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UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

In re	:	**Chapter 11**
	:	**Case No. 01-16034 (AJG)**
ENRON CORP., *et al.*,	:	
	:	**Jointly Administered**
Reorganized Debtors.	:	
SPRINGFIELD ASSOCIATES, LLC,	:	**District Court**
	:	**Case No. 06-07828 (RJH)**
Appellant,	:	
v.	:	
	:	
ENRON CORP.,	:	
Appellee.	:	

BRIEF OF *AMICI CURIAE*
THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION, THE INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, AND THE LOAN SYNDICATIONS AND TRADING ASSOCIATION IN SUPPORT OF APPELLANTS

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PRELIMINARY STATEMENT

The Securities Industry and Financial Markets Association ("SIFMA"), the International Swaps and Derivatives Association, Inc. ("ISDA"), and the Loan Syndications and Trading Association ("LSTA," and collectively, "*amici*") submit this brief of *amici curiae* in support of Appellants. *Amici*'s position rests on the real-world experiences of their members, who are both buyers and sellers of bankruptcy claims (including loans, bonds, and derivatives). As this Court has recognized, the precedent established in this case will have a far-reaching impact not only on buyers and sellers of bankruptcy claims, but also, more broadly, on the continued vitality of the markets for such claims. *Amici* seek to assist the Court in analyzing these issues with due regard for the proper and efficient functioning of those financial markets.

The bankruptcy court has ruled that a buyer of a bankruptcy claim may find itself holding worthless paper if it turns out that the seller (or someone prior in the remote chain of title) either committed an unrelated bad act against the debtor or its creditors, or holds an avoidable transfer. These opinions are incorrect as a matter of law; they would work an unprecedented and unsupported expansion of the doctrine of equitable subordination and the statutory provision governing disallowance. Moreover, the bankruptcy court's decisions would impose on buyers a new and unquantifiable risk: that the instruments they purchase may be tainted for reasons unknown (and very often unknowable) to them. This new uncertainty already threatens serious disruption of the existing markets in post-bankruptcy trading in bank and bond debt.

In exchange for imposing severe and far-reaching negative consequences on those markets, the bankruptcy court's new rules merely expand the supplemental remedies available to bankruptcy estates beyond the estates' existing unqualified rights directly to pursue (i) bad actors for damages caused by their wrongful conduct, and (ii) the recipients of avoidable transfers. As a result, the bankruptcy court's opinions deliver minimal benefits to bankruptcy estates while

significantly and adversely affecting the financial markets and the creditors that depend on these markets to liquidate their claims quickly.

The bankruptcy court fundamentally misperceived the markets' understanding of—and ability to price—the risks that these rulings would shift to transferees. The postpetition claims markets have already begun suffering from the impact of the bankruptcy court's decisions, as evidenced in press reports and recent examples where postpetition claims trading appears to have frozen due to the bankruptcy court's opinions. Because claim buyers lack reliable information to allow them to assess the risk that a claim could be equitably subordinated or disallowed, they are unable to assign an appropriate price discount. Indeed, even when a claim buyer knows of a risk, the buyer cannot assess with any certainty the magnitude of the impact.

While this case arises in a context involving large commercial actors, the bankruptcy court's rulings—unless reversed—would adversely affect a far wider and more diverse group of creditors. Commonly, when a corporate debtor files for bankruptcy, the creditor body will include many individuals and small businesses. Those creditors often lack either the liquidity to wait for payment until the end of the bankruptcy case (in Enron's case, five years to date and counting), or the sophistication to assess whether doing so would amount to a sound investment in the debtor's reorganization. In addition, other creditors—such as pension funds and mutual funds—are often prohibited by their charters from holding non-investment-grade instruments. Before the bankruptcy court's decisions, these creditors had access to a robust secondary market in bankruptcy claims. That secondary market permitted those creditors to "cash out" their claims early in the bankruptcy, providing them with necessary liquidity or facilitating compliance with governing requirements, and allowing seasoned investors in distressed debt to acquire the claims

and participate as creditors in the bankruptcy case. The bankruptcy court's opinions fundamentally threaten the functioning of this once-vigorous market.

Beyond this general havoc, the bankruptcy court's opinions will inflict significant damage on at least three segments of the financial markets that are ill-equipped to bear the burdens the opinions impose: trading in loans, trading in physically settled credit derivatives, and trading in bonds. If affirmed, the court's rulings not only will require potential transferees to investigate extensively the creditworthiness of the transferor, but will also force the transferee to sue the transferor to recover if the transferred claims are equitably subordinated or disallowed. In cases in which the immediate transferor was not the bad actor, that transferor, in turn, may have to sue ***its*** transferor, and so on up the chain of title, until the parties bring the wrongdoer into the litigation.

Those newly imposed requirements—the necessity to conduct extensive pre-transfer due diligence and to pursue waves of post-loss litigation—would hit the bond market particularly hard because most bonds trade anonymously. That anonymity renders pre-purchase due diligence—not only to verify creditworthiness but also to determine whether an upstream transferor has engaged in misconduct—a practical impossibility. And without knowing the identity of the seller, post-loss litigation would be a fruitless fishing expedition. All this sets the stage for drastic changes in the bond market, thereby damaging what to date has been an efficient and liquid market.

Congress never intended these results. The bankruptcy court's decisions are plainly wrong on the law. In its disallowance opinion, the bankruptcy court held that disallowance of a claim under Section 502(d) of the Bankruptcy Code imprints a "taint" on the claim that follows the claim into the hands of a buyer who received no avoidable transfers. The opinion rests on a

result-driven approach that subordinates traditional tools of statutory construction to the bankruptcy court's goal of maximizing recovery for the debtor's estate. And as with its equitable subordination decision, the opinion pays no regard to the crippling effects it imposed upon the capital markets or the importance of those markets to the estate's creditors.

In its equitable subordination opinion, the bankruptcy court stated that "[a]n assignee stands in the shoes of the assignor and subject to all equities against the assignor." (*See* Op.[1/] at 28 (quoting *Goldie v. Cox*, 130 F.2d 695, 720 (8th Cir. 1942)).) But the principle of *Goldie v. Cox* applies to equities held by the ***debtor***, not by other creditors; it is therefore inapplicable in the context of equitable subordination, which is an equity held by other ***creditors***, not by the debtor. Under traditional equitable principles, long relied on by the markets and adopted by Congress when it codified "principles of equitable subordination" into Section 510(c) of the Bankruptcy Code, a buyer of a claim takes that property free from the "latent equities" of parties other than the original obligor or debtor. Accordingly, the buyer acquires its claim free of any "latent equities," such as the equity of equitable subordination, that run in favor of third-party creditors.

Compounding these legal errors, the bankruptcy court disregarded the Second Circuit's directive to avoid statutory constructions that could disrupt the debt markets. In *Elliott Assocs., L.P.* v. *Banco de la Nacion*, 194 F.3d 363, 380 (2d Cir. 1999), the Second Circuit rejected an interpretation of a New York champerty statute (barring the purchase of a claim for the purpose of filing a lawsuit) that would have disrupted trading in the sovereign debt market and led to "higher borrowing costs," an "unreasonable result" that would ultimately hurt borrowers, even if

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[1/] Opinion Denying First Cause of Action of Motion to Dismiss Filed by Springfield Associates, L.L.C. Regarding Equitable Subordination, Adv. Pro. No. 05-01025, dated November 28, 2005 (as cited herein, "Op.").

the rule—which had been advocated by the debtors in that case—"might benefit the Debtors in the short run." *Id.* So too here, the bankruptcy court erred in ignoring the market impact of its decisions (erroneously asserting the "claims trading market is not a fundamental part of the bankruptcy process, its policies, historical roots, or purpose"[2]) and imposing new rules that would cripple the market for bankruptcy claims and increase borrowing costs.

Unless the bankruptcy court's new rules are reversed, they will continue seriously and needlessly to disrupt the bankruptcy claims market and to impair the marketability of debt instruments in financially distressed companies. That could result, as it has in more than one situation, in a near cessation of trading in certain debtors' claims. Without question, however, it will result in diminished liquidity in postpetition claims markets. At bottom, the net effect will be to turn formerly efficient markets into illiquid, and decidedly inefficient, markets. And that will impose considerable harm on small creditors that cannot afford to hold, large institutions that are required to sell, and troubled borrowers who depend on access to financing to facilitate their reorganizations.

STATEMENT OF INTEREST

SIFMA is the organization formed from the 2006 merger of the Bond Market Association and the Securities Industry Association. SIFMA brings together the shared interests of more than 650 securities firms, banks, and asset managers active in U.S. and foreign markets. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services, and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry.

