RECENT DEVELOPMENTS IN CLAIMS TRADING

*Ronald L. Cohen and Laurie R. Binder**

INTRODUCTION

There were three important developments in the world of claims trading during the last 12 months. First, in May 2004, a decision by the United States Bankruptcy Court in the Southern District of New York utilized section 502(d) of the Bankruptcy Code to deny voting rights to claim transferees whose transferor had allegedly received avoidable prepetition transfers that made the transferred claims subject to disallowance.[1] Second, on October 7, 2004, the New York State Appellate Division reinstated a $54 million jury verdict against an indenture trustee that failed to make a prompt motion to lift the stay in the *Continental Airlines* bankruptcy case, despite the assertion that the plaintiff, in purchasing its bonds long after the loss accrued in order to sue the trustee for breach of duty, was guilty of champerty.[2] Finally, in an effort to promote uniform standards for the marketplace, in November 2004, the Loan Syndication and Trading Association (the "LSTA") and the Bond Market Association (the "BMA") jointly proposed a Model Securities Trading Order (the "MST Order") for consideration by the bankruptcy courts.[3] The MST Order puts sufficient trading restrictions in place to preserve for the estate of a chapter 11 debtor valuable net operating losses ("NOL") that may be available under the Internal Revenue Code but, at the same time, avoids unnecessary disruptions to trading markets.

Attorneys who regularly advise claims trading clients should be fully familiar with these developments, each of which has the potential to alter the dynamics and direction of claims trading in bankruptcy cases. In particular, the ongoing litigation against both transferees and transferors in the *Enron* case will significantly impact the fate of billions of dollars of

*Mr. Cohen has a B.A. magna cum laude from Yale University and a J.D. from Stanford Law School where he was a notes editor on the Law Review. Afterwards, he clerked for the Honorable Charles L. Brieant, United States District Judge for the Southern District of New York. He is currently head of the Bankruptcy Department at Seward & Kissel LLP in New York City.

Ms. Binder has a B.A. from the State University of New York at Buffalo and a J.D. from New York University School of Law. She is currently an associate at Seward & Kissel LLP in New York City.

claims in the hands of transferees and could ultimately lead to the disallowance of Enron claims purchased by many transferees, forcing the transferors to repurchase these claims under the representations and warranties typically provided in the assignment documents. At the same time as the *Enron* case expands debtors' rights against transferees, the analysis adopted by the New York Appellate Division's decision in *Bluebird* clarifies that transferees enjoy the same rights as their transferors to sue the indenture trustee, even where one of the primary purposes in purchasing the claims was to bring such a suit. Finally, the joint LSTA/BMA initiative for the MST Order promises to bring certainty and "best practices" to the notice and compliance problems that often plague the efforts of debtors, particularly at the beginning of a case, to preserve their NOLs.[4]

THE *ENRON* RULING

The Bankruptcy Code and Rules freely allow the transfer of claims. Indeed, Congress's intent in revising Bankruptcy Rule 3001(e) in 1991 was to make it clear that the bankruptcy court's role with respect to claims trading was to be extremely limited.[5] Nevertheless, Judge Gonzalez's recent ruling in the Enron chapter 11 case, if followed by other courts, will not only thrust the bankruptcy court into examining the relationship between the debtors, the transferor, and the transferee, but will also likely chill claims trading.

In *Enron*, Bankruptcy Judge Gonzalez was presented with a motion of certain transferees to temporarily allow their claims for voting purposes under Rule 3018 of the Federal Rules of Bankruptcy Procedure. The transferees, who had acquired over $1.6 billion in claims postpetition, were beneficial holders of claims against Enron Corp. ("Enron") and Enron North America ("ENA") in that they held notes issued by certain trusts that in turn held claims against ENA, as primary obligor, and Enron, as guarantor. At the time of the temporary allowance motion, the trusts were defendants in an adversary proceeding in which ENA and Enron had sued to recover, among other things, approximately $300 million allegedly paid as a preference to the transferor of the claims prior to the transfer. In its prayer for relief against the trusts, the debtors had objected to their claims asserting, among other things, that their claims should be disallowed under section 502(d) of the Bankruptcy Code. This objection precluded the claim transferees from voting on the plan and precipitated their temporary allowance motion.[6]

