

**UPDATE**

August 29, 2007

Enron Swings and Misses: Bankruptcy Court's Decision on Equitable Subordination of Transferred Claims Is Struck Out by the District Court

The First Inning

In the Enron Chapter 11 case, the Southern District of New York Bankruptcy Court ruled last year that, under certain circumstances, the sins of a seller of a claim can be imputed to the buyer of the claim through equitable subordination of the claim in the buyer's hands. Earlier this week, the District Court reversed and remanded. Both the Bankruptcy Court's decision and the District Court's reversal are relatively narrow and the final innings in this game have yet to be played. Nevertheless, regardless of what tomorrow may bring, there are grounds for Joy in Debtville tonight.

The facts, in the smallest of ballparks, are that several distressed debt funds purchased various Citibank claims against Enron in open market transactions. Enron took a swing at the purchasers by seeking to subordinate their claims on the basis of Citibank's alleged misconduct. The debt purchasers moved to strike out the complaint on the basis that, as innocent claim purchasers, they should not be hit with the foul ball of any alleged Citibank misconduct. However, the Bankruptcy Court ruled the ball fair, holding, in essence, that "once a tainted claim, always a tainted claim," and therefore the claim would remain subject to equitable subordination even when sold to a third party. The purchasers dug in their heels and appealed the umpire's decision. Upon further review, the District Court reversed the umpire and sent Enron back to the dugout.

The Umpire Is Overruled

Specifically, District Court Judge Scheindlin held that equitable subordination is a "personal disability" of the claim seller that is not inherent in the claim (she also addressed the requested remedy of "disallowance" on the same basis). Therefore, one needs to examine the nature of the claim transfer in order to determine whether the relief pitcher could be saddled with the starting pitcher's poor performance. She held that, if the buyer acquired the claim by way of "assignment," the buyer effectively stands in the shoes of the seller and inherits the same strike count. If, however, the transaction involved a true "sale" of the claim, then the buyer can step up to the plate and swing away without regard to any claims assertable against the seller. In Judge Scheindlin's words, "a personal liability that has attached to a creditor who transfers its claim will travel to the transferee if the claim is assigned, but will not travel to the transferee of the claim if sold."

The Seventh Inning Stretch

It is important to note that Judge Scheindlin did not actually call the purchasers safe at second base. Instead, she remanded the matter to the Bankruptcy Court to make the determination of whether the transfer in question was an assignment or a sale. In fact, the Enron Creditors Recovery Corp. issued a press release declaring the result a "victory" for Enron on the basis that they "were confident that the Bankruptcy Court will determine the key claim transfers to be assignments...fully subject to equitable subordination." Regardless of the results of this particular remand, however, Judge Scheindlin did toss the market a big fat softball by observing that "sales of claims on the open markets are indisputably sales." Thus, the purchasers have hit a come-from-behind homerun, but this is still only the seventh inning stretch.

Bottom of the Ninth

One must presume that, unless the game is called on account of rain (or settlement), the Enron decision will proceed to the bottom of the ninth inning for consideration by the Second Circuit Court of Appeals (or could even go into extra innings in the Supreme Court). Further, even if the District Court's decision is affirmed (or not appealed), one can envision future ballgames in which the teams continue to argue with the umpire as to whether the particular

transfer in dispute involved is an "assignment" or a "sale." However, regardless of whether distressed debt purchasers or debtors ultimately win the World Series, the purchasers can rejoice in taking the league pennant.

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