

RENAISSANCE

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BANKRUPTCY CLAIMS TRADING: BUYER BEWARE...OR NOT?

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With increased use of stock offerings to fund debtors' reorganization plans, the trading and sale of bankruptcy claims has evolved into a billion-dollar industry. Well-established debt traders buy and sell claims as

they position themselves to control publicly traded corporations upon their emergence from bankruptcy.

Substantial debt trading also takes place in pre- and post-bankruptcy settings, where financial institutions use loans and participations to spread their risk. Those that acquire significant claim amounts often face increased scrutiny from debtors and creditors' committees. Battles with claims traders are being joined, and will likely increase in coming years.

One such case developed in the historic 2001 Enron bankruptcy filing. Shortly before the filing, a large syndicate of lenders entered into a \$1.25 billion long-term credit facility with Enron, as well as a \$1.75 billion, 364-day revolving credit facility.

As is common with large credit agreements, the lenders began transferring portions of their credit facility to other parties. Springfield Associates LLC acquired \$5 million of Enron's revolving indebtedness

from Deutsche Bank, which had previously acquired the indebtedness from Citibank. Both Springfield and Deutsche Bank acquired their claims pursuant to purchase and sale agreements that contained warranty and indemnification provisions, as well as through assignments and acceptances.

In September 2003, Enron filed a bankruptcy adversary action against Citibank and the other original members of the lending syndicate, seeking, among other things:

1. Equitable subordination of the lenders' claims pursuant to Bankruptcy Code Section 510(c)
2. Disallowance of the lenders' claims under Code Section 502(d), and
3. Actual and punitive damages

Then, in January 2005, Enron filed a series of bankruptcy adversary actions seeking to equitably subordinate and disallow claims by Springfield and other transferees. These complaints did not allege wrongful conduct by the transferees. They were based solely on the misconduct alleged against lenders in the 2003 lawsuit.

The transferor lenders promptly moved to dismiss the claims against the transferees, but the Bankruptcy Court denied the motions — using language that sent shudders through the claims trading community.

First, the Bankruptcy Court ruled that if an Enron lender had engaged in inequitable conduct toward the debtor, its entire claim, not just that portion of its claim related to the inequitable conduct, could be

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FROM THE DESK OF *Sid Lambersky*

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Here at MorrisAnderson we are actively involved in helping to facilitate change in businesses that are facing critical challenges. A company can face critical challenges whether it is underperforming, distressed — or doing very well. Such is the case with MorrisAnderson. During the past few years,



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MorrisAnderson has grown with the addition of new offices, employees and partners. Along with the constant growth and change have come demands on the management team and resources of the firm.

MorrisAnderson is not unlike any other firm. We, too, go through our stages of denial and stubbornness. “No, we have plenty of resources. We don’t need to hire anyone else.” Or, “We’ve always done it this way and we’ve never had a problem, so why do we need to change?” Changes are never easy for anyone — even if they promise the hope of something better. But, alas, changes must be made in order to keep MorrisAnderson strong and viable during our period of growth and beyond.

That’s where I come in. I was recently promoted to the position of Vice President of Operations and Strategic Development. It is now up to me to help MorrisAnderson with the challenges we are facing. Gulp... My first priority will be to help strengthen the infrastructure of the company: assess the personnel; review and update policies and procedures; put systems in place to help our employees be more efficient; work with the marketing manager to standardize all our forms, agreements, and marketing materials; and get involved in the training and development of our consultants. I have a long list of “to-do” items in front of me and it seems that the more I do, the faster my list grows! But that’s okay; I’m enjoying it.

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Bankruptcy Claims Trading, continued

subordinated to other claims. In addition, a claim transferee could not have greater rights or enjoy a better position than its original transferor, and its transferred claim would therefore be subject to subordination as if it were still in the transferor's hands. Also, the court said, a claim transferee could not be a good faith purchaser. Even if it could, the Enron transferees were on notice of possible subordination claims and could therefore not assert good faith defenses.

Second, the court ruled that, despite significant case law to the contrary, a final determination in an avoidance action is not necessary to disallow a claim. Because the focus of claim disallowance is on the claim itself, and not the holder, a claim in the hands of a transferee could be disallowed (thus preventing the transferee from gaining greater rights than the transferor). In that case, a good faith holder defense could not be raised because there was no attempt to avoid a transfer or otherwise recover property.

