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Can the Enron Claims Trading Issues Be Avoided?

Should You Consider Acquiring a Distribution Right?

By Andrew H. Sherman

Claims trading has become a part of the bankruptcy fabric as a short-term investment vehicle and a long-term opportunity with the intention of obtaining a strategic position in the confirmation process. It is now clear that the acquisition of a claim carries certain baggage, including the opportunity to be sued for actions that relate to the claim or other types of avoidance actions which can significantly delay the distribution on the claim. The baggage associated with a transferred claim has been articulated by Bankruptcy Judge Arthur Gonzalez in the *Enron* cases, where he held that a transferee's claim against a bankrupt's estate can be subordinated or disallowed solely because of the transferor's misconduct or failure to return avoidable transfers even when there is no finding of wrongdoing or receipt of avoidable transfers by the transferee. *Enron Corp. v. Avenue Special Situations Fund, II, LP (In re Enron Corp.)*, 340 B.R. 180 (Bankr. S.D.N.Y. 2006); *In re Enron Corp.*, 333 B.R. 205 (Bankr. S.D.N.Y. 2005). Under these rulings, a purchaser of a claim is subject to later attack and subordination of the claim, regardless of whether that transferee had any knowledge of the transferor's inequitable conduct or purchased the claim in good faith for value.

However, an investor may not need all the rights associated with the claim and simply wants to purchase the income stream from the claim without the other rights associated with the claim. Further, an investor may have concerns due to the greater uncertainty in the claims trading industry because of the *Enron* decisions. In these instances, an investor should consider acquiring a distribution right – the right to receive the distribution on the claim — nothing more and nothing less.

Andrew H. Sherman is a Member of the Creditors' Rights/Bankruptcy Reorganization Practice Group at Sills Cummis Epstein & Gross P.C. He may be reached at asherman@sillscummis.com or 973-643-6982. The views and opinions expressed in this article are those of the author and do not necessarily reflect those of Sills Cummis Epstein & Gross P.C.

The Enron Decisions and Impact on Claims Trading

On Sept. 24, 2003, Enron filed an adversary against various large institutional creditors alleging that such entities received certain preferences and fraudulent conveyances and that they aided and abetted Enron's accounting fraud injured Enron's creditors. Enron sought the recovery of the allegedly improper transfers to the transferees and equitable subordination of the banks' claims under credit agreements based on allegations of inequitable conduct. The lawsuit implicated the rights of claims purchasers because Enron sought to subordinate or disallow the claims that were acquired by the transferees based on the conduct of the claims transferors.

The claims purchasers moved to dismiss the complaints alleging, in part, that since the claims purchasers purchased the claims in good faith without any knowledge of misconduct, the claims purchasers should not be held liable for the predecessors' actions. The specific issues presented were whether the bank-loan claims, which were transferred by the original holder of the claims to innocent third parties, would be subject to subordination under § 510(c) of the Bankruptcy Code or disallowance pursuant to § 502(d) of the Bankruptcy Code.

The bankruptcy court ruled against the claim purchasers and denied the motions to dismiss. The court found that equitable subordination is not limited to only those claims related to the inequitable conduct that caused the injury to the creditor class. Instead, equitable subordination can apply to claims unrelated to any inequitable conduct held by the claimant alleged to have engaged in that conduct, limited by the amount of damages stemming from the inequitable conduct that is not otherwise compensated to that class. Consequently, the court concluded that the transfer of a claim subject to equitable subordination does not free such claim from subordination in the hands of a transferee. A claim in the hands of a transferee, either as an initial transferee or a subsequent transferee, who received that claim from a transferor found to have engaged in inequitable conduct is subject to the same equitable relief as if such claim were still held by the transferor. The remedy of equitable subordination remains with the claim and a claim in the hands of a transferee is not immunized from subordination even though such transferee may have paid value for such claim and not have engaged in any conduct that would otherwise subject the transferee to the remedy of equitable subordination.

Subsequent to the decision on equitable subordination, the Bankruptcy Court issued another opinion to address whether a claim which was transferred can be disallowed pursuant to § 502(d) of the Bankruptcy Code due to the possibility of avoidance actions against the party that filed the claim. Once again, the Bankruptcy Court denied a motion to dismiss the § 502(d) cause of action based on the principle that a transferred claim is subject to all defenses to which it was subject in the hands of the original holder of the obligation. The bankruptcy court further ruled that the good faith protections provided for by § 550(b) of the Bankruptcy Code can apply to claims transferees only in certain limited circumstances. That is, a claims transferee can rely on § 550(b) if it does not have either: 1) knowledge of the debtor's possible insolvency or unfavorable financial condition at the time of the transfer or 2) notice that the transfer may be recovered by the trustee. Applying these criteria to the facts of the motion to dismiss, the bankruptcy court concluded that the defendants clearly were not "without knowledge of the voidability of the transfer" as required by § 550(b). As a result, the bankruptcy court denied the defendants' motion to dismiss Enron's causes of action under § 502(d) of the Bankruptcy Code.

