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Enron and the Bravado Sheriff of Claims Trading¹

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In the Wild West, cowboys operated under their own code of lawlessness, or at least John Wayne and Clint Eastwood would have had us believe as much. Yet even in these classic Westerns, a few bravado sheriffs or deputies usually sought to impose law and order in an otherwise unruly town. As in the Wild West, the bankruptcy claims trading market is likewise not without its sheriffs. The article "Claims Trading: The Wild West of Chapter 11s," published in the July/August 2010 issue of the *Journal*, addressed four elements of claims trading: (1) historical background, (2) lack of meaningful regulation, (3) role of claims trading in modern reorganizations and (4) future of claims trading.²



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The authors' discussion of the second topic, the absence of regulation, largely focused on Hon. **Arthur J. Gonzalez's** decisions relevant to the claims-trading market during the case of *In re Enron Corp.*³ and its related adversary cases. As implied by the Wild West metaphor, the bankruptcy court in the Southern District of New York assumed the "bravado sheriff" role during the *Enron* cases, attempting to draw upon various sections of the Bankruptcy Code to impose order in this largely unregulated industry. This article

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further evaluates the Enron bankruptcy and its related adversary cases as they pertain to bankruptcy claims trading.

The Claims

Obtaining financing in 2001 was assuredly a less cumbersome ordeal than in today's tumultuous capital markets. Prior to filing for bankruptcy, several financial institutions agreed to "extend [Enron] multibillion-dollar credit facilities. In May 2001, Enron entered into two loans, a \$1.75 billion Long-Term Credit

The Claim Is Tainted



Michael A. Brandess

In 2003, Enron filed adversary complaints against its pre-bankruptcy lenders, alleging that these financial institutions had engaged in inequitable conduct during the execution of the pre-bankruptcy loans.⁸ Due to the breadth of these complaints,⁹ the resulting adversary cases became known as the "MegaClaim Litigation."¹⁰ Specifically, Enron blamed the pre-bankruptcy lenders for "the stunning downfall of what was once the seventh largest corporation in the United States. These banks and investment banks...participated with a small group of senior officers and man-

Financial Statements

Agreement and a \$1.25 billion Short-Term Credit Agreement."⁴ Unfortunately, these financing agreements would eventually cause more problems than they would solve. On Dec. 2, 2001, Enron Corp. filed for chapter 11 protection in the Southern District of New York.⁵ As Gordon Gecko proclaimed in *Wall Street*, "Money itself isn't lost or made, it's simply transferred from one perception to another."⁶ In Enron's case, debts became claims, and claims became tradable commodities. During the next two years, hedge funds purchased many Enron bankruptcy claims "with a par value of \$47.25 million" from Enron's pre-bankruptcy lenders.⁷

gers of Enron...in a multi-year scheme to manipulate and misstate Enron's financial condition."¹¹ Accordingly, Enron claimed that the defendant-banks' claims were tainted by their improprieties. The principal misconduct surrounded a financing mechanism used by Enron, referred to as a "prepay." A prepay would typically suggest that Enron received cash up front for services to be rendered later; however, these "prepays" were in fact disguised loans "to Enron using a bank and an obligation on Enron's part to repay the principal plus interest."¹²

¹ See Aaron L. Hammer and Michael A. Brandess, "Claims Trading: The Wild West of Chapter 11s," 29 *Am. Bankr. Inst. J.*, July/August 2010, at 1, 62-64.

² See *supra* n.1, at 1.

³ See Debtors' Petition, *In re Enron Corp.*, No. 01-16034-ajg (Bankr. S.D.N.Y. Dec. 12, 2001), ECF No. 1.

⁴ Adam J. Levitin, "The Limits of Enron: Counterparty Risk in Bankruptcy Claims Trading," *Norton J. of Bankr. L. and Practice*, vol. 15, p. 391 (2006) (citing *In re Enron Corp.*, 333 B.R. 205, 211 (Bankr. S.D.N.Y. 2005)).

⁵ See *supra*, n.4.

⁶ *Wall Street* (1987) (The character, Gordon Gecko, was portrayed by actor Michael Douglas).

⁷ Levitin, *supra*, n.5, at 391.

⁸ *Enron Corp. v. Ave. Special Situations Fund II LP (In re Enron Corp.)*, 333 B.R. 205, 210 (Bankr. S.D.N.Y. 2005).

⁹ Debtor's Adversary Complaint, *Enron Corp. v. Citigroup Inc. (In re Enron Corp.)*, No. 03-09266 (Bankr. S.D.N.Y. Sept. 24, 2003), ECF No. 1.