In a decision read into the record on May 24, 2004, the bankruptcy court denied the motion for temporary allowance, holding that under section 502(d) of the Code, the claims are subject to disallowance because of the alleged preference received by the transferor of the

claims, even though the claimants did not own the claims at the time of the alleged preference and did not receive any benefit from it. Section 502(d) of the Bankruptcy Code provides:

> [T]he court is to disallow any claim of any entity from which property is recoverable under Section 542 [turnover of property], 543 [turnover of property by a custodian], 550 [recovery from certain transferees] or 553 [setoff] of this title or that is a transferee of a transfer avoidable under sections 522(f) [liens avoidable that impair exemptions], 522(h) [setoff or transfer of exempt property], 544 [state fraudulent conveyances], 545 [avoidance of certain statutory liens], 547 [avoidance of preferential transfers], 548 [fraudulent transfers], 549 [unauthorized postpetition transfers] or 724(a) [avoidance of liens securing a fine or penalty] of this title, unless such entity or transferee has paid the amount, or turned over any such property, for which such entity of transferee is liable under section 522(i), 542, 543, 550, or 554 of this title.[7]

The *Enron* court held that the transferees took the claims subject to all of the section 502(d) objections and that the claims should be treated "as in the hands of the entity that held such claims on the day of the [bankruptcy] filing,"[8] which in this case was the transferor. The court also noted that although the transferor was accused in the adversary proceeding of engaging in serious misconduct for which the debtors sought damages as well as disallowance and equitable subordination of any claims, the transferees had not sought to refute any of these allegations against the transferor. Even recognizing that the transferees may not have refuted the debtors' claims so as to leave open their ability to pursue a recovery from the transferor, the court held that the "equitable considerations of a transferee of such claims appear to be irrelevant."[9] Based on this analysis, the court refused to temporarily allow the claims for voting purposes.

In its decision giving a broad reach to section 502(d), the *Enron* court relied heavily on *In Re Metiom.*[10] In *Metiom*, Bankruptcy Judge Drain held that the plain language of section 502(d) provides that the claim itself is to be disallowed so long as property is recoverable from the transferor, no matter who is currently holding the claim.[11] It is the claim that has been tainted and that taint follows the claim. The *Metiom* court held that permitting an assignment to destroy a claim defense under section 502(d) would be a "pernicious result."[12] Judge Drain advised potential claims assignees that it is "incumbent on . . . [them] to take into account possible claim defenses when they negotiate the terms of their assignments."[13] Although the *Enron* and *Metiom* decisions conflict with decisions that hold that section 502(d) applies only to claims in the hands of a claimholder from whom the debtor was entitled to recover the avoid-

able transfer, neither *Enron* nor *Metiom* reconciled those conflicting decisions or Congress's legislative intent in enacting section 502(d).[14]

The *Enron* and *Metiom* cases have potentially changed the claims trading landscape. Indeed, following Judge Gonzalez's decision, Enron initiated a number of adversary proceedings against claim transferees to disallow or subordinate their claims where their transferors had owned the claim on the day Enron filed for bankruptcy and had allegedly received avoidable transfers.[15] If followed by other courts, a transferee of a claim would now take that claim subject to a multitude of a potential prepetition transactions that, through no fault of the transferee, can cause the claim's disallowance.[16] As a result, the level of due diligence that a potential transferee must undertake will dramatically increase, and still, given the multiple reasons for which a claim can be disallowed under section 502(d), a transferee may never be assured that the claim will be free from disallowance under that section. Standard claims trading documentation must be altered to take into account the consequences of a possible section 502(d) action seeking to disallow the claim, including clearly stating which party is responsible if the claim is ultimately disallowed and for the costs of defending such challenges. To the extent there is doubt whether a transferor can perform its defense or buyback obligations, purchasers may want to consider obtaining collateral or holding back some portion of the purchase price if a claim challenge is reasonably foreseeable. At the very least, the representations and warranties in the transfer agreement must be absolutely clear so as to require repurchase of the claim and return of the amount paid, with interest, if the court disallows the claim under section 502(d).

