d) – that is, to coerce the return of assets obtained by a preferential transfer. Indeed, section 502(d) was not intended to punish, but rather to give creditors an option to keep their transfers (and hope for no action by the trustee) or to surrender their transfers and their advantages and share equally with other similarly situated creditors. As such, the Court found that applying section 502(d) to purchasers of claims would be punitive because they have no option to surrender something they do not have, which means they have not personally obtained an advantage that they could surrender.

Further, the Court analyzed the distinction between a transfer being made as an assignment or as a sale. The Court explained that, in the case of an assignment, an assignee stands in the shoes of the assignor and, thus, remains subject to all of the equities against the assignor – *i.e.*, an assignee of a claim takes with it whatever limitations the claim had in the hands of the assignor.

By contrast, a purchaser does not stand in the shoes of the seller and, as a result, purchasers are protected from being subject to the personal disabilities of their sellers. The Court further explained that this distinction is particularly imperative in the distressed debt market context, where sellers are often anonymous and purchasers have no way of ascertaining whether the seller (or a transferee up the line) has acted inequitably or received a preference. Parties to true assignments, however, can contract around the risk of equitable subordination or disallowance by entering into indemnity agreements to protect the assignee. In the instant matter, the Court found that the Bankruptcy Court expressly extended its holding to all transferees of bankruptcy claims and, by doing so, it ignored the critical distinction between assignments and sales and failed improperly to address whether equitable subordination and disallowance travel with the claim or are personal disabilities.

Based on the foregoing, the Court held that (i) equitable subordination under section 510(c) of the Bankruptcy Code and disallowance under section 502(d) are not attributes of a claim but are personal disabilities of individual claimants and, therefore, (ii) whether equitable subordination and disallowance can be applied to a transferee depends on the nature of the transfer. Although characteristics that inhere in a claim may travel with the claim regardless of the mode of transfer, the same cannot be said for personal disabilities of claimants. A personal disability that has attached to a creditor who transfers its claim will travel to the transferee if the claim is <u>assigned</u>, but will not travel to the transferee if the claim is <u>sold</u> (though there are certain exceptions in each instance). The Court found that the Bankruptcy Court did not address this issue and, thus, it remanded the matter to the Bankruptcy Court with instructions to determine whether the claims transferred to the appellants were transferred by way of sale or pure assignment.

While the decision provides useful guidance in structuring transactions in the distressed debt market context, it does not clearly amplify the factors which would help distinguish between sales and assignments of claims and further judicial experience will be needed to provide practitioners with greater certainty.

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