

Client Alert

Buyers of Bankruptcy Claims Should Proceed With Caution

On March 31, 2006, the *Enron* Court ruled that a bankruptcy claim purchased after the commencement of the case may be disallowed under section 502(d) of the Bankruptcy Code if the seller of the claim is subject to an avoidance action (e.g., a preference or fraudulent conveyance action) even though the avoidance action has not yet been fully adjudicated. Section 502(d) provides that the bankruptcy court shall disallow any claim of any entity (a) from which property is recoverable under the turnover and preferential setoff provisions of the Bankruptcy Code, or (b) that is a transferee of a transfer avoidable under the avoidance provisions of the Bankruptcy Code.

In the *Enron* case, a group of financial institutions (claimants) purchased claims arising from a loan made by a bank to Enron Corp. Enron thereafter filed a lawsuit against the bank to recover alleged preferential and fraudulent transfers that were unrelated to the transferred claims.

Enron later commenced an adversary proceeding against the claimants to disallow the purchased claims under section 502(d) of the Bankruptcy Code on the basis that the transferor-bank allegedly received avoidable transfers that had not been returned to Enron. The claimants moved to dismiss the complaint arguing that adjudication of an avoidance action, and a finding that a claim holder is liable for the return of property, is a prerequisite to section 502(d) disallowance. The claimants argued that since the avoidance action against the transferor-bank had not yet been tried, the transferred claims should not be subject to disallowance under the plain language of section 502(d). The claimants also argued that disallowance was unwarranted because the alleged preferences or fraudulent conveyances were unrelated to the purchased claims and were asserted against the transferor-bank, not the claimants.

In response, Enron argued that, under section 502(d), the transferred claims would have been disallowed had the claims not been transferred from the bank to the claimants and, further, that because the claimants are transferees who take subject to any defense, their claims should be disallowed to the same extent as if the transferor bank had continued to hold the claims.

In denying the claimants' motion to dismiss, the *Enron* Court held that a disallowance action under section 502(d) should not be dismissed even though the court has not yet heard the underlying avoidance action because a debtor may, by objecting to a proof of claim or commencing an adversary proceeding, use section 502(d) as a defense to the claim. In support, the *Enron* Court relied on well established precedent holding that a section 502(d) defense to a claim is valid even if the debtor's avoidance action is time-barred or otherwise unrecoverable. The *Enron* Court did note, however, that the claim could not be disallowed under section 502(d) until a judicial determination was reached on the merits of the underlying avoidance action.

The *Enron* Court also held that a claim subject to disallowance under section 502(d) in the hands of a transferor is not insulated from disallowance merely because the claim has been transferred or sold. The *Enron* Court held that the claim and the section 502(d) disallowance defense are linked, and the relationship is not severed by a transfer.

Finally, the *Enron* Court rejected a “good faith” purchaser defense raised by the claimants by holding that the section 550(b) “good faith” defense applies only to a transferee who acquires property of a debtor’s estate. The defense is not available to the purchaser of a claim against the estate. The *Enron* Court also held that a transferee of a claim against a bankruptcy estate cannot establish a “good faith” defense when it purchased claims with knowledge of a debtor’s bankruptcy status.

It is important to note that this ruling comes on the heels of a decision rendered in November 2005 by the *Enron* Court holding that claims purchased post-petition could be equitably subordinated based on the inequitable conduct of the original holder, even where the inequitable conduct did not relate to the transferred claim.

At first blush, it would appear that these two decisions, if upheld on appeal, could have a chilling effect on the distressed debt market because of the perceived increased risk to buyers. Some practitioners have suggested that these decisions may (i) require buyers to perform more due diligence, (ii) cause the distressed debt market to become less liquid, and (iii) result in lower purchase prices for bankruptcy claims.

These concerns may be overstated, however, because sophisticated claims traders, including most institutional traders, are already aware of these risks and take protective measures. For example, many standard assignment agreements require the seller of a claim to “represent” and “warrant,” among other things, that (i) the claim is a valid and allowable claim in a specified amount, (ii) the seller is not a party to any proceeding (which would include an avoidance action) that would materially affect the claim, and (iii) the seller has not engaged in any acts or conduct that will result in the buyer receiving less in distributions or less favorable treatment than other creditors holding similar claims. Most standard assignment agreements also contain a provision requiring the seller to repay to the buyer the purchase price or a portion thereof, plus interest, in the event that the claim in question is disallowed or reduced by the bankruptcy court.

Nevertheless, in light of the *Enron* decision, it would be prudent for claims buyers to fully understand their risks, conduct greater due diligence into whether the seller’s actions or lawsuits filed against the seller could affect the transferred claim, bid for the claim taking into account the associated risks, and include contractual protections such as those described above when drafting any sale document.

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April 11, 2006

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