

# The Limits of *Enron*: Counterparty Risk in Bankruptcy Claims Trading

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### ABSTRACT

Creditors have long understood that any claims they submit for repayment in a bankruptcy might be valid, but subject to subordination in the order of payment of the bankruptcy estate's limited funds if the creditor behaved inequitably as the debtor failed. Enron's ongoing bankruptcy has raised many instances of inequitable conduct, but a recent opinion by the bankruptcy court expands the practice of equitable subordination far beyond its traditional reach. According to the court, buyers of bankruptcy claims are now subject to subordination not just for their own conduct, but also for conduct of previous owners of the claims, regardless of whether the conduct was connected to the claims.

### I. INTRODUCTION

Creditors have long understood that any claims they submit for repayment in a bankruptcy might be valid, but subject to subordination in the order of payment of the bankruptcy estate's limited funds if the creditor behaved inequitably as the debtor failed. Enron's ongoing bankruptcy has raised many instances of inequitable conduct, but a recent opinion by the bankruptcy court expands the practice of equitable subordination far beyond its traditional reach.<sup>1</sup> According to the court, buyers of bankruptcy claims are now subject to subordination not just for their own conduct, but also for conduct of previous owners of the claims, regardless of whether the conduct was connected to the claims. This is a new level of counterparty risk—the risk entailed by dealing with a particular transaction partner—that is hard for claims purchasers to protect against through diligence, pricing, warranties, or insurance.

In a world of active bankruptcy claims trading, *Enron* raises powerful policy questions that may affect both the doctrinal development of bankruptcy law and the survival of a market that has provided liquidity for

creditors with claims against bankrupt debtors. Already, developments in the *Refco* bankruptcy show that *Enron* has had a major impact on the claims trading market and has created a potential for market manipulation in claims trading. This article examines these policy questions raised by *Enron* and argues that *Enron* stands on questionable legal authority and does not present the best policy solution for redressing the problems of inequitable behavior by creditors.

## II. THE *ENRON* EQUITABLE SUBORDINATION DECISION

In the spring of 2001, Enron was flying high. Creditors were willing to extend it multibillion-dollar credit facilities. In May 2001, Enron entered into two loans, a \$1.75 billion Long-Term Credit Agreement and a \$1.25 billion Short-Term Credit Agreement.<sup>2</sup> These loans were syndicated among a number of banks, including Fleet Bank.<sup>3</sup>

By the end of 2001, Enron's fortunes had plummeted amidst the exposure of a massive accounting fraud, and Enron filed for bankruptcy in December 2001.<sup>4</sup> Between August 2002 and March 2003, five hedge funds ("the Funds") purchased claims in Enron's bankruptcy.<sup>5</sup> These claims, with a par value of \$47.25 million, came from Fleet Bank's \$53.67 million participation in the Short-Term Credit Agreement.<sup>6</sup> All five Funds purchased their claims from other banks that had in turn purchased the claims from Fleet.<sup>7</sup> One Fund also purchased a claim directly from Fleet.<sup>8</sup>

In September 2003, Enron commenced an adversary proceeding, known as the "Megacomplaint," against 10 banks participating in the loans.<sup>9</sup> The Megacomplaint named Fleet as a defendant in voidable preference and fraudulent conveyance claims arising from prepaid forward transactions.<sup>10</sup> The Megacomplaint also alleged that Fleet aided and abetted Enron's accounting fraud to Fleet's advantage and that Enron's fraudulent financials induced other creditors to make unsecured loans to Enron that they would not have otherwise made.<sup>11</sup> The Megacomplaint did not allege any wrongdoing with respect to the Credit Agreements.<sup>12</sup>

In January 2005, Enron commenced another adversary proceeding, this time against the Funds that had purchased Fleet's loan participation claims.<sup>13</sup> Enron requested that the bankruptcy court equitably subordinate under 11 U.S.C.A. § 510(c) the Fleet loan participation claims held by the Funds.<sup>14</sup> Section 510(c) provides that:

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.<sup>15</sup>

Enron's complaint did not allege that the Funds had any knowledge of Fleet's alleged wrongdoing when they purchased the claims. The Funds filed a motion to dismiss under Fed. R. Civ. P. 12(b)(6) and Fed. R. Bankr. P. 7012(b), arguing that, as a matter of law, the Fleet claims could not be subordinated in their hands.

On November 17, 2005, U.S. Bankruptcy Judge Arthur Gonzalez denied the motion to dismiss the equitable subordination action.<sup>16</sup> Judge Gonzalez observed that there were three issues involved in the motion: (1) whether a claim could be equitably subordinated on account of inequitable behavior unconnected to the claim; (2) whether a claim that could be equitably subordinated in the hands of the inequitable party could be subordinated in the hands of a transferee; and (3) whether a good faith purchaser defense is available for a transferee of a bankruptcy claim.

Judge Gonzalez resolved the first issue in the affirmative. He concluded that:

equitable subordination is not limited to only those claims related to the inequitable conduct that caused the injury to the creditor class. Rather, equitable subordination can apply to claims unrelated to any inequitable conduct held by the claimant alleged to have engaged in the conduct, limited by the amount of damages stemming from the inequitable conduct that is not otherwise compensated to that class.<sup>17</sup>

As for the second issue, Judge Gonzalez concluded that "the transfer of a claim subject to equitable subordination does not free such claim from subordination in the hands of a transferee.... The remedy of equitable subordination remains with the claim."<sup>18</sup> As assignees, the Funds took only as good as they were given; the defenses traveled with the claim. Accordingly, if it turned out that Fleet had acted inequitably, the Funds could be subordinated on account of being transferees of Fleet's claims.