THE *BLUEBIRD* DECISION

While the *Enron* court attributes the transferors' burdens to transferees, reducing the rights of transferees against a debtor's estate, the *Bluebird* decision makes available to transferees causes of actions against indenture trustees and presumably other third parties that originally accrued to the transferor, while narrowly construing the champerty defense traditionally asserted against claims purchasers.

In *Bluebird*, the Appellate Division, First Department, of the New York State Supreme Court unanimously reinstated a $54 million jury award against First Fidelity Bank, N.A., in favor of Bluebird Partners, L.P.[17] A motion for leave to appeal was filed with the New York Court of Appeals on March 14, 2005 and was dimissed on the ground that the orders sought to be appealed from do not finally determine the action. This litigation, brought by a purchaser of secured debt issued by Continental Airlines, challenged the alleged failure of an indenture trustee to protect the rights of bondholders during the Continental chapter 11 case. The

plaintiff in *Bluebird* had purchased its bonds long after the bankruptcy petition had been filed. The plaintiff's principal allegation against the indenture trustee was that the trustee had acted imprudently after the bankruptcy filing by failing to make a prompt motion to lift the automatic stay to foreclose on its security interest in Continental's airplanes, engines, and spare parts, even though the trustee had brought a motion for adequate protection. A lift-stay motion would likely have required Continental to protect the bondholders from a decline in the value of their interest due to the imposition of the automatic stay. The plaintiff maintained that there would have been a pledge of new value or cash payments to the trustee as a condition for continued use of the equipment during the chapter 11 case, failing which the trustee could have seized the collateral. Although a lift-stay motion was eventually made some 18 months after the filing, the value of the collateral was alleged to have fallen precipitously by that time, causing large losses to the holders of the secured debt, who had not been protected from such decline.

The trustee defended its conduct arguing that at the time of the Continental bankruptcy its adequate protection motion was sufficient to protect the bondholders' interests in the collateral. Moreover, the trustee pointed out that the plaintiff had not owned the secured debt at the time of the trustee's alleged failure to act and that it later purchased the Continental debt at a reduced price with the sole purpose of suing the trustee for its alleged lack of prudence, thereby violating New York law against trafficking in claims, the ancient legal doctrine known as champerty.

Unfortunately for the trustee, the appellate division found that, based upon the testimony of the plaintiff's expert, the jury could have reasonably concluded the prudent course of action was to make both a lift-stay motion and, in the alternative, an adequate protection motion. The appellate division thus affirmed the jury's conclusion that the trustee's imprudent conduct had substantially contributed to the loss in value of the collateral. In addition, the court rejected the trustee's champerty defense finding that there was evidence from which the jury could conclude that Bluebird had purchased the debt for reasons other than suing the trustee. The record on this point consisted of Bluebird's principal's testimony that he had an investment purpose because he had acquired different tranches of the debt with arbitrage and hedging in mind.

The *Bluebird* ruling, which was foreshadowed by a prior court of appeals decision in the same case, [18] has significantly limited the doctrine of champerty in New York courts so it is far less likely that claims transferees will have their actions dismissed. Prior to the *Bluebird* decisions, a claim could be dismissed if a primary purpose of the assignee in acquiring the claim was to bring a lawsuit. *Bluebird* narrowed the standard so the defendant now has to prove that bringing the lawsuit was the

primary purpose (not just a primary purpose) for the acquisition of the claim. If there was another purpose besides bringing a suit in acquiring the claim, the claim will not be dismissed by New York courts for champerty. In any event, it is extremely unlikely that the defendant will be able to have the suit dismissed by motion at the outset.[19]

With the defense of champerty becoming very difficult to prove in New York, claims transferees will have much freer reign to purchase claims so long as they can point to purposes other than bringing suit if the defense is raised and the court conducts a factual inquiry. In addition, transferees will have broad rights against other parties whose action or inaction may have harmed any previous claimholder at any time, even when the transferee acquired the claim after the alleged injury took place, suffered no injury itself, and bought the claims at a substantial discount. So long as the transferee can show it had a reason (such as a business motive) for purchasing the claim in addition to bringing an action, it will not be stopped by champerty from pursuing such action.