¹⁰ Brief of Debtor in Support of Finding of Facts and Conclusions of Law with Respect to Confirmation of Debtor's Fifth Amended Joint Chapter 11 Plan, *In re Enron Corp.*, No. 01-16034, (Bankr. S.D.N.Y. June 23, 2004), ECF No. 19307.

¹¹ See *supra*, n.9, at ¶11.

¹² Testimony of Robert Roach, chief investigator, Permanent Subcommittee on Investigations, "The Role of the Financial Institutions in Enron's Collapse," July 23, 2002, <http://hsgac.senate.gov/072302roach.pdf>.

Among the institutions cited by Enron was Citigroup, which had executed 14 “prepay” transactions prior to Enron’s bankruptcy worth approximately \$2.5 billion by the petition date.¹³ The transactions between Citigroup and Enron “were financed through bond offerings. ‘Yosemite’ was the name of a series six synthetic Enron bond offering used to raise [approximately] \$2.4 billion. All of these bonds...remained outstanding at the time of the Enron bankruptcy.”¹⁴ In a decision read to the court on May 24, 2004, Judge Gonzalez denied Yosemite’s motion for temporary allowance of its claims for voting purposes, “holding that under section 502(d)...the claims are subject to disallowance because of the alleged preference received by the transferor of the claims, even though the claimants did not own the claims at the time of the alleged preference and did not receive any benefit from it.”¹⁵ The court specifically stated that Yosemite “took the Disputed Claims subject to the Debtors’ section 502(d) objections (5/24/04 Hearing Tr. at 24). Yosemite... had the burden of proof to present sufficient evidence that they have colorable claims capable of temporary allowance. (5/24/04 Hearing Tr. at 27)...[Yosemite] provided no argument in defense of the claims in the MegaClaim Litigation against Citibank that would undermine the basis for the section 502(d) objection. (5/24/04 Hearing Tr. at 27).”¹⁶

The Taint Follows the Claim

In rendering the *Yosemite* decision, Judge Gonzalez tipped his hand to all parties in interest that he could disallow tainted claims using § 502(d). Because the defendant-banks had transferred many of their claims, Judge Gonzalez was tasked with deciding whether “the bank-loan claims, which were transferred by the original holder of the claims who is alleged to have engaged in certain inequitable conduct, would be subject to subordination under section 510(c)...in the hands of a transferee.”¹⁷ In January 2005, two years after fil-

ing its complaints against the original claimholders, Enron filed adversary proceedings against the transferees, asserting two causes of action: “(1) equitable subordination of the transferee’s claims under section 510(c) based solely on the alleged misconduct of the transferor; and (2) disallowance of the transferee’s claims under section 502(d) based solely on the allegation that a transferor received and failed to repay an avoidable transfer.”¹⁸

Although the Enron district court decision was unequivocally the most significant case for claims traders in recent years, the holding merely reinstated the status quo in the claims-trading market. The district court’s decision minimized the impact of the bankruptcy court’s attempted regulation of the claims-trading market, and in effect nullified a decision that would have severely chilled a booming industry.

In a decision rendered by the court on Nov. 17, 2005, in *Enron Corp. v. Avenue Special Situations Fund II (In re Enron)*, Judge Gonzalez addressed three issues pertinent to the case: “(1) whether a claim could be equitably subordinated on account of inequitable behavior unconnected to the claim; (2) whether a claim that could be equitably subordinated in the hands of the inequitable party could be subordinated in the hands of a transferee; and (3) whether a good faith purchaser defense is available for a transferee of a bankruptcy claim.”¹⁹ The court ruled against the transferees on all three issues, indicating that when a claim is tainted by the inequitable conduct of its original holder, the taint will follow the claim to its subsequent holders.²⁰

¹⁸ See *Enron Corp. v. Springfield Assoc. LLC. (In re Enron)*, 379 B.R. 425, 429 (The citation in footnote 21 of “Claims Trading, the Wild West of Chapter 11s” required a correction. In the article, the citation included for this case was “279 B.R. 425, 436 (S.D.N.Y. 2007).” The correct citation was actually “*Enron Corp. v. Springfield Assoc. LLC (In re Enron Corp.)*, 379 B.R. 425, 436 (S.D.N.Y. 2007).” The authors apologize for any inconvenience this may have caused).

¹⁹ Levitin, *supra*, n.5, p. 392; citing 333 B.R. at 210.

