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**UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK**

In re

ENRON CORP., et al.,

Reorganized Debtors.

SPRINGFIELD ASSOCIATES, LLC,

Appellant,

v.

ENRON CORP.,

Appellee.

X
: **Chapter 11**
: **Case No. 01-16034 (AJG)**
:
: **Jointly Administered**
:
X
: **District Court**
: **Case No. 06-07828 (SAS)**
:
:
:
:
:
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X

REPLY 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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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 reply brief of *amici curiae* in support of Appellants.

PRELIMINARY STATEMENT¹

In its Opening Brief, *amici* showed how the bankruptcy court’s new rule will disrupt the post-bankruptcy markets for trading bank debt, bond debt, and derivatives. Indeed, in at least two recent cases, that disruption—all of which would be avoided entirely by the proper application of longstanding principles of equity—has already begun.

In response, Enron and its amici² prove unable to defend the bankruptcy court’s judgment with sound reasoning and instead offer various *theories* of bankruptcy law that would represent a sharp departure from existing law. While the Intervenor Bank Citibank N.A. (“Citibank”) addresses many of those deficiencies in its reply brief, *amici* herein counters Enron’s and the Enron-Amici’s misunderstanding of the workings of the financial markets and of controlling equitable principles.

Beyond all of that, at bottom, this is a case about allocation of risk: what is the proper allocation as between two innocent parties of the risk that the seller of a bankruptcy claim did something (engaged in conduct warranting equitable subordination of its claims) or did not do

¹ Capitalized terms not defined herein shall have the meaning set forth in the 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 (the “Opening Brief”), filed with the Court on March 12, 2007 as Exhibit A to *amici*’s motion for leave to participate.

² Three proposed amici filed briefs in support of Enron; only the Brief of Amici Curiae Abrams Capital, LLC, Blavin & Company, Inc., And Citadel Investment Group, L.L.C. In Support Of Appellee And Affirmance Of The Bankruptcy Court’s Order’s (“Enron-Amici” and the “Enron-Amici Br.”) requires specific response. Enron’s brief is cited herein as “Enron Br.”

something (failed to return avoidable transfers) that, in either case, would render the claim essentially worthless if the seller still held it? The buyer wishes to collect the distribution otherwise due, and thus believes that it takes the claim free and clear of any risk of loss attributable to the seller. The debtor's other creditors, by contrast, want to deny any distribution on the claim until and unless the seller makes them whole through other remedies, and thus want to impose the risk of loss upon the buyer. This case turns on the proper allocation of that risk of loss as between those two parties.

In answering this risk-allocation question, one must recognize that the debtor's creditors (represented by a bankruptcy trustee, debtor in possession, or other estate representative) have powerful, readily-available legal remedies to recover in full *directly* against the seller. Even if they cannot assert supplemental remedies that deny distribution on the claim to the buyer, they nevertheless retain their primary legal actions against the seller to obtain a full recovery. And the resources consumed in that pursuit are fairly spread among all interested parties. Simply put, the estate representative takes on the responsibility of collecting on behalf of creditors, and the expenses of those actions are borne by the creditors collectively.

In stark contrast, if the claim buyer does not receive the distribution otherwise due with respect to its claim, then it would have, at best, a rarely used, contingent indemnity action to collect an uncertain, perhaps insufficient, sum from the seller. And in many cases, such as in the market for public bonds, the buyer does not hold any rights of indemnity against the seller (whose identity is typically unknown to it), and thus would have *no remedy whatsoever*. Even if it were to hold nominal indemnity rights, the buyer still must incur the time and expense of complex litigation to recover something on its bankruptcy claim—and cannot spread that expense amongst a large group.

In shifting the risk of the seller's bad conduct to the buyer (and its transferee and others down the chain of title), the bankruptcy court fashioned a new rule that not only ignores longstanding equitable principles, but also reallocates risk to innocent buyers of a magnitude never before seen in the markets. It made a policy choice—it stated so explicitly³—and reached the wrong result. It elevated above all else the estate representative's ability to use supplemental, and often wholly redundant, legal remedies, and in the process casually discarded the interest of the sound functioning of the markets.