While champerty can still be raised as a defense, the force of such a defense is, in our view, now much diminished. This trend may bring additional liquidity to the claims trading market if it attracts speculators willing to commence litigation against indenture trustees and others whose acts or omissions can be alleged to have harmed the holders long ago. Even claims that have little hope of payment by the issuer and are available at deep discounts may be attractive if they permit the commencement of actions against indenture trustees and others and bring with them the possibility of a substantial damage recovery.

THE MODEL ORDER

The MST Order has been jointly drafted by the BMA and the LSTA specifically to address the disruptions to debt and equity trading markets that were being caused by orders entered by bankruptcy courts to protect a debtor's ability to utilize net operating loss ("NOL") carryovers to offset future tax liability. While such orders have preserved the debtor's NOL carryovers, they have at the same time also halted or seriously restricted trading in the debtor corporation's debt and equity, often without adequate notice to the marketplace.

The goal of the MST Order is to reduce such disruption and the expense that inevitably result from the current trading orders that seek to preserve the NOLs, which not only differ in each instance but often threaten or necessitate litigation over their scope and terms. It attempts to create a standard and less restrictive mechanism for dealing with the NOL carryover issues raised by debt or equity trading during a bankruptcy case. Under the MST Order, creditors remain free to buy debt claims throughout a case unless and until the debtor proposes a plan

that relies on the use of NOLs. At that time, the order requires the claimants to sell claims to preserve the NOL exemption but not below the level they held before the order became effective.

Specifically, the MST Order provides that within 30 days of the later of the notice being provided of the order's entry on Bloomberg's News Service or in the Wall Street Journal (the "Effective Time") and the date upon which an entity becomes a substantial shareholder or substantial claimholder, such entity is to inform the debtor of the amount of shares or claims which it holds with such information to be kept confidential by the debtor. An entity is a substantial claimholder when it holds an aggregate amount of claims of the debtor that equal or exceed the threshold amount. The threshold amount for debt trading purposes is the dollar amount, to be determined by the debtor in consultation with the creditors' committee, of claims that could be exchanged for 5% or more of a debtor's equity pursuant to the plan (holdings of 5% or more by any single holder as a result of acquiring claims have significant potential to jeopardize a debtor's use of NOL carryovers). Considerations in determining a threshold amount involve estimates of the aggregate amount of unsecured claims that will be allowed in the chapter 11 case and the extent to which postconfirmation business operations will require a debt for equity exchange in order to establish a feasible capital structure. The notes to the MST Order recognize that these factors will be difficult to determine with any degree of precision, particularly at an early stage in the proceedings.

After the Effective Time, any shareholder who wishes to purchase shares so that it will become a substantial shareholder, and any substantial shareholder who wishes to sell or purchase shares, must notify the debtor at least 10 days prior to the proposed consummation of such transaction. If the debtor objects to such transaction, it may not be consummated so long as the debtor can establish, upon the shareholder's petition to the bankruptcy court, that there is a reasonable possibility that allowing the proposed transaction to be consummated would jeopardize substantial NOL carryovers or other tax attributes.

After filing a proposed plan and disclosure statement that utilizes the NOLs, the debtor may petition the court for the issuance of sell down notices. Such notices require substantial claimholders who purchased more claims or an entity that became a substantial claimholder after the Effective Time to transfer certain of their claims in order to prevent such entities from owning an excessive dollar amount of claims that would cause a loss of the NOL. The sell down notices, however, must give the creditor the right to hold either the threshold amount or such entity's protected amount, i.e., the amount such entity held as of the Effective Time.

Claimholders may object to sell down notices. If they do, then the court will not issue them unless the debtor can show that there is a reasonable possibility that the plan will be confirmed, there will be substantial tax attributes for the debtor to carryover, and the transfer of the claims is necessary to assure that the ownership requirements under the Internal Revenue Code will be satisfied.[20] If a disclosure statement is not approved within 90 days of the petition for issuance of sell down notices, the notices will be automatically void ab initio.