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[2] Opinion Denying Defendants' Motion to Dismiss Second Cause of Action Regarding Disallowance of Claims Held by Defendants, Adv. Pro. No. 05-01029, dated March 31, 2006 (as cited herein, "Second Op."), at 41.

ISDA, which represents participants in the privately negotiated derivatives industry, is the largest global financial trade association by number of member firms. ISDA was chartered in 1985, and today has approximately 700 member institutions from 50 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities, and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities.

LSTA is the trade association for all segments of the floating rate corporate loan market. With over 220 members, including broker-dealers, commercial banks, investment banks, mutual funds, merchant banks, and other major financial organizations worldwide, LSTA seeks to foster the development of policies and market practices designed to promote just and equitable marketplace principles and to encourage cooperation and coordination with firms facilitating transactions in loans and related claims.

Collectively, *amici* are uniquely positioned to address the effect of the bankruptcy court's incorrect rulings in these adversary proceedings on the nation's financial markets.[3/]

[3/] Wilmer Cutler Pickering Hale and Dorr LLP ("WilmerHale"), counsel for *amici*, represents various members of the *amici* associations on a wide variety of matters. WilmerHale has also advised Citibank N.A., a defendant in the Mega-Complaint Proceedings, on issues related to those presented in this case.

FACTUAL AND PROCEDURAL BACKGROUND[4/]

In May 2000 and May 2001, Enron Corporation ("Enron"), as borrower, entered into two credit agreements with certain participating banks (the "Banks"), including Chase Manhattan Bank and Citibank N.A. ("Citibank") as co-administrative agents, and Citibank as paying agent. The first, dated May 18, 2000, was a $1,250,000,000 Long Term Revolving Credit Agreement. The second, dated May 14, 2001, was a $1,750,000,000 364-day Revolving Credit Agreement.

On December 2, 2001 (the "Petition Date"), Enron and certain of its affiliated entities filed voluntary petitions for relief under chapter 11 of the Bankruptcy Code, 11 U.S.C. §§ 101 *et. seq.* (the "Bankruptcy Code"). As of the Petition Date, Citibank held claims against Enron arising from its loan under the credit agreements (the "Claims"). On or about May 15, 2002, Springfield Associates, L.L.C. (the "Assignee") purchased certain of these Claims from a third party, BT/Deutsche Bank.

On September 23, 2003, almost two years after the bankruptcy filing and more than one year after the Assignee purchased the Claims, Enron filed suit against the Banks alleging, among other things, that they received certain preferential and fraudulent transfers. Enron also alleged that the Banks participated in prepetition misconduct with respect to Enron, and benefited from that conduct to the detriment of Enron's other creditors. That suit, known as the "Mega-Complaint Proceeding," remains pending. The Banks contest the Mega-Complaint's misconduct

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[4/] The facts set forth herein are taken from the bankruptcy court's Opinion Denying Cause of Action of Motion to Dismiss Filed by Springfield Associates, L.L.C. Regarding Equitable Subordination, Adv. Pro. No. 05-01025, dated November 28, 2005 (as cited herein, "Op."), the Order Denying Defendant Springfield Associates, L.L.C.'s Motion to Dismiss Plaintiff's Second Cause of Action Against Springfield Associates, L.L.C. Seeking Disallowance of Claims Pursuant to 11 U.S.C. § 502(d), Adv. Pro. No. 05-01025, dated November 6, 2006 (as cited herein, "Order"), and the Opinion Denying Defendants' Motion to Dismiss Second Cause of Action Regarding Disallowance of Claims Held by Defendants, Adv. Pro. No. 05-01029, dated March 31, 2006 (as cited herein, "Second Op."), which is incorporated by reference into the Order.

allegations, which have not yet been adjudicated in any proceeding. Significantly, Enron has not alleged, in the Mega-Complaint Proceeding or elsewhere, that any fraudulent or unlawful conduct occurred under the credit agreements.

On January 12, 2005, Enron began this adversary proceeding against the Assignee. In its complaint, Enron alleged causes of action for equitable subordination under Section 510(c) of the Bankruptcy Code and disallowance under Section 502(d) of the Bankruptcy Code. Specifically, Enron asserted that had Citibank continued to hold the Claims, the bankruptcy court would have equitably subordinated them—which is to say, the bankruptcy court would have ordered that other claims of a like priority be paid in full before the Claims receive any distribution in the bankruptcy. Alternatively, Enron argued, the Claims once held by Citibank should be disallowed because Citibank held an avoidable transfer. Citibank, of course, had transferred the Claims indirectly to the Assignee well before Enron began this action. Enron therefore contended that the bankruptcy court should subordinate or disallow the Claims in the hands of the Assignee to the same extent as if Citibank had continued to hold the Claims.

On April 1, 2005, the Assignee moved to dismiss this adversary proceeding for failure to state a claim. In its motion, the Assignee contended that the sole basis of Enron's complaint is that Citibank, not the Assignee, allegedly received preferences or fraudulent conveyances from Enron, or engaged in misconduct—misconduct, moreover, unrelated to the credit agreements or the Claims arising therefrom. Accordingly, the Assignee argued, the Claims should not be subject to equitable subordination or disallowance in the Assignee's hands because these remedies apply only against a holder of a claim whose own misconduct or failure to return avoidable transfers causes injury to the creditors. Because Enron never alleged that the Assignee committed bad acts or had itself failed to return avoidable transfers, equitable subordination or

disallowance of the Assignee's Claims based on Citibank's conduct would only punish an Assignee undeserving of punishment.

On December 23, 2005, the bankruptcy court denied the Assignee's motion to dismiss the equitable subordination cause of action, based on an earlier opinion dated November 28, 2005. Addressing the issue in two steps, the court first held that under Section 510(c) of the Bankruptcy Code, a court may subordinate a claim held by a creditor found to have engaged in inequitable conduct, regardless of whether the claim itself bears any relation to the misconduct. Next, the bankruptcy court decided that, even in the hands of an assignee that purchased the claim for value, the claim remains subject to equitable subordination based on the inequitable conduct of the previous holder. Thus, according to the bankruptcy court, even though the Assignee had paid value for the Claims, taken without notice of any misconduct by the Banks, and engaged in no misconduct of its own, its Claims remained subject to equitable subordination, just as if the alleged wrongdoer, Citibank, continued to hold the Claims.

On November 6, 2006, the bankruptcy court issued its second decision, based on the reasons set forth in an earlier opinion dated March 31, 2006 (issued in a separate adversary proceeding coordinated with this adversary proceeding), which held that even though a transferee purchased a claim for value, the court may nevertheless disallow the claim under Section 502(d) of the Bankruptcy Code because a previous claim holder received, and has not returned, an avoidable transfer. Despite recognizing the future adverse impact of this holding on the vibrancy and fluidity of the underlying markets, the bankruptcy court maintained that indemnity agreements and market pressures, such as the LSTA Standard Terms and Conditions, "may coerce payment of the avoidable transfer," thereby promoting the policies underlying disallowance. (Second Op. at 39.) Rejecting the Assignee's arguments against penalizing

transferees through disallowance, the bankruptcy court emphasized that "the claims trading market is not a fundamental part of the bankruptcy process, its policies, historical roots, or purpose." It stated that "[e]ven if the Defendants are correct that the judicial holding urged by Enron would have a negative impact on the claim-transfer market, it is an issue for Congress." (*Id.* at 41.) The court concluded that when balancing the "harm to the other members of the injured-creditor class as against the risks to a claim-purchaser," the interests of the former prevail. (*Id.* at 42.)

On January 30, 2007, this Court granted Appellants leave to appeal the bankruptcy court's decisions to address whether equitable subordination under Section 510(c) and disallowance under Section 502(d) can be applied, as a matter of law, to claims held by a transferee to the same extent they would be applied if such claims were still held by the transferor.[5]

ARGUMENT

I. THE BANKRUPTCY COURT'S OPINIONS, IF ALLOWED TO STAND, WILL SEVERELY DISRUPT THE POSTPETITION CLAIMS TRADING MARKET.

The bankruptcy court's opinions impose a risk on claim purchasers that a prior holder's wrongful conduct or receipt of an avoidable transfer, in each case wholly unrelated to the purchased claims, could cause the claims to be worthless. Unsurprisingly, the opinions have already begun to affect the postpetition claims market negatively.

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[5] On October 10, 2006, a*mici* filed a brief (and an accompanying motion for leave to file the *amicus* brief) with this Court in support of the Appellants' appeal of the bankruptcy court's decisions. In accordance with the revised briefing schedule ("so ordered" by this Court on February 14, 2007), *amici* are filing this brief, which has been updated to address the Court's ruling on January 30, 2007, as well as subsequent market developments.