On appeal, District Court Judge Shira Scheindlin boiled the issue down quite simply:

[A]re equitable subordination under Section 510(c) and disallowance under Section 502(d) attributes of a claim or are they personal disabilities of particular claimants[?] If they are attributes of the claim, they travel with the claim regardless of the method of transfer, whereas if they are personal disabilities, their application to transferees depends on whether the transfer was by way of sale or assignment.

The District Court held these actions were personal disabilities that did not automatically attach to the claims, and observed that the proper focus was on the claimant and not the claim.

The District Court also noted that the Bankruptcy Court had failed to determine whether Springfield's claims were acquired by sale or assignment, and had mistakenly held that all transfers — including open market purchases — were subject to causes of action against original claimants. This distinction was particularly important to the

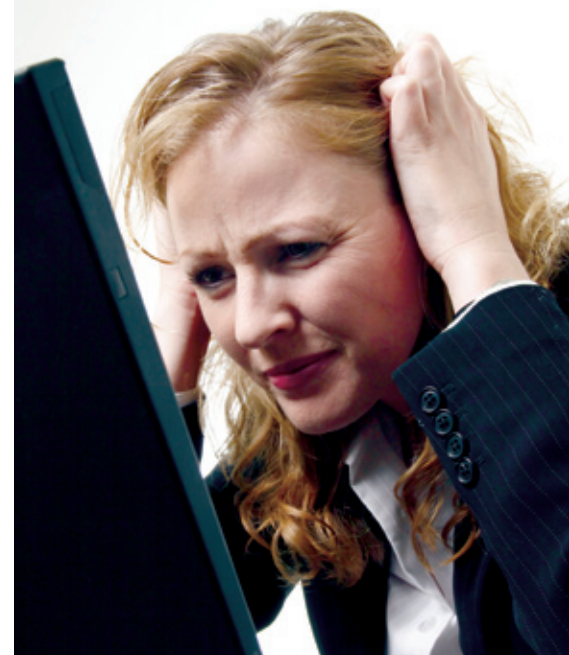
District Court because of the “distressed market context, where sellers are often anonymous and purchasers have no way of ascertaining whether the seller (or transferee up the line) has acted inequitably or received a preference.”

The District Court remanded the case to the Bankruptcy Court to determine whether the Springfield transfers were a sale or an assignment. The case is pending, but those involved in claims trading and distressed debt markets can benefit from the District Court's ruling. Parties engaged in any transfer of claims should make every effort to characterize the transfer as a sale, rather than an assignment.

Claim transfer documents contain a sometimes schizophrenic amalgam of assignment and sale language. Often titled “Assignment of Claim,” they purport to “sell, transfer and assign” claimants’ “rights, titles and interests” in the claims. The documents include purchase prices, thus connoting sales, but they define the claim transferors as assignors, and contain extensive provisions for, and indemnification for damages resulting from, assignor representations and warranties. They also require assignors to repay the purchase prices to the assignees — as opposed to repurchasing the claims — if someone seeks to disallow, avoid, subordinate, or reduce the claim. The transfer documents go on to state that assignees shall not be responsible for any assignors’ obligations or liabilities related to the claims.

Asked to determine whether such a document is a sale or an assignment, a bankruptcy court will likely rule that it is an assignment, with the result that causes of action and defenses against the transferor travel with the claim. A potential remedy for claims traders is obvious and easy — reform the claim transfer documents.

The title of any claim transfer document should be “Purchase Agreement” and the parties should be defined as “seller” and “buyer” (or “purchaser”). Moreover, claims traders should consider foregoing or limiting



indemnification and repurchase provisions, as these terms are glaring indications that a claim transfer is not an unqualified and final sale.

With proper representations and warranties that the transferor did not engage in any misconduct or receive any avoidable transfers, and is not aware of any grounds for claim objection, a claim purchaser can protect itself. If any of these representations and warranties prove untrue, the claim purchaser will likely have strong common law rights to recover its purchase price if a court finds that the agreement was an assignment rather than a sale.

Parties who buy or sell bankruptcy claims or distressed debt have now been given some guidance on how to protect their claims, and they should take steps to avoid — or at least reduce — the problems faced by Springfield Associates in Enron.

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