The MST Order also provides sanctions for noncompliance. A substantial shareholders' failure to provide notice of the purchase or sale of shares, or a shareholders' failure to notify the debtor that it has become a substantial shareholder, will void the transaction ab initio and reverse it. Failing to comply with a sell down notice results in the claimholder receiving no distributions in respect to the claims that were required to be, but were not, sold. In the alternative, a claimant can accept the distribution, but it must indemnify the debtor for any losses suffered as a result of the ensuing limitations on its using the NOL carryovers.

The MST Order provides that the debtor has four months after the entry of the order to establish that they will propose a plan that utilizes the NOL carryovers and that there is a reasonable possibility that the plan will be confirmed. Should it fail to make such a showing, all the provisions of the MST Order relating to affected claims will be void ab initio.

While the MST Order may leave many questions unanswered, it will at least allow claims trading to continue for most of the chapter 11 case. No doubt, issues of interpretation and compliance will arise, but there will be greater certainty in the claims trading marketplace if courts use this uniform order when a debtor seeks protection of its NOL carryover and other tax attributes.

---

1. In re Enron Corp. (May 24, 2004 Transcript of Decision on Temporary Allowance for Voting Purposes (Gonzalez, J.)).

2. Bluebird Partners, L.P. v. First Fidelity Bank, N.A., N.J., 11 A.D.3d 232, 784 N.Y.S.2d 479 (App. Div. 1st Dep't 2004), leave to appeal dismissed, 4 N.Y.3d 882, 798 N.Y.S.2d 726, 831 N.E.2d 971 (2005).

3. A full copy of the Model Order can be found at http://www.abiworld.org/pdfs/lsta.swf.

4. See Bromley, J. *"Protecting Trading Market and NOLs in Chapter 11,"* ABI Journal, Vol. XXIV, No. 1, p.p. 1, 48 (February 2005).

5. In 2004, the courts have continued to interpret Rule 3001(e)(1) and (2) as procedural only, requiring simply a bare-bones notice of a transfer to be filed if there is a transfer other than for security. Any efforts to impose substantive requirements (such as disclosure of the amount paid for the claim) have been almost uniformly rejected. For example, in In re Burnett, 306 B.R. 313 (B.A.P. 9th Cir. 2004), the Bankruptcy Appellate Panel overruled the bankruptcy court and held that, absent some special fiduciary obligation to the debtor or other statutory requirement, disclosure of the consideration paid by an assignee of a claim transferred postpetition was not required as a condition to allowing the claim.

6. As a matter of disclosure, our firm, Seward & Kissel LLP, represented The Bank of New York, the Indenture Trustee for the holders of the Notes issued by each of the Trusts, and joined in the Temporary Allowance Motion.

7. 11 U.S.C.A. § 502(d).

8. Transcript, p. 24.

9. Transcript, p. 26-27.

10. In re Metiom, Inc., 301 B.R. 634 (Bankr. S.D. N.Y. 2003).

11. Judge Drain found that the case most directly on point is the Eighth Circuit's decision in Swarts v. Siegel, 117 F. 13 (C.C.A. 8th Cir. 1902). In that decision, the transferee had its claim disqualified from allowance by a reason of a prepetition preference that had been received by the transferor. The facts in the *Swarts* case are, however, distinguishable from the typical claims trading case. The transferee in *Swarts* had also benefited from the preference because it was an accommodation party on the underlying note, and its liability had been reduced by the debtor's partial payment of the note during the preference period.