A. The Bankruptcy Court's Opinions Have Already Impacted The Markets.

As one commentator has noted, the court's opinions are sending a "shiver up the spines of hedge funds and other investors that dominate the market for distressed debt." *See generally* David M. Toll, *Judge Deals Blow to Distressed-Debt Market*, DAILY BANKR. REVIEW, April 13, 2006, at 12. A high-profile case proves the point.

On October 17, 2005, Refco Group Ltd., LLC ("Refco") and certain of its affiliates filed for bankruptcy. (*See* Ganz Decl. ¶ 3, attached hereto as Exhibit 1.) An Austrian bank, BAWAG P.S.K. Bank für Arbeit und Wirtschaft und Österreichische Postsparkasse Aktiengesellschaft ("BAWAG"), functioned as one of Refco's primary lenders and held a substantial amount of Refco debt. As with most issuances of significant amounts of debt, Refco's bank debt was widely traded by banks and financial institutions.

A few months after Refco filed for bankruptcy, rumors began to emerge that BAWAG had been complicit in prepetition misconduct leading to Refco's collapse. (*See* Mot., Pursuant to 11 U.S.C. §§ 105(a), 1103(c)(5), and 1109(b), To Authorize Official Committee of Unsecured Creditors to (I) Intervene (As a Right) in Adversary Proceeding Commenced by BAWAG and (II) Answer, Defend, and Prosecute Counterclaims on Behalf of Refco Group Ltd., LLC at 13, *In re Refco Inc.*, No. 05-60006 (Bankr. S.D.N.Y. April 21, 2006).) Against this backdrop, the bankruptcy court's opinions in these adversary proceedings provoked fear in the market: If BAWAG had in fact participated in misconduct, any bank debt previously held by BAWAG could be subject to equitable subordination or disallowance, rendering those claims against Refco essentially worthless; the only value would be in litigation claims against previous holders. Given the new precedent set by the bankruptcy court's opinions, the market necessarily had to view any Refco debt previously held by BAWAG as tainted.

Under the bankruptcy court's theory, buyers of Refco bank debt previously held by BAWAG would simply include a discount for the additional risk of purchasing potentially tainted debt, and trading would continue. But the bankruptcy court was wrong—the potential purchasers of the debt had great difficulty pricing the risk of subordination or disallowance attributable to BAWAG's alleged bad acts. (Ganz Decl. ¶ 4.) Accordingly, trading of Refco debt potentially tainted by BAWAG's rumored conduct all but ceased. *See* Joseph Rebello, *Ruling on Claims Trading Spurs Fears Of Broad Harm to US Capital Markets*, DAILY BANKR. REVIEW, Aug. 18, 2006, at 1, 11 (reporting that following the bankruptcy court's equitable subordination ruling at issue here, claims trading involving BAWAG debt "ceased entirely," according to several investment banks); *see also* (Ganz Decl. ¶ 4).

The results have been disastrous. First, those entities that held the debt when the rumors began to circulate encountered significant obstacles when they attempted to sell their Refco debt previously held by BAWAG. (*Id.* ¶ 5.) The market for it essentially vanished. (*Id.*) Sophisticated financial institutions—those that provide the necessary liquidity in the market—simply were not interested in buying bank debt when potentially the only method to extract value is through time-consuming, expensive, and uncertain litigation against previous holders. (*Id.*) That is neither a risk that potential buyers can appropriately price, nor an exposure that they wish to take. (*Id.*)

Second, during the limbo between the beginning of the rumors of prepetition misconduct and BAWAG's entry into a court-approved settlement, *see* Order Approving and Clarifying Stip. and Order of Settlement, *In re Refco Inc.*, No. 05-60006 (Bankr. S.D.N.Y. July 6, 2006), those entities could not avail themselves of any indemnities they may have had in their purchase documents, because the mere fact that the bankruptcy court's opinions had scared away all

potential purchasers did not trigger the indemnities. (Ganz Decl. ¶ 6.) Thus, holders that intended to own Refco debt previously held by BAWAG for only a short term, a typical expectation in fluid, efficient markets, found themselves forced into holding for an uncertain duration, without any opportunity to recover on their indemnities. (*Id.*) Moreover, just because it took the Refco parties a matter of months, rather than years, to reach a settlement does not mean that the disruption to the market was not real or significant. Nor does it mean that parties to the next case will settle as quickly.

Third, to make matters worse, the holders suffered significant impediments to accomplishing their mandate of "marking to market." (*Id.* ¶ 7.) While many financial institutions must perform this requirement daily, without a market to provide the necessary price points, compliance for those holding BAWAG-tainted Refco bank debt became considerably more difficult. (*Id.*) Indeed, the charters, prospectuses, and other governing documents of some funds mandate that they obtain some market quotes before they mark to market. (*Id.*) Without a market to provide those quotes, not only were the unlucky holders left with an inalienable piece of bank debt, but also, in certain circumstances, they also faced an untenable situation in trying to comply with governing requirements. (*Id.*)

Fourth, when the BAWAG rumors began to fly, some transactions in Refco debt previously held by BAWAG had not yet closed. (*Id.* ¶ 8.) Many buyers, taking full account of the bankruptcy court's opinions, refused to go forward with purchases since they might receive tainted debt, and their only recovery could be through lawsuits. (*Id.*) Many sellers, by contrast, would not release the buyers from their contractual obligations. (*Id.*) Thus, the contracts remained open, creating an absurd situation in what was previously a fluid and efficient market. (*Id.*)

The market identified BAWAG, a relatively small, foreign bank, as potentially imprinting a taint on Refco debt. Rather than quickly adjusting through market mechanisms and continuing to trade in that potentially tainted debt (as the bankruptcy court assumed), the market players instead quarantined any Refco debt previously held by BAWAG.

Nor is this an isolated event. Following the bankruptcy filing of bottled drink company Le-Nature's, Inc. in Pittsburgh in November 2006, some began to ask the question whether Le-Nature's' lender, Wachovia Bank, N.A. ("Wachovia"), was in any way complicit in the debtor's pre-petition misconduct. (*See, e.g.*, Response of Official Committee of Unsecured Creditors to Motion of Wachovia Bank, National Association and Wachovia Capital Markets, LLC to Quash the *Ad Hoc* Committee of Lenders' Subpoenas for Rule 2004 Discovery, at 3-4, *In re Le-Nature's, Inc.*, No. 06-25454 (Bankr. W.D. Pa. Jan. 4, 2007).) As a result, entities that held bank debt previously owned by Wachovia in the secondary market found that bidders for Le-Nature's bank debt in the market viewed that debt as potentially subject to an "equitable subordination taint." Thus, bidders were either unwilling to purchase such Wachovia-tainted debt, or were willing to do so only at steep discounts as compared to the market price for Le-Nature's bank debt that had not previously been held by Wachovia for its own account. (Ganz Decl. ¶ 10.) The market reacted in this fashion even though no real evidence of Wachovia misconduct had come to light; rather, it was simply market jitters of what might one day be discovered that caused an "equitable subordination taint" to affix to the debt previously owned by Wachovia in the secondary market, thereby drying up any market for that instrument.

As these examples demonstrate, the market impact of the bankruptcy court's opinions is real and significant. In the wake of the bankruptcy court's decisions, a widely traded issuance of debt can suddenly become "tainted," causing the market price of an instrument that was trading

at or near par value to plummet in response to the risk of subordination or disallowance much more than it otherwise would, with the resultant financial distress felt by numerous financial institutions. In addition, since such a risk has never to date been a factor in pricing debt or other securities, the market would be hard-pressed to adjust to that counter-party risk. As the markets struggle to account for these impediments, the liquidity and efficiency that free markets otherwise offer—in particular, the New York financial markets—begins to disappear. The bankruptcy court's opinions, purportedly based on a sound "policy" choice, have instead inflicted unnecessary and severe damage on some of the very institutions that it should seek to protect.

B. Commentators Describe The Consternation In The Market Due To The Bankruptcy Court's Decisions.

In addition to the BAWAG and Le-Nature's examples, the recent observations of market watchers demonstrate the immediate and widespread damage to the financial markets that the bankruptcy court's opinions have spawned.[6/] For instance, one observer emphasized the "drastic effect" the bankruptcy court's equitable subordination opinion, if affirmed, would have "on the emerging market in claims trading," and especially on unsecured creditors. Dan Schechter, *Equitable Subordination As to One Claim May Affect Unrelated Claims, Even If Unrelated Claims Have Been Transferred to Third Parties*, COMM. FIN. NEWS., Nov. 24, 2005, at 87. Specifically,

> [Unsecured creditors] are the ones who have benefited the most from the liquidity that claims trading has provided in recent years. But now, instead of being able to cash out of a protracted reorganization, the unsecured creditors will have to wait forever for any distribution; alternatively, they can still sell their claims, but at an even greater discount.

6/ Commentary related to the market impact of the bankruptcy court's decision, including the materials cited herein, is collected in Exhibit 2.