Whatever Enron and the Enron-Amici might say, the market participants in post-bankruptcy trading in bank and bond debt have *always* understood that the entire creditor body should bear the risk of loss in this circumstance; it should not be foisted upon a single claim buyer (as well as that buyer's downstream transferees) against whom there are no allegations of wrongdoing and who did not receive an avoidable transfer. Thus, the buyer of a bankruptcy claim—at least up until the bankruptcy court's decision—took free of those unknown (and often unknowable) risks. And that principle makes sense, as it permits a liquid market for the trading of post-bankruptcy claims without the need for potential purchasers to conduct extensive and impractical pre-transfer due diligence of the seller or to worry about waves of post-loss litigation. Moreover, the principle is a longstanding one, grounded in historic and long-standing principles of equity—as a case from over one hundred years ago makes clear. *See Charles Rettig & Son v. Becker*, 11 Pa. Super. 395 (1899).

Tellingly, the Enron-Amici are willing *partially* to recognize this principle, acknowledging that buyers of bankruptcy claims involving *bonds* take free of the risk of loss attributable to the seller. As presumably sophisticated market participants, they know that the

³ *See Op.* at 33.

bankruptcy court's new rule would cause profound disruption in the bond market. Nevertheless, they assert that buyers of *bank debt* should be treated differently without offering any principled basis to support their position that the correct principle should be limited to the bond market.

The Enron-Amici—really putative intervenors who think they will enjoy significant economic upside if Enron wins this appeal—want to make money on their Enron claims, so they have come up with whatever they can muster to win an affirmance. But the mere fact that the Enron-Amici themselves recognize fatal flaws in the bankruptcy court's conclusions highlights that the bankruptcy court was creating new, radically different, rules for the markets. And those new rules fail to appreciate a simple point: Markets cannot function if buyers of claims must now bear the risk of loss for something that they cannot price and, for all practical purposes, cannot protect against.

ARGUMENT

I. ENRON AND THE ENRON-AMICI FAIL TO UNDERSTAND THE SEVERE DISRUPTION THAT THE BANKRUPTCY COURT'S OPINIONS HAVE INFLICTED AND, IF ALLOWED TO STAND, WILL CONTINUE TO INFLICT ON THE POSTPETITION CLAIMS-TRADING MARKET.

A. The Boilerplate Indemnities Do Not Solve the Market Problem.

Enron and the Enron-Amici rely heavily on boilerplate indemnity language in standard LSTA post-bankruptcy bank debt trade documentation. (*See* Enron Br. at 3, 47; Enron-Amici Br. at 12-16, 48.) That language purports to provide an indemnity right to the buyer if the purchased claim is equitably subordinated or disallowed. The Enron-Amici contend that such an indemnity provides the buyer with an easy and satisfactory remedy, and maintain that the availability of such a remedy renders the buyer's concerns (and concerns for the market as a whole) illusory. (*See* Enron-Amici Br. at 15.) Further, they claim that the mere inclusion of such an indemnity in the sale document shows that traders of bank debt always knew that, as

between the buyer and the debtor's other creditors, the buyer bore the risk of loss. (Enron-Amici Br. at 14.) That position, however, betrays a fundamental misunderstanding of the markets for trading post-bankruptcy claims.

First, sophisticated financial institutions—those that provide the necessary liquidity in the market—have no interest in buying a claim that must be collected through a lawsuit against the seller. Thus, in light of the bankruptcy court's new rule, the market for post-bankruptcy claims—whether or not accompanied by an indemnity—now dries up when even vague rumors of an equitable subordination or a disallowance risk appear. (See Part I. C, *infra* (discussing Refco and Le-Nature).) Those market participants understand the gross inefficiencies, if not impracticality, attendant to time-consuming, expensive, and uncertain litigation against previous holders as a means of recovery.