²⁰ See *In re Enron*, 333 B.R. at 237.

The Taint Follows the Claim... Only if the Claim Is Assigned

Eleven days later, Judge Gonzalez again held in Enron’s favor in a parallel adversary case pertaining to the same issues.²¹ However, the defendants, Springfield Associates LLC, moved to file an interlocutory appeal of the bankruptcy court’s decision to subordinate their claims.²² On Aug. 27, 2007, almost two years after the bankruptcy court rendered its initial decision on the matter, the district court overturned the lower court’s holding.²³ In its written opinion, the district court concluded that the transferee of bankruptcy claims tainted by the conduct of the original holder “may be subject to equitable subordination and disallowance based solely on the conduct of the transferor if the claims were transferred to [the transferee] by way of an assignment.”²⁴ The district court thereby vacated the bankruptcy court’s subordination and disallowance orders and remanded the matter back to the bankruptcy court.²⁵ Therefore, the *Enron* decisions, in aggregate, only impacted claims obtained through assignment.²⁶

The Wild West: Still as Hot as Ever

Although the *Enron* district court decision was unequivocally the most significant case for claims traders in recent years, the holding merely reinstated the *status quo* in the claims-trading market. The district court’s decision minimized the impact of the bankruptcy court’s attempted regulation of the claims-trading market, and in effect nullified a decision that would have severely chilled a booming industry. Because the taint remains with a transferred claim only if assigned but not if sold, the *Enron* jurisprudence should only affect a small percentage of secondary claim-holders. The *Enron* cases also suggest that claims trading is a valuable solution for “creditors who want to get out of the bankruptcy case because they have done something nefarious that would cause the claim to be disallowed or subordinated in their hands.”²⁷

²¹ *Enron Corp. v. Springfield Assoc. LLC (In re Enron)*, 2005 WL 3873893 (Bankr. S.D.N.Y. 2005).

²² See Tally M. Wiener and Nicholas B. Malito, “On the Nature of the Transferred Bankruptcy Claim,” 12 *U. Pa. J. Bus. L.* 35, 48 (Fall 2009) (By time Southern District of New York had “ruled on the merits of the appeal, all of the Transferee Litigation had settled except the litigation targeting the \$5,000,000 claim held by Citigroup’s transferee Springfield Associates LLC.”).

²³ See *supra*, n.19, at 436.

²⁴ *Id.* at 449.

²⁵ *Id.*

²⁶ See *supra*, n.1, at 62.

²⁷ Adam J. Levitin, “Bankruptcy Markets: Making Sense of Claims Trading,” 4 *Brook. J. Corp. Fin. & Com. L.* 64, 90 (2010).

¹³ See *id.* at App. D, <http://hsgac.senate.gov/072302roach.pdf>.

¹⁴ *Id.*

¹⁵ Ronald L. Cohen and Laurie R. Binder, “Recent Developments in Claims Trading,” 2005 *Ann. Surv. of Bankr. Law*, Part 1 § 17 (September 2006), www.sewks.com/files/Publication/0e3d4675-ad2f-45b4-bd93-0a7b29bde65f/Presentation/PublicationAttachment/9e3d4e1c-84d6-4c90-91bc-00dc43883738/2005_RecentDevelopments.pdf. (Although the authors were unable to procure a copy of the May 24, 2004, transcript referenced in Mr. Binder and Ms. Cohen’s article, a summary of the court’s holdings can be found on the docket for *In re Enron*, et al. (01-16034-ajg). Specifically, on June 23, 2004, the debtors filed their “proposed findings of fact and conclusions of law with respect to confirmation of the debtors’ fifth amended joint chapter 11 plan.” *In re Enron Corp.*, No. 01-16034-ajg, (Bankr. S.D.N.Y. June 23, 2004), ECF 19307).

¹⁶ *Supra*, n.11, ¶ 91.

¹⁷ *Id.*

While there is no evidence that such illicit behavior is motivating widespread claims trading, in one September 2010 report a total of \$2.41 billion in claims were traded in 785 transfers.²⁸ Thus, despite the sheriff's best efforts, the *Enron* decisions did little to bring order to the Wild West.²⁹ ■

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²⁸ Secondmarket.com September 2010 newsletter, www.secondmarket.com/pdf/news/2216.pdf. This website is one example of a claims-trading platform, and there are other similar platforms currently in use.

²⁹ The authors express no opinion herein as to the benefits or costs associated with a largely unregulated claims trading market, notwithstanding their own personal *laissez-faire* philosophies.