Id. Several other commentators focused on the opinions' potentially widespread impact on capital markets generally. For example:

> A decision by the judge overseeing Enron Corp.'s bankruptcy has generated alarm across Wall Street, prompting warnings from investment banks, bond traders and stock investors that it could do broad harm to U.S. capital markets. . . . [The bankruptcy court's equitable subordination decision] had an immediate effect on the trading of bankruptcy claims, a market of at least $300 billion . . . .

Joseph Rebello, *supra*, at 1, 11. As another commentator recently concluded:

> The precedent and policy analyses that supported *Enron* are questionable, but the most serious problem with the decision is the uncertainty that it has injected into the distressed debt markets . . . . At the very least, it affects credit default swaps and loan participations. But its trajectory presents a slippery slope that implicates all securities, debt, and derivative transactions.

Adam J. Levitin, *The Limits of Enron: Counterparty Risk in Bankruptcy Claims Trading*, 15 J. BANKR. L. & PRAC. 4 Art. 3 (2006). Furthermore,

> *Enron* created a new level of counterparty risk that will decrease liquidity in the claims trading market, which will spillover into regular capital markets and raise bankruptcy risks for all creditors. The costs imposed by *Enron* are unnecessary. There is at best questionable authority for the subordination of innocent claims purchasers on account of sellers' behavior unrelated to the claims, and direct actions by injured creditors against inequitable claims sellers present a better remedy for the concerns of claims washing and injured creditors. *Enron* may well have created more problems than it solved.

Id.

Even Enron's own counsel recognized that the bankruptcy court's equitable subordination decision changed the market:

> Participants in the burgeoning claims-transfer market ***should take special note*** of the *Enron Corp.* decision. As the court observes, claims purchasers likely will account for the risk of equitable subordination by adjusting the market price and demanding comprehensive indemnity agreements from their transferors.

> General unsecured creditors who elect to transfer their claims may receive less money in exchange for such claims.

Rachel Ehrlich Albanese, *Assignment of Claims Does Not Prevent Equitable Subordination Attack*, WEIL, GOTSHAL & MANGES LLP BANKR. BULL., Feb. 2006, at 1, 14 (emphasis added), *available at* http://www.weil.com (follow "Resources" hyperlink, then follow "Bankruptcy Bulletin," "Archive" and "February 2006" hyperlinks) (last visited March 2, 2007).[7]

Similarly, yet another market watcher reported that if this Court had declined interlocutory review, this Court might have "dramatically alter[ed] the secondary market for a range of debt instruments." John Hintze, *Secondary Markets Await Enron Appeal*, HIGH YIELD REPORT, July 24, 2006, at 1. Another report observed that, on the heels of its equitable subordination ruling, the bankruptcy court's disallowance opinion "is sending another shiver up the spines of hedge funds and other investors that dominate the market for distressed debt." Toll, *supra*, at 12; *see also* Brad Eric Scheler & Alan N. Resnick; *Enron Ruling Impacts Claims Trading Industry*, N.Y.L.J., March 6, 2006, at 9, 13 (observing that the bankruptcy court's equitable subordination decision "may have wide-ranging impact on the claims trading industry" and pointing out weaknesses in the bankruptcy court's reliance on existing indemnities); Lawrence Kotler, *Claim Purchasers Beware: No Good Faith Defense to Equitable Subordination*, 25-FEB AM. BANKR. INST. J. 22, 26 (2006) (stating that the bankruptcy court's equitable subordination decision "should serve as an urgent warning to those in the business of buying or selling distressed debt/unsecured claims" and criticizing the opinion for "distort[ing] the concept of equitable subordination" by permitting the estate to recover doubly and for

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[7] *See also Brief Update: Bankruptcy Court Denies Motion to Dismiss Cause of Action Based on Equitable Subordination*, WEIL, GOTSHAL & MANGES LLP BANKR. BULL., Dec. 2005, at 11 (summarizing bankruptcy court's equitable subordination decision), *available at* http://www.weil.com/wgm/pages/Controller.jsp?z=r&sz=nl&db=wgm/cwgmpubs.nsf&d=D349D129A366792D852570D20058F893&v=Bankruptcy&f=a200512 (last visited March 2, 2007).

holding that an assignee is "subject to the same liabilities of an assignor"); Evan C. Hollander & Douglas S. Mintz, *Claim Traders Beware: Your Acquisition May Come With Unwanted Baggage*, BNA'S BANKR. LAW REPORTER, Feb. 2, 2006, at 122 (reporting on the bankruptcy court's "potentially far-reaching decision" regarding equitable subordination); Carrianne Basler & Michelle Campbell, *Savvy Claims Purchasers Must Avoid Pitfalls*, 25-JUN AM. BANKR. INST. J. 26, 27 (2006) (warning distressed capital investors of the repercussions of the bankruptcy court's decisions).

As this deluge of articles demonstrates, the bankruptcy court's opinions announced precedents completely out-of-step with market expectations. Market players neither expected such rulings, nor can properly account for their effects. While Enron has argued that nothing about the bankruptcy court's opinions should cause concern, the opposite is obviously true.

C. The Bankruptcy Court Erroneously Confused Market Participants' Ability To Price Credit Risk With Their Ability To Price Counter-Party Risk.

The bankruptcy court's analysis misperceives market participants' awareness of and practical ability to price the risk that an upstream party's actions may result in the equitable subordination or disallowance of claims held by downstream purchasers. In the court's view: "[P]articipants in the claims-transfer market are aware of, or should be aware of, the risks and uncertainties inherent in the purchase of claims against the debtors, including the possibility of claims being temporarily disallowed under Section 502(d) . . . . They assume the liabilities arising from the claims when participating in the claims-transfer market." (Second Op. at 37.)

This perspective erroneously confuses market participants' ability to price credit-risk in the distressed debt market (that is, the risk that the issuer of the debt cannot pay) with their ability to price a previously unknown species of counter-party risk (the risk that the acts of a prior holder will cause subordination or disallowance of the debt). The bankruptcy court's

assertions notwithstanding—and as the Refco/BAWAG and Le-Nature's examples show—a claim buyer cannot adequately value the risk that a transferor somewhere in the chain of ownership engaged in conduct that could subject the claim to disallowance or equitable subordination. And without an ability to price that risk, market participants either simply will not buy those claims, or, in the best-case scenario, will buy them at a steep discount.

First, a claim buyer cannot ascribe a generic statistical possibility to the inherent risk that a claim could be subject to subordination or disallowance. Reliable information simply does not exist to generate that statistical probability. And without that information, a claim buyer cannot assign an appropriate price discount to account for the possibility that a claim may be subordinated or disallowed based on the conduct of someone in the chain of title.

Second, in any given circumstance, a claim buyer cannot properly gauge the variety of issues that may arise from an incomplete set of facts. For example, even today, sufficient publicly available information does not exist to properly determine the risk that Enron will be successful in disallowing or subordinating the Claims. Yet, according to the bankruptcy court, a claim buyer can immediately assimilate all facts, reach a perfect analysis of the situation, and ascribe an appropriate price discount, thus permitting it to trade with confidence in the market for postpetition debt. That simply is not the case.

Third, if and when a legitimate risk is known, a claim buyer cannot know with any certainty the magnitude of the potential impact. In other words, one cannot know the damages for which a previous holder will be found liable. And, perhaps more important in the disallowance context involving an allegedly avoidable transfer, one cannot know how much of that will remain unpaid after either a settlement or a judgment, forcing the estate representative to pursue its remedies against the transferees. This uncertainty is especially problematic for

creditors that want to or are required by regulation to "cash out" early. Immediately following a declaration of bankruptcy, little or no information likely exists regarding misconduct. As a result, creditors that cannot wait must sell in a stagnant, or at best inefficient, market. For all these reasons, the bankruptcy court's assumption that postpetition markets are aware of and can properly price the risk that the acts of a prior holder will cause subordination or disallowance of the claim was erroneous.

II. AT LEAST THREE PREVIOUSLY VIBRANT FINANCIAL MARKETS WILL SUFFER BECAUSE OF THE BANKRUPTCY COURT'S OPINIONS.

The bankruptcy court's holdings, if allowed to stand, will profoundly disrupt at least three major segments of the bankruptcy claims market: trading in bank debt, trading in credit derivatives, and trading in bonds.

A. Postpetition Trading In Bank Debt Will Diminish, Despite The Existence Of LSTA Indemnification Provisions.

The rules announced by the bankruptcy court threaten to sap liquidity from the previously healthy postpetition market in bank debt. The bankruptcy court brushed aside these concerns, reasoning that the indemnification protections embodied in LSTA's standardized provisions relating to transfer rights, assumed obligations, and buyer's rights and remedies would protect a buyer of bank debt in the event that a court subordinates or disallows its claim due to past misconduct by a previous claim holder. (*See* Op. at 38; Second Op. at 38-40.) That view, however, mistakenly overlooked the reality that the bankruptcy court's sweeping new analysis would require those indemnities to bear far greater weight than they presently do.