Second, market participants often buy post-bankruptcy claims with a view towards selling them at an opportune time—not with a view of holding them for the duration of the case. When the market for post-bankruptcy claims is destroyed by rumors of equitable subordination or disallowance, those participants find themselves in the unwanted position of holding illiquid claims. But the fact that no one will buy the claims until an ultimate determination is made as to whether subordination or disallowance is appropriate does not necessarily mean that they have suffered a loss that triggers any indemnity in their purchase documents. Thus, holders that intended to own these post-bankruptcy claims for only a short term (a typical expectation in fluid, efficient markets) could find themselves forced into holding for an extended period, without any contemporaneous right to recover on their indemnities.

Third, Enron and the Enron-Amici assume that the indemnity claim upon which they place such great weight will always make the innocent buyer whole. Yet they do not point to a

single instance (a reported decision or otherwise) in which an innocent buyer that was denied recovery against the debtor's estate successfully sued its seller on the indemnity. Indeed, David Abrams, the declarant tendered by the Enron-Amici, submits that he has “been trading distressed debt since 1984”—over 20 years—and yet he provides *not one example* of a successful suit by a buyer against its seller. (*See generally* Abrams Decl.)

Moreover, Mr. Abrams' sworn statement recognizes that the bankruptcy court's new rule contemplates the prospect of not simply a single lawsuit by the buyer against the culpable seller, but, when multiple assignments have taken place, potential waves of litigation up the chain of title until the risk of loss finds its way to the original seller.⁴ Neither Mr. Abrams nor anyone else has ever suggested that such a daisy chain of lawsuits has ever occurred—not even once. The inconsistency in their argument is immediately apparent. Despite insisting that the market for trading post-bankruptcy has always relied on recovery through a stream of indemnity lawsuits, they cannot identify a single case where that actually took place. Far from bolstering their argument, they have in fact shown the opposite to be true: The bankruptcy court has imposed a new rule upon the markets never before seen, whether the litigation is pursued by a buyer against its seller or otherwise—and it has done so in complete disregard for the damage it will do, particularly considering that the number of potential lawsuits is as numerous as the number of end buyers holding claims, whether ten buyers with \$10 claims or one-hundred buyers each with a \$1 claim.

Fourth, Mr. Abrams recognizes that the LSTA form, with its included indemnity provision, is not universally used in all post-bankruptcy trades of bank debt. (Abrams Decl.,

⁴ Abrams Decl., ¶17 (“Moreover, where such a claim has gone through a number of assignments subsequent to a bankruptcy filing, the result of each purchaser having indemnity rights against its seller is that the risk of loss will ultimately be put back to the original holder.”).

¶16.) Indeed, while Mr. Abrams claims that his firm “ordinarily” requires those indemnities, he does not attest that those indemnities always exist in all his trades, much less those of all market participants. (*Id.*) And if Enron and the Enron-Amici want the courts to force market participants to rely on those indemnities, then one would expect that they would have made some effort to show that, as an economic matter, the buyer would be made whole. That is, they should show that the buyer does not simply get its money back (rescission damages), but rather would receive whatever distribution it would have received from the estate (expectation damages), and would show that result for any intermediate blameless transferee in the chain of title as well. But those damage calculations turn on the specific language of a given indemnity—in fact, in documentation for the sale of bank debt in the “par market,” no such indemnities exist—and one cannot summarily conclude that they will function as Enron and the Enron-Amici envision. In sum, there are serious deficiencies in Enron’s and the Enron-Amici’s claim that indemnification suits by the innocent buyer against the seller will provide the solution the market requires.

Finally, Congress did not enact the underlying statutes based on an understanding that an elaborate chain of indemnities would protect the innocent purchaser and other downstream innocent transferees. Indeed, when Congress enacted sections 502(d) and 510(c), there was no system of contractual indemnifications in place, as the LSTA did not promulgate its forms until some years later. And nowhere in the legislative history does any mention appear of a future development of a system of indemnifications. Thus, not only do the indemnities not provide the protection that Enron and the Enron-Amici assert, but also Congress never contemplated that those indemnities were to function in such a role.

B. Enron and the Enron-Amici Confuse Market Participants' Ability To Price Credit Risk With Their Ability To Price Counter-Party Risk.