12. In re Metiom, Inc., 301 B.R. 634, 643 (Bankr. S.D. N.Y. 2003).

13. In re Metiom, Inc., 301 B.R. 634, 643 (Bankr. S.D. N.Y. 2003).

14. Judge Drain's conclusion is not the only plausible reading of section 502(d) of the Bankruptcy Code. As some other courts have pointed out, the only creditors whose claims are disallowed by the language of the statute are those entities from whom property is recoverable or were themselves transferees of the avoidable transfer. See In re Wood & Locker Inc., 1988 U.S. Dist. LEXIS 19501 at 8-9 (W.D. Tex. June 17, 1988) (section 502(d) is not triggered because transferee bank is not the kind of creditor from whom property is recoverable under section 550 or the kind of creditor liable under section 547). A party that purchases a claim postpetition is not "an entity from which property is recoverable" since it received no property from the debtor; nor is the claim purchaser an entity "that is a transferee of a transfer avoidable" under the cited sections. Moreover, courts that have reviewed the statutory purpose of section 502(d) have noted that it is to be narrowly construed "to ensure compliance with judicial orders." In re Odom Antennas, Inc., 340 F.3d 705, 708, 41 Bankr. Ct. Dec. (CRR) 230, 51 Collier Bankr. Cas. 2d (MB) 940, Bankr. L. Rep. (CCH) P 78903, 2003-2 U.S. Tax Cas. (CCH) P 50634, 92 A.F.T.R.2d 2003-5827 (8th Cir. 2003). See also In re Atlantic Computer Systems, 173 B.R. 858 (S.D. N.Y. 1994) ; Matter of Davis, 889 F.2d 658, 19 Bankr. Ct. Dec. (CRR) 1845, 22 Collier Bankr. Cas. 2d (MB) 285, Bankr. L. Rep. (CCH) P 73189 (5th Cir. 1989) (purpose of section 502(d) is coercive not punitive).

15. See Enron Corp. v Kensington International Ltd., et al., Adv. Pro. No. 05-01030 (Bkrtcy. S.D.N.Y., filed January 12, 2005) (AJG); Enron Corp. v. Springfield Associates LLC, Adv. Pro. No. 05-01025 (Bkrtcy. S.D.N.Y. filed January 10, 2005); Enron Corp. v. Bear Stearns & Co., Inc., et al., Adv. Pro. No. 05-10704 (Bkrtcy. S.D.N.Y. filed January 10, 2005); Enron Corp. v. Avenue Special Situation Fund II, LP, et al., Adv. Pro. No. 05-01029 (Bkrtcy. S.D.N.Y. filed January 12, 2005); Enron Corp. v. Rushmore Capital-I, LLC, Adv. Pro. No. 05-01024 (Bkrtcy. S.D.N.Y. filed January 10, 2005); Enron Corp. v. Rushmore Capital-II, LLC, Adv. Pro. No. 05-01026 (Bkrtcy. S.D.N.Y. filed January 10, 2005); Enron Corp. v. Allied Irish Banks plc, Adv. Pro. No. 05-01061 (Bkrtcy. S.D.N.Y. filed January 13, 2005); Enron Corp. v. OCM Administrative Services II, LLC, Adv. Pro. No. 05-01023 (Bkrtcy. S.D.N.Y. filed January 10, 2005). OCM and Springfield have recently filed motions to dismiss the complaints, arguing that *Metiom* was wrongly decided, giving Judge Gonzalez an opportunity to revisit the issue.

16. It is noteworthy that debtors in both *Metiom* and *Enron* also argued for equitable subordination of the claims in the hands of the transferees, arguing that the misconduct of the transferors attaches to the claim. Neither court has yet to reach this issue, although OCM's motion to dismiss urges the *Enron* bankruptcy court to throw out the equitable subordination count.

17. See note 2.

18. See Bluebird Partners, L.P. v. First Fidelity Bank, N.A., 94 N.Y.2d 726, 709 N.Y.S.2d 865, 731 N.E.2d 581 (2000).

19. Semi-Tech Litigation, LLC v. Bankers Trust Co., 272 F. Supp. 2d 319 (S.D. N.Y. 2003) (indenture trustee's motion to dismiss claim purchaser's lawsuit on grounds of champerty denied where any basis is advanced that the sole or primary purpose was not commencement of a lawsuit); OS Recovery, Inc. v. One Group Intern., Inc., 2004 WL 1092158 (S.D. N.Y. 2004) (same).

20. See Internal Revenue Code § 382. The MST Order provides an exemption to the requirements of a sell down for substantial claimholders to the extent it is not necessary to successfully implement the bankruptcy plan. The exemption is available to substantial claimholders in the chronological order in which they filed their substantial claimholder notice. Thus there is a potential benefit to prompt compliance with the MST Order because those substantial claimholders who are the first to file notices with the bankruptcy court are more likely to be exempt from any sell down and will thereby be protected from having to sell into what could be a buyer's market.