First, because the indemnities are only as valuable as the credit of the indemnifying party, each purchaser would need to conduct more extensive due diligence into the creditworthiness of its seller—slowing the process and increasing costs. *See, e.g.,* Scheler & Resnick, *supra*, at 12 (noting likely need for additional due diligence "to insure the creditworthiness of the

indemnifying party"). Moreover, current standard indemnities cover acts or omissions of only the immediate transferor, and thus a transferee may be vulnerable if its claim has passed through more than one transferor. *See, e.g., id.* Should the estate representative prevail in an equitable subordination suit, the holder of the subordinated claim may first have to bring suit against its transferor to recover its loss. Assuming the inclusion of a standard indemnity for each transfer, the transferor, if it were not the wrongdoer, may then have to bring suit against its respective transferor, and so on up the chain of title, until the stream of litigation reaches the wrongdoer.

The bankruptcy court's analysis—with its single-minded focus on delivering benefits to the estate—gave no weight to these severe additional burdens on both the market participants and the judicial system. Because they levy unprecedented and substantial transaction costs, the bankruptcy court's new rules, if affirmed, would disrupt an otherwise efficient market.

B. Trading In Credit Derivatives Products, Particularly Physically Settled Derivatives, Will Suffer.

Credit derivative swaps ("CDSs"), at their core, operate as forms of risk transfer. For example, the holder of a bond, in exchange for a purchase price, may obtain the right to be paid in full on the bond, even in the event that the obligor on the bond defaults. A CDS is thus a contract to transfer the risk of the total return on a reference obligation (such as a bond) with respect to a credit event (such as a default), without the actual transfer of the underlying obligation (that is, without selling the bond). Therefore, the contract is an agreement between a protection buyer and a protection seller, whereby the buyer pays a periodic fee to the seller, in return for the right to receive payment from the seller in the event that a credit event (such as a bankruptcy or other default) happens to the reference entity (such as the issuer of the bond) or to the obligations of the reference entity. The contingent payment usually replicates the loss incurred by creditors of the reference entity in the event of its default.

The most basic credit event is the bankruptcy of the reference entity. Upon the bankruptcy of the reference entity, the protection buyer historically had two choices, depending on the drafting of the credit derivative product: (i) physical settlement, or (ii) cash settlement. Single name credit derivative products are typically physically settled. In such a product, the protection buyer will physically transfer the reference obligation to the protection seller in return for payment of the face value of the obligation.

In the CDS market, the detrimental effect of the bankruptcy court's holdings would be felt most directly with respect to physically settled credit derivative products. Upon the bankruptcy of the reference entity, the protection buyer of a physically settled CDS will transfer the deliverable obligation—and necessarily the bankruptcy claim based on that obligation—at the time of settlement, which would occur post-bankruptcy. The protection seller would have no basis to know whether the protection buyer (or the party from whom the protection buyer purchased the obligation) was involved in some wrongdoing that could give rise to equitable subordination or disallowance. If the protection buyer or any other transferor of the obligation were involved in some wrongdoing, the claim acquired by the protection seller as part of this transaction would, under the rule adopted by the bankruptcy court, be subordinated or disallowed. (*See* Op. at 39 n.15 (noting that a party who "enters into a pre-petition agreement under which such party agrees to accept a transfer of proofs of claim" in the event of a bankruptcy "assumes the risk" that the claim it receives could be subject to equitable subordination).)

Like the postpetition buyer of bank debt, the protection seller will suffer exposure to much greater risk than it bargained for before the bankruptcy court's decision in this matter. To protect against that risk, the protection seller likely will require indemnities similar to those

provided in the context of a postpetition sale of bank debt, discussed above. As with the sale of bank debt, those indemnities present an imperfect solution; while they might theoretically provide a means to place the liability on the offending party, their imposition would significantly alter the CDS market by increasing transaction costs and introducing due diligence obligations, additional litigation risks, and substantial delay.

One additional, and quite significant, complication exists. CDSs can go through layers of transactions, as each protection buyer and seller seeks to isolate the specific risk that it is willing to bear. Thus, settlements of derivatives can involve numerous parties and transactions. The complications introduced by the bankruptcy court's opinions would be felt exponentially by the CDS market, whose annual notional value of trades exceeds $26 trillion.

C. Trading In Bonds Likely Will Suffer Unique Harm Because Of The Anonymity Of These Trades.

The opinions' impact on the bond market demonstrates that the bankruptcy court's new rules are fundamentally unworkable. As the bankruptcy court correctly recognized in dictum: "[N]o legal [or] policy basis supports the premise that transferees of bonds or notes should be treated differently than those holding the transferred loan claims." (Op. at 39 n.15.) Yet the bankruptcy court nevertheless created rules that ignore the realities of the bond market, in which trades are anonymous. The bankruptcy court's acknowledgement that its opinion would apply to bond trading coupled with its refusal to consider the deleterious impact of that ruling on the bond markets demonstrate the court's indifference to the effects of its new rules.

Due to the anonymity inherent in bond trading, bondholders likely would incur significant and unique harm under the bankruptcy court's holding. That is, the buyer effectuates the trade through its broker dealer or a market maker; it often does not know the identity of the seller, and vice versa. This inability to verify creditworthiness, let alone to determine whether an

upstream transferor has engaged in misconduct, sets the stage for a steeply discounted or even an illiquid market.

First, the anonymity of bond trading when the trades occur would not preclude estate representatives from uncovering information from third parties, such as broker dealers and market makers, sufficient to establish a trail of likely buyers and sellers. Accordingly, through use of their subpoena power and otherwise, estate representatives would quickly become adept at tracing the trail of "tainted" bonds.

Second, notwithstanding the potential for an estate representative to trace the provenance of bonds following a sale or series of sales, anonymity of the trades would actually put the buyer of bonds in a worse position than the buyer of bank debt. The anonymous trading of bonds prevents the buyer from conducting any pre-purchase due diligence to assess the risk that the seller, or any of the entities further up the chain of title, engaged in conduct that could "taint" its claims. Thus, because they lack this information, all buyers of bonds would have to apply a discount to their bid prices to account for the risk that any seller in a chain might have engaged in misconduct.

Finally, the anonymous buyer of bonds does not (and, as the market is now structured, cannot) receive the same indemnities that a buyer of bank debt receives. Thus, if and when a buyer of bonds suffers a loss because of a "taint" imprinted by the misconduct of a previous holder of the bonds, the buyer likely will not have a contractual right of indemnity against its transferor. For the bond market to adapt to provide rights of indemnity—which, at best, would cause it to reach the current state of affairs of the market for trading bank debt—it would need to undergo a fundamental change from a dynamic, liquid market to a sluggish, document-intensive

market reliant on burdensome indemnities and litigation. That result would not be a positive change to what has been one of the most efficient and robust markets in the financial world.

III. THE BANKRUPTCY COURT'S DISALLOWANCE OPINION ERRONEOUSLY FAILED TO CONSIDER ALL RELEVANT INTERESTS IN CONSTRUING SECTION 502(d).

In its disallowance opinion, the bankruptcy court committed several errors. First, the court disregarded the plain language of Section 502(d), erroneously concluding that the provision focuses on claims, rather than on entities that receive and fail to return an avoidable transfer. (*See* Opening Brief of Permitted Intervenor Bank Citibank, N.A. on the Issue of Equitable Subordination and Disallowance of Transferred Claims at 28-30.) Second, the bankruptcy court adopted a rule that disserves the purposes underlying Section 502(d): promoting equal distribution of the debtor's estate and coercing the return of avoidable transfers. (*See id.* at 31-33.)

In addition to these errors advanced by the intervenor, the bankruptcy court failed to examine all of the relevant interests when it construed Section 502(d). Instead, it engaged in a result-driven analysis directed solely toward maximizing return for the debtor. This approach is incorrect for two reasons. First, it ignores basic bankruptcy policy: maximizing return for the debtor's estate is an appropriate policy goal because it furthers the policy of enabling creditors to recover their share of the estate equitably and efficiently. By creating rules that may well maximize the debtor's estate but that simultaneously disable creditors from liquidating their claims—rules that actually prevent creditors from quickly obtaining their equitable share—the bankruptcy court's disallowance opinion runs counter to a fundamental interest that the Code seeks to protect. Second, the bankruptcy court disregarded the market turmoil its decisions will create (and indeed, have already begun to create). The interest in the sound functioning of the

financial market is both a distinct policy consideration ***and*** a means by which creditors can recover without waiting for the resolution of the bankruptcy proceeding.