Enron and the Enron-Amici allege that common due diligence will permit the claim buyer to properly account for the risk that its purchased claim may be equitably subordinated or disallowed because of the conduct of the seller. They view this as just another risk attendant to buying distressed debt. In purported support of their point, they include equitable subordination and disallowance in lists with other risks associated with non-payment by the issuer of the debt. (*See* Enron Br. at 9, 48; Enron-Amici Br. at 46; Abrams Decl., ¶9.) But this approach erroneously conflates market participants' ability to conduct due diligence and price credit-risk in the distressed debt market (that is, the risk that the issuer of the debt cannot pay) with their ability to conduct due diligence and 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).

Mr. Abrams, the 20-year veteran of distressed debt trading, nowhere explains how a purchaser of bank debt might go about conducting an exhaustive investigation of the possibility that the seller engaged in unrelated bad acts or received an avoidable transfer that it has not returned. And nowhere does he claim ever to have himself engaged in such due diligence, even for entities that sold him bankruptcy claims directly, much less for those remote transferors up the chain of title. While it is easy baldly to claim that such due diligence and price discounting should simply be part of the process, neither the bankruptcy court below, nor Enron, the Enron-Amici, nor Mr. Abrams ever discusses how it could be done, the costs of doing it, or whether they have ever even seen such activity in the past.

A simple example proves the point. Assume that buyer has purchased \$100 of claims from seller, who had itself purchased the claims postpetition from an intermediate holder. Assume also that that intermediate holder had purchased the claims postpetition in two different

tranches—\$50 from an innocent bank and \$50 from a bank that was involved in alleged misconduct. Under the Enron-Amici’s theory, the former \$50 would be a “good claim,” while the latter would be equitably subordinated based upon the other bank’s misconduct. That result—whereby two otherwise identical claims purchased from the same seller are treated differently—makes no sense.

To avoid that result, the buyer would be charged with performing due diligence on not only the seller, but also the intermediate holder, the innocent bank, and the bank involved in misconduct. And that due diligence would involve not only misconduct related to the claim, but also *any* misconduct that the previous holders may have engaged in and any receipt of an avoidable transfer. That would mean that a claim buyer must investigate all relationships that each previous holder may have had with the debtor, a truly impossible task.

Even if a claim buyer had the time and resources to attempt such due diligence, nothing suggests that the intermediate transferee or those further up the chain of title would be willing to respond to such expansive due diligence requests. Rather, one would expect market players to be quite reluctant to provide detailed information on their various relationships with the debtor. (Mr. Abrams, for example, does not state that his internal records are now freely available to all who might hold an instrument he once held.) Finally, assuming such an investigation could ever be performed, it does not provide a defense to equitable subordination or section 502(d) disallowance, as the bankruptcy court has enacted a strict liability rule.

Enron’s response to all this is telling. “If [the buyers] do not like their chances or are unwilling to rely on the indemnity, they need not purchase the claim.” (Enron Br. at 48.) In other words, anyone who cannot price the risk and does not wish to rely on untested indemnity rights—which is everyone—should just stay out of the market. But reallocating that risk to

buyers, and thus driving them from the market if they do not wish to assume it, is not the province of the bankruptcy court.

C. The Le-Nature's and Refco Situations Illustrate the Market Impact.

The Enron-Amici and Mr. Abrams attempt to avoid the obvious conclusions about market impact to be drawn from the Refco and Le-Nature's bankruptcies. But because they cannot offer any cogent response (since none exists), they try to attack the causal connection between the bankruptcy court's rulings and the market disruptions in each of those credits. They also seemingly ignore some critical facts.⁵

With regard to Refco, the Enron-Amici and Mr. Abrams claim that the tumult in the trading of Refco debt was not tied to the bankruptcy court's decisions. (Enron-Amici at 44-45; Abrams Decl. at ¶¶9-10.) In fact, the Refco trading history shows the opposite.