The Enron decisions are currently under appeal and the District Court recently determined that it would consider an interlocutory appeal on these issues. *Enron Corp. v. Springfield Assocs., L.L.C. (In re Enron Corp.)*, 2006 U.S. Dist. LEXIS 63223 (S.D.N.Y. 2006). As a result of the Enron decisions, there is certainly greater uncertainty in the claims trading markets. Claims purchasers should be conducting further diligence into the claims that are being purchased as well as the credit of the claims transferor. Since many agreements for claims trading contain representation and warranties as well as indemnification provisions, purchasers of claims should conduct additional diligence into the creditworthiness of the indemnifying party in case those provisions are necessary. Also, the scope of the indemnification language in the agreement should be sufficiently broad to cover all contingencies if there is a claim objection or avoidance action.

An Alternative to Claims Trading

At its core, a bankruptcy claim is nothing more or less than an enforceable obligation entitling the party to a right to payment from the debtor. The bankruptcy claim includes certain rights to the holder of the claim and is best viewed as a bundle of rights. For example, a holder of a claim has the right to be heard in a bankruptcy case and, generally, has the right to vote in favor of or in opposition to a plan of reorganization. The holder of a bankruptcy claim may also hold a right of setoff and counterclaim against a debtor as a result of the claim. These rights, in and of themselves, have certain value for parties in a bankruptcy case. As a result of this bundle of rights, a bankruptcy claim can be a powerful and strategic tool.

These powerful rights and benefits of the holder of a claim in bankruptcy are usually not important to an investor who only wants the economic component of the claim. Through a distribution rights transaction, the bundle of rights associated with a claim is parsed into various components. The economic component of the claim — the distribution to be paid by the bankruptcy debtor to its creditors — is usually the discrete right which a claims investor seeks to acquire and may be able to be severed from the claim itself. Because this individual right can be separately identified, there may be a means for an investor to only purchase the right to receive the distribution (the distribution right) while leaving the balance of rights associated with the claim with the holder of the original claim. For example, bankruptcy courts have allowed parties to sever certain rights and separately trade those rights in various instances including designation rights. In a designation rights transaction, bankruptcy courts have allowed a debtor to realize the economic value of leases by selling the rights to assume or reject such leases. *See In re Ames Dep't Stores*, 287 B.R. 112, 114 (Bankr. S.D.N.Y. 2002). Similar to the designation rights concept, a distribution right is severed from the actual claim allowing a party to sell the value of the claim, separate and apart from the underlying claim.

A distribution rights transaction could avoid the consequences under the *Enron* examples described above because the holder of the original claim must still defend the claim and face the consequences of an any possible avoidance actions, and the acquirer of a distribution right never faces those issues. Therefore, the indemnification risks are diminished. Once cash, stock or other consideration is ready to be distributed to the holder of the claim, the holder of the claim has contracted with the purchaser of the distribution right to transfer those assets for a fixed sum.

One distinct advantage of a distribution rights transaction is the ability to separate a claim such that the claim can be allowed in one amount for distribution purposes and allowed in another amount for all other purposes. This concept can protect a creditor and preserve full rights of setoff, while limiting the distribution to the amount recognized by the debtor.

Can It Work?

Distributions rights have been sold in a least one bankruptcy case, but such transactions are not commonplace and have yet to face judicial scrutiny. In a distribution rights transaction, the investor enters into a contract with the holder of the claim whereby the investor will pay a fixed sum for the right to receive the distribution due to the creditor. The consideration for the purchase or a portion of the consideration can be paid at the time of the contract with the balance to be paid upon the occurrence of the distribution by the debtor. Obviously, these terms can vary on a transaction-by-transaction basis.

Because there is no current market for distribution rights, it is unclear whether a distribution right will trade (or should trade) above or below the price of a claim. Since a distribution right does not transfer an entire claim, there is a strong argument that a distribution right should trade at a price less than a full claim. The discount, if any, may be small because the purchaser of a claim or distribution right is primarily seeking the economic component of the claim. Obviously, the market should (and will) set the price of a distribution right.

A transfer of a distribution right is not a panacea for all claims trading issues. The sale of a distribution right is not provided for in the Bankruptcy Code and has not been tested by the courts. Consequently, it is a novel type of transaction that faces some risk. There may be risk due to the lack of notice for these transactions. Unlike a claims transfer that requires notice and an opportunity to object, there is no such scrutiny for a sale of a distribution right. Further, since there is not an open market for distribution rights, there may be some tension in how to value the transactions. In some instances there may be a premium paid over the price of a claim while in others there may be a discount to the price of a claim. Another possible concern is the lack of control over any litigation relating to the claim, but that issue can be addressed through drafting.

Conclusion

The sale of a distribution right is simply another type of transaction that can be considered or discussed as a means to transfer a right to payment in a bankruptcy case. Although the transaction is not a silver bullet, it does address and/or simplify the claims sale process and provides another strategy that can be considered.