A. The Bankruptcy Court's Result-Driven Analysis Incorrectly Focused Solely On Maximizing Return For The Debtor's Estate.

The bankruptcy court acknowledged the importance of the postpetition claims market to bankruptcy proceedings. (*See* Second Op. at 34 n.19 ("recogniz[ing] that the existence of a market to transfer claims is commonly viewed to provide a source of liquidity to the original or subsequent holders of the claims, including the financial institutions that provide pre-petition loans to debtors"); *id.* at 41 ("acknowledg[ing] that the active participation of the transferees in the distressed debt market may well have a significant influence on a debtor's bankruptcy proceeding").) However, in analyzing the policies underlying Section 502(d), the bankruptcy court declined to consider the market impact of its ruling. Instead, the bankruptcy court erroneously construed the statute with the exclusive aim of maximizing return for the debtor, concluding that "the claims trading market is not a fundamental part of the bankruptcy process, its policies, historical roots, or purpose" (*see id.*).

The bankruptcy court purported to balance the relevant interests by weighing "the harm to the other members of the injured-creditor class as against the risks to a claim-purchaser who voluntarily becomes a participant in the bankruptcy process" and concluding that "the interests of the other members of the injured-creditor class prevail." (*Id.* at 42.) The bankruptcy court failed, however, to grasp that the claims trading market is a mechanism for ensuring that "the interests of the injured-creditor class prevail," thereby achieving a key goal of the Bankruptcy Code: creditor recovery. *See, e.g.*, *Susquehanna Chem. Corp. v. Producers Bank & Trust Co.*, 174 F.2d 783, 787 (3d Cir. 1949) ("In bankruptcy the object is . . . to pay off [the bankrupt's] creditors as quickly . . . as possible."); 3A Sutherland Statutory Construction § 70.6 ("The federal

bankruptcy laws were enacted for the . . . purpose[] of . . . providing a speedy and efficient means of distributing debtors' assets equitably among their creditors."). And one of the primary ways creditors recover on their claims is to sell those claims before the bankruptcy process is complete. The bankruptcy court simply failed to appreciate that, by crippling the markets for postpetition trading in claims, it has erected a significant obstacle for creditors seeking to liquidate their claims quickly and for a satisfactory return.

That obstacle, of course, presents the greatest challenge for the creditor holding a smaller claim—typically an individual or small business creditor that does not have the time or financial means to pursue its remedies. Before the bankruptcy court's opinions, the standards governing postpetition claims trading encouraged a creditor holding a small claim to sell it for a fair price to a creditor seeking to aggregate claims and realize economies of scale in its pursuit of the best possible return. With the new impediments to the claims trading market, smaller claimholders no longer can easily sell their claims, but nevertheless still face the unattractive alternative of spending disproportionate time and money fighting for their proper return on those claims. In that regard, the bankruptcy court's perceived intrinsic benefit of "maximizing the estate" actually has damaged the very constituents that bankruptcy policy seeks to protect.

Even worse, in considering the aggregate costs and benefits, from a policy perspective, of its rule, the bankruptcy court failed to recognize that disallowance pursuant to Section 502(d) is simply a ***supplemental*** remedy that the estate representative may enforce against the recipient of an avoidable transfer. If, as asserted in the Mega-Complaint, the Banks received avoidable transfers, Enron would hold a cause of action against the Banks. Indeed, the Enron estate has filed and is actively pursuing a lawsuit against those Banks to avoid alleged preferential and fraudulent transfers. The right to disallow a creditor's claim is merely a supplement to that

primary form of relief. While the bankruptcy court focused on the benefits of extending this supplemental remedy, it failed to consider whether those marginal benefits, if any, justify the substantial costs imposed on creditors and on the market for bankruptcy claims.

B. The Bankruptcy Court Disregarded The Critical Interest In Maintaining A Functioning Financial Market.

In addition to misapplying the bankruptcy policy of maximizing and easing creditor recovery, the bankruptcy court disregarded the Second Circuit's disapproval of statutory interpretations that cause unnecessary market tumult. In *Elliott Assocs., L.P. v. Banco de la Nacion*, 194 F.3d 363 (2d Cir. 1999), the Second Circuit reversed a district court's decision that it found would likely lead to "unreasonable results" in the financial markets. *See id.* at 380. The Second Circuit reasoned:

> While the district court's rule might benefit the Debtors in the short run, the long term effect would be to cause significant harm to . . . developing nations and their institutions seeking to borrow capital in New York. The district court's interpretation would mean that holders of debt instruments would have substantial difficulty selling those instruments . . . . This would therefore add significantly to the risk of making loans to developing nations with poor credit ratings. The additional risk would naturally be reflected in higher borrowing costs to such nations. It could even make loans to some of them unobtainable in New York. A well-developed market of secondary purchasers of defaulted sovereign debt would thereby be disrupted and perhaps destroyed even though its existence provides incentives for primary lenders to continue to lend to high-risk countries.

Id.

Likewise, by disregarding the severe market impact of its construction of Section 502(d), the bankruptcy court has triggered the disruption of a "well-developed market of secondary purchasers." *See id.* And for precisely the same reasons the Second Circuit articulated, that disruption elevates the risks associated with lending to any troubled business. If a financial institution cannot trade some of its debt, thereby reducing its exposure to a given debtor, it will

be unable to lend significant sums of money on economically palatable terms. The bankruptcy court's opinions thereby disserve one of the Bankruptcy Code's paramount purposes—facilitating the reorganization of distressed businesses.

Adhering to precedent and the controlling statutory language, rather than promulgating new, judicially created rules, as the bankruptcy court here has done, would visit no injustice on the debtor or its estate. As a recent article points out, "Purchasers and sellers as a whole should not be the ones forced to insure against the risks of a seller's inequitable behavior. These are costs better borne by the inequitable actors themselves." Levitin, *supra*.[8/] Enron will have recourse against the transferor-banks should they prove liable in the Mega-Complaint proceedings.

IV. THE BANKRUPTCY COURT'S EQUITABLE SUBORDINATION OPINION APPLIED THE WRONG EQUITABLE PRINCIPLE.

Section 510(c) of the Bankruptcy Code[9/] permits a court, "under principles of equitable subordination, [to] subordinate . . . all or part of an allowed claim to all or part of another allowed claim . . . ." *Allied E. States Maint. Corp. v. L.E. Miller (In re Lemco Gypsum, Inc.)*,

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8/ Levitin's article analyzes only the bankruptcy court's equitable subordination ruling. Both of the bankruptcy court's opinions, however, impose on claim purchasers the risk that transferor misconduct, wholly unrelated to the purchased claims, could render the claims worthless. The disallowance opinion therefore threatens the liquidity of the financial markets in precisely the same ways and for the same reasons as does the equitable subordination opinion. Accordingly, Levitin's policy and market impact discussion is relevant to both of the rulings now before this Court.

9/ Section 510(c) of the Bankruptcy Code states:

> Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or (2) order that any lien securing such a subordinated claim be transferred to the estate.

911 F.2d 1553, 1556 (11th Cir. 1990). This section "adopts the long-standing judicially developed doctrine of equitable subordination under which a bankruptcy court has power to subordinate claims against the debtor's estate" to claims that are "ethically superior." *Id.* The "fundamental aim" of the doctrine "is to undo or to offset any inequity in the claim position of a creditor that will produce injustice or unfairness to other creditors in terms of the bankruptcy results.'" *Trone v. Smith (In re Westgate-Cal. Corp.)*, 642 F.2d 1174, 1177 (9th Cir. 1981) (quoting *Bostian v. Schapiro (In re Kan. City Journal-Post Co.)*, 144 F.2d 791, 800 (8th Cir. 1944)).

In finding that the doctrine of equitable subordination applied to the facts as alleged here, the bankruptcy court simply failed to appreciate the established and longstanding equitable principle that guides the inquiry. That is, the statutory language, case law, and legislative history all make clear that the doctrine of equitable subordination does not present a roving invitation to the bankruptcy court to do what it considers "equitable". *See United States v. Noland*, 517 U.S. 535, 539 (1996) (stating that doctrine of equitable subordination does not permit a court to "adjust the legally valid claim of an innocent party who asserts the claim in good faith merely because the court perceives that the result is inequitable").

Rather, Congress specifically intended traditional principles of equitable subordination, as developed in the case law, to guide the application of Section 510(c). *See United States v. Mansfield Tire & Rubber Co. (In re Mansfield Tire & Rubber Co.)*, 942 F.2d 1055, 1062 (6th Cir. 1991) ("The legislative history [of Section 510(c)] makes clear that the use of that term [equitable subordination] was meant to codify 'existing case law.'"), *cert. denied*, 502 U.S. 1092 (1992); *Tese-Milner v. TPAC, LLC (In re Ticketplanet.com)*, 313 B.R. 46, 65 (Bankr. S.D.N.Y. 2004); *In re Sunbeam, Corp.*, 284 B.R. 355, 363 (Bankr. S.D.N.Y. 2002). *See also Noland*, 517

U.S. at 539 ("the reference in § 510(c) to 'principles of equitable subordination' clearly indicates congressional intent at least to start with existing doctrine.").