Elliot Ganz, the general counsel of the LSTA and who has been involved with the postpetition claims trading markets for over 20 years, has examined the trading in Refco debt. When rumors of BAWAG's bad acts first appeared, the bankruptcy court had not yet issued the first of its two opinions. Of critical importance, at that time, Refco debt that had been held by BAWAG *continued to trade*.

On November 17, 2005, the bankruptcy court issued the first of its opinions. Based on trading reports, Mr. Ganz determined (as anyone who had access to such information would

⁵ Enron, for its part, objects to the declaration submitted by *amici* that speaks to the upset in the markets arising from the bankruptcy court's decisions. (Enron Br. at 47 n.26.) Yet Enron has also complained when allegations of market turmoil were not supported by sworn statements. (See Enron's Memorandum of Law in Opposition to Defendant's Motions for Leave to Appeal From the Bankruptcy Court's Decisions Concerning Equitable Subordination of Transferred Claims, *In re Enron Corp., et al.*, No. 05-01029 (Bankr. S.D.N.Y. February 28, 2005).) Apparently, rather than address them on the merits, Enron wishes to view concerns about the market impact solely as evidentiary issues.

surely conclude) that the trading in Refco debt all but ceased soon after that date. While those facts certainly more than support the inference, market players confirmed to Mr. Ganz that this freezing-up of the market occurred because of the bankruptcy court's opinions and the attendant confusion and uncertainty it had evoked in market participants. The Enron-Amici and Mr. Abrams are simply factually incorrect in their assertions to the contrary.

With regard to the Le-Nature's case, the Enron-Amici and Mr. Abrams seem to miss the point. In that case, rumors circulated that Wachovia, one of the debtor's lenders, had been involved in alleged prepetition misconduct. The market then reacted in a way never before seen. Trading of Le-Nature's bank debt that Wachovia held prepetition in the secondary market essentially came to a halt, while non-Wachovia-tainted debt continued to trade. Thus, the trading in a single issuance literally bifurcated between "good" and "tainted" debt. *Amici* are not aware of that ever happening in the markets before then.

In addition, the trading in the Le-Nature's case shows that the market did not interpret the bankruptcy court's decisions to support the rule advocated by Enron. Of critical importance, the "tainted" Le-Nature's bank debt was touched by Wachovia prepetition, but it was *not* held by Wachovia on Le-Nature's petition date. Thus, the market did not believe that a claim is "fixed as of the petition date," as Enron and the Enron-Amici claim, because the market was worrying that a "Wachovia taint" might have been imprinted on the claims pre-petition, even though a good faith purchaser held the claims on the petition date. Thus, not only is that market reaction inconsistent with Enron's "petition-date" theory, but also it shows that the bankruptcy court's opinions are presenting problems never before seen in the market, leading to nothing but confusion.

In addition, the Le-Nature's case shows the fallacy of the idea that indemnities will protect innocent purchasers. Much of the Le-Nature debt traded prepetition on "par documents" that do not contain indemnities. Thus, when innocent purchasers got stuck holding the Wachovia-tainted debt, they had no recourse against their respective sellers.

D. Fixing Claims on the Petition Date Invites Claims Washing

Enron and the Enron-Amici attempt to discredit Citibank's arguments by raising a concern about "claims washing." (Enron Br. at 7, 9, 26-27, 45-46; Enron-Amici Br. at 37-38.) Nothing in the facts of this case, however, raises even a specter of claims washing. Indeed, Mr. Abrams never even suggests that he has ever seen or heard about market players looking for opportunities to "wash" claims. Nevertheless, assuming claims washing were an issue of any concern, Enron's proposed rule of fixing claims on the petition date would invite precisely the "claims washing" that Enron's statutory interpretation purports to cure.

Enron and the Enron-Amici argue that claims are fixed on the petition date. (Enron Br. at 13-17; Enron-Amici Br. at 23-25.) But if that were the law, bad actors (who presumably know a great deal about not only their own misconduct, but also the debtor's impending bankruptcy) would sell their claims before the petition date, and truly have washed the claims of any taint. And the buyer of that claim would likely have no indemnities because, even with regard to trading of bank debt, no indemnities exist in "par documents." Moreover, postpetition, those same bad actors could buy claims from innocent holders, and the claims would not be subject to equitable subordination in their hands, a truly inequitable result. Enron's and the Enron-Amici's construct not only proves unworkable, but also does not prevent the very conduct that they find troubling.

II. THE ENRON-AMICI ADMIT THAT THE PRINCIPLE ADVANCED BY *AMICI* MUST APPLY TO THE BOND MARKET YET OFFER NO PRINCIPLED REASON WHY IT SHOULD NOT APPLY HERE.

In its Opening Brief, *amici* raised the concern that the plain logic of the bankruptcy court's reasoning would require that the new rule it announced to apply equally to the bond market. The bankruptcy court stated: "[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's new rule wholly ignores the realities of the bond market, in which trades are anonymous. Thus, even if it had the time and budget to do so, the buyer of a post-bankruptcy bond claim cannot, even theoretically, perform any due diligence on the seller, much less previous transferors, and thus cannot price the risk that the seller engaged in conduct warranting equitable subordination or failed to return avoidable transfers.

In response, the Enron-Amici *agree* that the bankruptcy court reached the wrong conclusion regarding the bond market. (Enron-Amici Br. at 16 n.5.) They implicitly acknowledge—as any market participant must—that the bond market does not and cannot function as the bankruptcy court envisions. The notion that the Enron-Amici—comprised of entities that believe they will reap significant economic gain if the bankruptcy court is upheld—would voluntarily file papers that assert errors in the bankruptcy court's new rule speaks volumes.

In an attempt to right the ship, the Enron-Amici offer the following rule for the bond market: "a 'purchaser for value' of a 'security' who takes that security 'without notice of the particular defense' ... takes free of unknown claims and defenses," which presumably includes equitable subordination or disallowance under section 502(d) that would otherwise be effective against the seller. (Enron-Amici Br. at 16-17.) That, of course, is the same fundamental principle that *amici* identified in its Opening Brief. But, relying on the Uniform Commercial

Code (the “UCC”) for the legal embodiment of that rule, the Enron-Amici claim that the rule applies to trading only in public bonds, not bank debt, because only public bonds fall within the UCC’s definition of a “security.” Not only is that limitation flawed, but also it exposes glaring inconsistencies in Enron’s and the Enron-Amici’s arguments.

First, the New York Court of Appeals last month held that debt evidenced by a promissory note is a “security” under the New York UCC. *Highland Capital Mgmt. LP v. Schneider*, 2007 WL 966746 (N.Y.), 2007 N.Y. Slip Op. 02791 (N.Y. April 3, 2007). Given that holding, the New York courts could easily conclude that syndicated bank debt (also evidenced by a promissory note) likewise satisfies the definition of a “security.” So, if the Enron-Amici are correct in stating that the New York Uniform Commercial Code provides protection for innocent purchasers of a “security,” then that protection could very well extend to innocent purchasers of bank debt. Under the Enron-Amici’s very own legal analysis, purchasers of bank debt would then take free of any risk of loss based on the seller’s conduct.

Second, while the Enron-Amici are surely right to recognize that purchasers of bonds must take free of equitable subordination and section 502(d) disallowance risks, their analysis that relies solely on the UCC proves tortured. On the one hand, section 510(c) of the Bankruptcy Code looks to “principles of equitable subordination” for direction. State statutes that turn on technical definitions of the term “security” do not in any way purport to codify “principles of equitable subordination.” On the other hand, the applicability of section 502(d), as a federal statute, does not turn on whether a state statute immunizes (or does not immunize) a category of claims.