Although the bankruptcy court seemingly recognized the necessity of employing equitable principles to decide this matter, the court erred when it chose the wrong principle of equity. Disregarding a long and established line of cases that sets out the equitable principles applicable when a buyer of a chose in action or other non-negotiable property acquires its claim unaware of "latent equities" held by a third party, the bankruptcy court misunderstood the fundamental question: how to apply the principles of equity as between the Assignee—a party who purchased the Claims without having been alleged to have any knowledge of the asserted misconduct of Citibank, the original assignor—and other creditors allegedly harmed by Citibank's bad acts. For centuries, courts have resolved this question by ruling that equity will not saddle a buyer with the "latent equities" that a third party might hold against the seller. And that principle takes on great importance in the functioning of the capital markets that are dependent on the liquidity of countless securities and other instruments.[10]

As the plain language of Section 510(c) makes clear, equitable subordination provides an equitable remedy that runs in favor of one or more injured *creditors* holding valid claims by permitting their claims to take priority over the otherwise legitimate claims held by the wrongdoer. Although a chapter 7 trustee or, as is the case here, a "debtor in possession" in a chapter 11 case, may be the procedurally proper party to assert equitable subordination, importantly, in those circumstances it "act[s] as a representative of the creditor, not the debtor."

[10] *Amici* recognize that the Court has ruled that the Assignee's appeal of the bankruptcy court's decisions could not proceed with respect to the issue whether the good faith defense is available as a matter of law to purchasers of a claim (and if so, whether it is available to purchasers of post-petition claims). Regardless of whether the Court addresses the "good faith" issue in the context of this interlocutory appeal, *amici* submit this discussion so that the Court has a fulsome presentation of the long-standing principles of equity at hand in considering the pending issues.

Blumenberg v. Yihye (In re Blumenberg), 263 B.R. 704, 718 (Bankr. E.D.N.Y. 2001) (quoting *In re Weeks*, 28 B.R. 958, 960 (Bankr. W.D. Okla. 1983)); *see also Audre Recognition Sys., Inc. v. Casey (In re Audre, Inc.)*, 210 B.R. 360, 363 (Bankr. S.D. Cal. 1997) (holding that a debtor in possession may bring an equitable subordination action because Section 1107 of the Bankruptcy Code grants a debtor in possession the powers of a trustee). Indeed, in a bankruptcy filed by an individual, the debtor personally lacks standing to seek equitable subordination.[11/]

Here, the bankruptcy court ruled that "[a]n assignee stands in the shoes of the assignor and subject to all equities against the assignor." (*See* Op. at 28 (citing and quoting *Goldie v. Cox*, 130 F.2d 695, 720 (8th Cir. 1942).) But the equitable principle of *Goldie v. Cox* applies to equities held by the ***debtor***, and is therefore simply inapplicable to this case, which involves equities held by ***third-party creditors***. Applying the wrong equitable principle, the bankruptcy court erroneously concluded that the alleged "taint" remains with the Claims, as if imprinted on them, after they were transferred to the Assignee. (*Id.* at 39-40.)

The traditional equitable principle regarding latent equities ***held by third parties***—the principle the bankruptcy court should have applied—yields a very different result. That rule provides that an assignee without notice of any wrongdoing who purchases non-negotiable property, such as a chose in action,[12/] takes the property free from the latent equities of parties

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11/ *See Riccitelli v. U.S. Trustee (In re Riccitelli)*, 14 F. App'x 57, 58 (2d Cir. 2001) (holding that a debtor has no standing to seek equitable subordination), *cert. denied*, 535 U.S. 987 (2002) (citing *Societa Internazionale Turismo v. Barr (In re Lockwood)*, 14 B.R. 374, 381 (Bankr. E.D.N.Y. 1981) and *In re Weeks*, 28 B.R. 958, 960 (Bankr. W.D. Okla. 1983)). In addition, even where an estate representative acts for the benefit of all creditors, courts have found that individual creditors and creditors' committees have standing to assert equitable subordination. *See, e.g., In re Vitreous Steel Prods. Co.*, 911 F.2d 1223, 1231 (7th Cir. 1990); *Tenn. Valley Steel Corp. v. B.T. Commercial Corp. (In re Tenn. Valley Steel Corp.)*, 183 B.R. 795, 799 (Bankr. E.D. Tenn. 1995).

12/ In contrast to negotiable paper, which may provide transferees with even greater protections, a "chose in action" is (1) a "proprietary right in personam, such as a debt owed by

other than the original obligor or debtor.[13] *E.g., Charles Rettig & Son v. Becker*, 11 Pa. Super. 395 (1899) (stating that third-party latent equity rule protects a purchaser of a debtor's note from the secret equities between the assignor and third parties following insolvency of debtor). Far from "stand[ing] in the shoes of the assignor," a buyer takes unburdened by latent equities of third parties against the assignor.

This principle has been a hallmark of free trade for centuries, as reflected in the Supreme Court's decision in *National Bank of Washington v. Texas*, 87 U.S. 72 (1873). The Court stated that the assignee of a chose in action "takes subject to the equity residing in the debtor, but ***not to an equity residing in a third person against the assignor.***" *Id.* at 89 (emphasis added). This rule is by no means one of limited application or in any way obsolete. Rather, from the early 19th century to the present, courts have repeatedly and widely applied this equitable principle to rule that purchasers take free of latent imperfections in the title held by their assignors.[14]

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another person, a share in a joint-stock company, or a claim for damages in tort"; (2) "[t]he right to bring an action to recover a debt, money, or thing"; (3) "[p]ersonal property that one person owns but another person possesses, the owner being able to regain possession through a lawsuit." BLACK'S LAW DICTIONARY 258 (8th ed. 2004).

[13] Purchasers of negotiable instruments or investment securities may enjoy even greater protection under applicable case law and statutes, including the Uniform Commercial Code. At a minimum, the general equitable principles incorporated into the Bankruptcy Code protect ***all*** claims against a debtor from third parties' latent equities.

[14] *See, e.g., E. Armata, Inc. v. Korea Commercial Bank of N.Y.*, 367 F.3d 123, 129 n.7 (2d Cir. 2004) (noting that in "order for a third-party transferee to be liable to trust beneficiaries for receiving trust property, the transferee must also have had notice of the trustee's breach of trust"); *Albee Tomato, Inc. v. A.B. Shalom Produce Corp.*, 155 F.3d 612, 615 (2d Cir. 1998) (applying trust principles that "allow a 'bona fide purchaser' to retain trust property even if the property was transferred in breach of trust"); *Consumers Produce Co.. v. Volante Wholesale Produce*, 16 F.3d 1374, 1390 (3d Cir. 1994) (same); *Hoxworth v. Blinder*, 170 B.R. 438 (D. Colo. 1994) (noting that, where transferees were not bona fide purchasers for value, transfer failed to extinguish judgment creditors' equitable lien), *aff'd*, 74 F.3d 205 (10th Cir. 1996); *First Nat'l Bank of Binghamton, N.Y. v. Mayor of Balt.*, 27 F. Supp. 444, 452 (D. Md. 1939) ("The equities of the debtor will also prevail, unless he is estopped; but equities in favor of third parties (sometimes called 'latent equities') do not defeat the assignee, in the absence of notice,

In addition to the Supreme Court, numerous state high courts follow this principle.[15/] As *amici*'s survey of the case law shows, this compels the presumption that Congress incorporated

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according to the apparent weight of authority."), *aff'd*, 108 F.2d 600 (4th Cir. 1940); RESTATEMENT (SECOND) OF CONTRACTS § 343 (1981) ("If an assignor's right against the obligor is held in trust or constructive trust for or subject to a right of avoidance or *equitable lien of another than the obligor,* an assignee does not so hold it if he gives value and becomes an assignee in good faith and without notice of the right of the other.") (emphasis added); RESTATEMENT (SECOND) OF TRUSTS § 284 (1959) (when a bona fide purchaser takes trust property or a legal interest in the subject matter of the trust based on a breach of the trust by the trustee, such transferee "holds the interest so transferred or created free of the trust, and is under no liability to the beneficiary"); RESTATEMENT (FIRST) OF RESTITUTION § 172 (1937) (when a transferee acquires title to property "under such circumstances that otherwise he would hold it upon a constructive trust or subject to an equitable lien, he does not so hold" if he qualifies as a bona fide purchaser); 6A C.J.S. *Assignments* § 109 (2005) ("An assignee takes subject to equities of third persons of which he or she has notice, but . . . it is generally held that he or she does not take subject to latent equities of which he or she has no notice."); 9 ARTHUR LINTON CORBIN, CORBIN ON CONTRACTS § 900 (interim ed. 2002) ("An assignee takes subject to many defenses . . . which were available to the obligor against the assignor, even though the assignee is a purchaser for value and without notice. . . . The more generally prevailing rule is, however, that such an assignee takes the claim free from the equities of all others than the obligor.").