Third, the Enron-Amici argue that the UCC provides protection for buyers of securities who take “without notice of a particular defense.” (Enron-Amici Br. at 16.) In advancing this

proposition to protect good faith, post-bankruptcy bond purchasers, the Enron-Amici necessarily recognize—as *amici* have argued all along—that financial distress that leads to bankruptcy does *not* put the world on notice that a given creditor engaged in misconduct or has failed to repay an avoidable transfer. (See Part III *infra*.) Otherwise, the Enron-Amici’s UCC argument would collapse upon itself. But that proposition must apply equally to post-bankruptcy purchasers of bank debt; there are no grounds for maintaining that notice is adequate in one instance but not the other. Nevertheless, seemingly oblivious to the patent inconsistency in their argument, the Enron-Amici argue that purchasers of bank debt somehow are automatically on notice of the risks of equitable subordination or section 502(d) disallowance merely because the debtor has filed bankruptcy. (Enron-Amici Br. at 22; *see also* Enron Br. at 39-40.) Again, they do nothing to defend this *ad hoc* distinction.

At the end of the day, the Enron-Amici’s analysis falls flat. They know that the bankruptcy court’s new rule simply would be unworkable in the bond market. But they do not want to concede that the correct principle (the very one they advocate for the bond market) applies here, for fear of losing their perceived substantial economic recovery. So they have invented a legally incorrect, logically inconsistent argument to reach their desired result. And, quite ironically, they claim that participants in the distressed debt market must have known that this jerry-rigged construct has always been the law unless they “lived in a cave without access to a hornbook on assignment law.” (Enron-Amici Br. at 5.) Apparently, those living “in a cave” consist of, among others, all the commentators and practicing lawyers that wrote about the

significant impact of the bankruptcy court's decisions, including Enron's very own bankruptcy counsel, Weil, Gotschal and Manages LLP.⁶

III. THE PRINCIPLE CONCERNING LATENT EQUITIES OF THIRD PARTIES APPLIES HERE.

Enron and the Enron-Amici continually rely on the proposition that an assignee cannot take more than the assignor has to give. (Enron Br. at 32–41; Enron-Amici Br. at 9–23.) But that principle has limits and, of critical importance, simply does not apply to the situation here. A good faith buyer (the Assignee) without notice of any wrongdoing takes the property (claims against Enron) free from the latent equities of third parties (Enron's creditors). *See 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).⁷

Enron and the Enron-Amici attempt some rudimentary attacks on this principle. Each fails in light of not only controlling Supreme Court and Second Circuit precedent, but also simple logic.

⁶ See Rachel Ehrlich Albanese, *Assignment of Claims Does Not Prevent Equitable Subordination Attack*, WEIL, GOTSHAL & MANGES LLP BANKR. BULL., Feb. 2006, available at <http://www.weil.com> (following "Resources" hyperlink, then follow "Bankruptcy Bulletin" "Archive" and "February 2006" hyperlinks) (last visited May 10, 2007). *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=wgmcwgmcpubs.nsf&d=D349D129A366792D852570D20058F893&v=Bankruptcy&f=a200512> (last visited May 10, 2007).

⁷ Under the "shelter rule", the good faith purchaser's good title, of course, would shield all future purchasers, whether or not they knew of any third-party equities.

Enron and the Enron-Amici first claim that the proffered principle concerning latent equities of third parties is not followed in every state. (Enron Br. at 40; Enron-Amici Br. at 20.) The Supreme Court has stated, however, that when a federal court must incorporate a proposition developed by the states—such as principles of equity as referenced in section 510(c)—it should choose “the dominant consensus of common-law jurisdictions, rather than the law of any particular State.” *See Field v. Mans*, 516 U.S. 59, 71 & n.9 (1995). Here, *amici* have identified twenty-two states (along with several Restatements and other secondary sources) that have adopted the equitable principle that good faith purchasers take free of latent equities of third parties. (Opening Brief at 33–35.) In response, Enron and the Enron-Amici have identified only five (which includes two territories, Dakota and Montana, before they became states). (Enron Br. At 40; Enron-Amici Br. at 20 n.7.) A tally of 22–5 leaves no doubt as to which principle is “dominant”.⁸

Enron and the Enron-Amici next try to claim that the issue here does not concern third-party rights since Enron, as debtor in possession, is asserting the causes of action. (Enron Br. at 39; Enron-Amici Br. at 21.) But that reasoning wholly fails to acknowledge that, as debtor in possession, Enron “act[s] as a representative of the creditor, not the debtor.” *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)). Indeed, a debtor acting for itself, without the powers of a