15/ *See, e.g., Brooks v. Greil Bros. Co.*, 68 So. 874, 876 (Ala. 1914) (stating that a "mere latent equity of a third party in a nonnegotiable instrument . . . is lost when such an instrument is assigned, for value, and the assignee has no notice of such equity at the time he acquires it"); *Dabney v. Philleo*, 237 P.2d 648, 655 (Cal. 1951) (stating that a claim of a third party to an assignment "would be at the most an undisclosed equitable interest which could not be asserted against the bona fide assignees for value"); *Fairchild v. Brown*, 11 Conn. 26, 38 (Conn. 1835) (observing that "[i]f a third person were permitted to set up a secret equity against the assignor, to defeat or controul the interest of the assignee, no transfer could be made, which would be safe for the assignee"); *Wewahitchka State Bank v. Mixon*, 504 So. 2d 1328, 1329-30 (Fla. Dist. Ct. App. 1987) (holding that a "bona fide assignee for value" of non-negotiable life insurance policies takes free of latent third-party equities of which the assignee lacks notice); *King Bros. & Co. v. Cent. of Ga. Ry. Co.*, 69 S.E. 113 (Ga. 1910) (holding that the title of a bona fide purchaser to a chose in action is unaffected by latent equities of a third party); *Haynes v. Coles County*, 84 N.E. 747, 750 (Ill. 1908) ("The law is well settled that an assignee takes a nonnegotiable instrument subject to all the infirmities which exist against it in the hands of the assignor, excepting latent equities of third persons."); *Raymond v. Whitehouse*, 93 N.W. 292, 294 (Iowa 1903) ("The assignee of an ordinary judgment stands, as a rule, in no better position than his assignor. . . . But . . . this rule does not obtain as to equities residing in third persons."); *Garland v. Plummer*, 72 Me. 397, 401-02 (Me. 1881) (applying rule shielding bona fide purchaser assignees from the latent equities between the assignor and a third party); *People's Banking Co. of Smithsburg v. Fid. & Deposit Co. of Md.*, 171 A. 345, 346 (Md. 1934) (adopting rule that "latent equities cannot prevail against the title of a second or subsequent assignee of a nonnegotiable chose in action, and that the assignee only takes subject to the equities in favor of

this rule into Section 510(c). *See Field v. Mans*, 516 U.S. 59, 71 & n.9 (1995) (stating that the Supreme Court construes terms in the Bankruptcy Code "to incorporate . . . the dominant consensus of common-law jurisdictions, rather than the law of any particular State").

The present case concerns the equities of third-party creditors harmed by Citibank's (and the other Banks') alleged misconduct. Enron has not alleged that the Assignee is anything other

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the debtor party" as the "preferable doctrine" to the theory that "the holder of a nonnegotiable chose in action cannot transfer anything but the beneficial interest he possesses"); *Sleeper v. Chapman*, 121 Mass. 404, 408 (Mass. 1876) (holding that a mortgage that is "given to hinder, defeat and delay creditors" is not void in the hands of a bona fide purchaser as against a creditor who seeks to attach the mortgage); *Saginaw Fin. Corp. v. Detroit Lubricator Co.*, 240 N.W. 44, 45 (Mich. 1932) ("An assignment [to a bona fide purchaser] is not subject to latent equities not known to the assignee."); *Moffett v. Parker*, 73 N.W. 850, 851 (Minn. 1898) (stating "well settled" rule that the "assignee of a mere chose in action . . . takes it subject to the equities of the original parties thereto, but not as to any equities of third parties of which he has no notice"); *Duke v. Clark*, 58 Miss. 465, 474 (Miss. 1880) (stating that although the "assignee of a chose in action takes it subject to all the equities to which it was subject in the hands of the assignor," this rule applies to equities "in favor of the debtor, and not those claimed by a third person against the assignor"); *Williams v. Donnelly*, 74 N.W. 601, 605 (Neb. 1898) (applying the rule protecting good-faith purchasers for value from the latent equities between the assignor and a third party and noting that "the weight of authority is favorable to" it); *Rose v. Rein*, 172 A. 510, 511-12 (N.J. 1934) (holding that a bona fide assignee of a chose in action "took it free from all latent equities existing in favor of third parties against the mortgagor"); *Bourquin v. Feland*, 117 P.2d 789, 791 (Okla. 1941) ("The weight of authority is that an assignee of a chose in action who takes without notice of latent equities of third parties acquired priority over such equities."); *Akin v. Sec. Sav. & Trust Co.*, 68 P.2d 1047, 1051 (Or. 1937) (applying "well-established legal proposition that a bona fide assignee for value of a tangible chose in action . . . takes it free and clear" of "latent equities in a third party"); *Cancilla v. Bondy*, 44 A.2d 586, 588 (Pa. 1945) ("A bona fide purchaser from a fraudulent grantee is protected against the equities of third persons not arising out of the instrument."); *Madson v. Ballou*, 260 N.W. 831, 832 (S.D. 1935) ("[T]he law does not require that the assignee for value of a thing in action take it subject to the latent equities of third persons of which he has no notice; he takes subject to all equities existing in favor of the debtor."); *Congregational Church Bldg. Soc'y v. Scandinavian Free Church of Tacoma*, 64 P. 750, 751 (Wash. 1901) (adopting the rule shielding a good-faith assignee that purchased for value from the latent equities between the assignor and a third party and noting that "the great weight of authority is opposed to" extending liability beyond the equities existing between a mortgagor and mortgagee); *Citizens State Bank of Sheboygan v. City of Sheboygan*, 224 N.W. 720, 726 (Wis. 1929) ("According to the weight of authority an assignee who takes without notice of latent equities in favor of third persons acquires priority over such equities." (quoting 5 C.J. 974)); *First Nat'l Bank of Green River v. Ennis*, 14 P.2d 201, 206 (Wyo. 1932) (same).

than an innocent buyer who purchased the Claims without notice of the alleged wrongdoing. Thus, the rule mandates that the Assignee took the Claims free of the equitable subordination "taint."

The bankruptcy court's counterweight to these authorities is flimsy—and indeed supports the rule that a purchaser takes free of "latent equities" of third persons. *Goldie v. Cox*, on which the court relied for the proposition that "[a]n assignee [is] . . . subject to all equities against the assignor," 130 F.2d at 720, is inapposite. *Goldie* concerned a gratuitous assignment, not a purchase, and thus the rule barring the assertion of latent equities of third parties did not apply. *See id.* The bankruptcy court, however, overlooked that distinction. The remaining circuit court cases the bankruptcy court cited do not even address assignors with latent equities and are thus beside the point. (*See* Op. at 28 (citing *Citibank, N.A. v. Tele/Resources, Inc.*, 724 F.2d 266 (2d Cir. 1983); *Carnegia v. Ga. Higher Educ. Assistance Corp.*, 691 F.2d 482 (11th Cir. 1982); *In re Dorr Pump & Mfg. Co.*, 125 F.2d 610 (7th Cir. 1942)).)

The bankruptcy court sought to bolster its analysis by insisting that "[t]here is no basis to find or infer that transferees should enjoy greater rights than the transferor." (Op. at 28.) The Supreme Court of Pennsylvania addressed exactly this point and found it inapplicable in these situations:

> It is not easy to see how an assignee can take an interest superior to that which the assignor had to give . . . . Is not an equity in a third person as much a defect in title as if it existed in the obligor? Yet it has not been so treated.

Peele's Appeal, 3 Walk. 255, 259-60 (Pa. 1881). The court then found that a blatantly fraudulent transaction had occurred but that the rights of the defrauded plaintiff could not trump the rights of the assignee (who had no notice of the fraud). *Id.*; *see also United States v. Detroit Timber & Lumber Co.*, 200 U.S. 321, 336 (1906) ("The equity . . . upholds the purchaser in his honest

purchase . . . . Equity sustains the title in spite of the fact that his grantor may have wrongfully obtained it, and upholds it because of his rightful conduct.").

Although the bankruptcy court purported to apply equitable principles, it in fact applied the wrong equitable principle—an error that caused it to reach the wrong result.

CONCLUSION

For the foregoing reasons, the bankruptcy court's decisions should be reversed.

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