⁸ Enron and the Enron-Amici seek to distinguish *amici*’s cases by asserting that many of the cases deal with property rights. (Enron Br. at 20; Enron-Amici Br. at 21.) That position makes no sense. As Mr. Abrams’s sworn statement acknowledges, assignment law concerns the transfer of property rights. (Abrams at ¶8.) Whether the cited cases discuss a third party’s rights to, on the one hand, take ownership of the property, or, on the other hand, simply take value from the property (such as when the claim is subordinated in favor of other claims) is a distinction without a difference. While the Enron-Amici seeks to create two distinct questions (Enron-Amici Br. at 21), the issue is singular: what rights does the buyer acquire when it purchases the property?

debtor in possession, has *no standing* to bring an equitable subordination action. *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)).

Filing a bankruptcy case has provided Enron with the procedural vehicle, as the representative of creditors, to bring the causes of action on behalf of those creditors against suspected wrongdoers. Bankruptcy, however, does not upset basic tenets of equitable principles with respect to those equitable proceedings. It would make no sense if, on the one hand, were the debtor's creditors to allege equitable subordination, a transferee could assert that it took free and clear of any equitable subordination "taint" based on the principle of latent equities of third parties.⁹ But, on the other hand, the transferee would be denied the right to invoke that principle when faced with the identical challenge from the debtor in possession, acting on behalf of those very same creditors.

Having losing arguments concerning the principle of latent equities of third parties and its applicability, Enron and the Enron-Amici next claim that a post-bankruptcy transferee cannot, as a matter of law, satisfy the "good faith" standard. (Enron Br. at 39–40; Enron-Amici Br. at 22.). That reasoning, however, confuses financial distress that leads to bankruptcy, on the one hand, with misconduct by creditors, on the other hand. Indeed, the Enron-Amici have already conceded this point, given their UCC argument. (*See* Part II, *supra*.)

⁹ 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).

Nevertheless, to support their flawed analysis, they cite cases that state that a bankruptcy filing puts a party on notice that a debtor might not pay its debts, or might seek to have preferential transfers returned to the estate. (*See* Enron Br. at 40; Enron-Amici Br. at 22.) Those cases make sense to the extent they equate bankruptcy with a prospective failure to pay a debt coming due. But it by no means follows that a bankruptcy filing puts a claim purchaser on notice that a given creditor engaged in misconduct or otherwise might bear some liability to the debtor's estate.

Finally, Enron and the Enron-Amici claim that the underlying policy of the latent equities principle would not be served by applying the principle here. They argue that, if the claims purchaser can speak with the debtor in possession or trustee to discover that a claim might lie against the seller, the rule protecting innocent purchasers from latent equities of third parties has no place. (Enron Br. at 38, Enron-Amici Br. at 21.) Once again, their argument reveals a fundamental misunderstanding.

The question is which of two innocent parties—the innocent buyer or the debtor's other creditors—should bear the risk of loss. If the potential buyer can go to the estate representative to learn that claims exist against the prospective seller, then the estate representative should solve its latent equities problem by putting the world on notice. It does that by taking advantage of a longstanding equitable principle, *pendente lite*: the filing of a lawsuit concerning property provides constructive notice of those claims to all potential purchasers of the subject property. *E.g., Whiting v. Beebe*, 12 Ark. 421, 1851 WL 462, *78 (Ark. 1851). If the estate representative files a complaint against the prospective purchaser alleging equitable subordination or section 502(d) disallowance, all the world then has notice of those risks. That is especially true given that today's bankruptcy court system uses electronic filing, allowing anybody with a internet

connection to access for a minimal fee any such complaint with ease. Thus, if such a complaint were filed, then no party could take free of the allegations set forth therein.

The estate representative can thus take action to protect itself. And the law gives it every incentive to do so. The estate should not, however, be rewarded by keeping its potential actions against a prospective seller secret, so that the innocent purchaser takes on a hidden risk of loss, for which no remedy may exist.

CONCLUSION

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

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Respectfully submitted,

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