Regarding the third issue, Judge Gonzalez concluded that the statutory good faith purchaser defense in 11 U.S.C.A. § 550(b) was limited to 11 U.S.C.A. § 550(a)'s enumerated preference recovery, postpetition trans-

fer, and fraudulent transfer actions<sup>19</sup> and that in any event, the Funds could not take in good faith because they were aware of the possibility of subordination by virtue of buying bankruptcy claims.<sup>20</sup>

### III. ENRON'S QUESTIONABLE AUTHORITY

*Enron* broke new ground on all three issues, but it did so on the basis of questionable precedent. *Enron* failed to undertake the analysis necessary to support its results, and as a doctrinal matter, it is not clear that its results are warranted.

#### A. Subordination of Claims Unrelated to Inequitable Behavior

Before *Enron*, no court had held that claims of a nonfiduciary creditor could be subordinated on account of the creditor's unrelated inequitable conduct. To be sure, several cases have stated that subordination need not be on account of behavior connected to the claim. These cases, however, either involved fiduciary creditors<sup>21</sup> or made such statements in dicta.<sup>22</sup> Moreover, there are rulings refusing to subordinate creditors because the grounds for subordination were unrelated to the bankruptcy claim.<sup>23</sup>

*Enron* relied on the contrapositive implication from the absence of binding precedent. Since no case outright forbade equitable subordination in such circumstances, *Enron* was free to subordinate the loan participation claims on account of unrelated behavior by Fleet.<sup>24</sup> The precedents *Enron* considered point in different directions and present a complicated picture. *Enron*, however, treated them as if they were uniform in supporting its position and never undertook the analysis necessary to reach its result.

Although the bankruptcy court believed that it was writing on a blank slate in *Enron*, it relied heavily on dicta in the Fifth Circuit's decision in *Mobile Steel*, the case that provides the standard test for equitable subordination.<sup>25</sup> *Mobile Steel* contains a far-ranging discourse on equitable subordination, much of which is ultimately unnecessary for its holding. *Mobile Steel* noted that "inequitable conduct directed against the bankrupt or its creditors may be sufficient to warrant subordination of a claim irrespective of whether it was related to the acquisition or assertion of that claim."<sup>26</sup> For authority, *Mobile Steel* cited a pair of circuit court rulings, *In re Kansas City Journal-Post Co.*<sup>27</sup> and *L & M Realty Corp. v. Leo*,<sup>28</sup> and a Supreme Court case, *Taylor v. Standard Gas & Electric Co.*

(The *Deep Rock Case*),<sup>29</sup> which was relied upon by both circuit court rulings in turn.

All three of these cases involved a distinguishing factual situation that *Mobile Steel* ignored and *Enron* did not catch. In all three, the inequitable creditors were fiduciaries of the debtor. Indeed, this point was stressed in the opinions cited by *Mobile Steel*.<sup>30</sup> The distinction is important because fiduciary creditors are held to a more exacting standard of behavior than a general creditor. The entirety of a fiduciary's dealings must be discharged with "a punctilio of honor the most sensitive,"<sup>31</sup> and a fiduciary must account for the entirety of his dealings, not just on a one-off basis. If the fiduciary has violated any of his duties, he is not entitled to compensation, except quantum meruit.<sup>32</sup> The cases cited by *Mobile Steel* allowed for subordination of claims unrelated to the inequitable conduct because they involved fiduciary creditors, only because the courts undertook a broader inquiry into the fiduciary creditors' actions than they would have done for a regular creditor. *Mobile Steel* incorrectly derived a general rule from an exceptional situation.<sup>33</sup> In light of the special fiduciary circumstances in all of *Mobile Steel's* precedents, it has questionable value as an authority for *Enron*.

The distinction between fiduciary creditors and general creditors was underscored by a later Fifth Circuit decision, *In re Missionary Baptist Foundation*,<sup>34</sup> which *Enron* cited as supporting subordination of a creditor for inequitable behavior unrelated to his claim. In *Missionary Baptist*, the Fifth Circuit permitted the subordination of a claim because of the inequitable transactions with which the claimholder was "intimately connected."<sup>35</sup> The claimholder was the general partner of one of the parties that benefited from the inequity and a 50% shareholder of another.<sup>36</sup> The Fifth Circuit essentially engaged in veil-piercing and thus connected the inequitable dealings of one party with the claims of a creditor, rather than aggregating a single creditor's separate dealings.

*Missionary Baptist* was decided after *Mobile Steel*, but it did not adopt *Mobile Steel's* broad dictum. Instead, it did

not express an opinion on a hypothetical case in which a note is in some way passed by an inequitable actor to an innocent, uninvolved bystander. In that hypothetical situation, one which is not presented in this case, there might be reasons to find that subordination of a note would be contrary to the principles of equitable subordination as they have developed in the courts.<sup>37</sup>

*Missionary Baptist* does not evangelize for *Enron*; it preaches a subtler gospel.

*Enron*, unfortunately, never pursued the “principles of equitable subordination” line of questioning suggested by *Missionary Baptist*, although *Mobile Steel* itself acknowledged that there were cases that refused to subordinate creditors for inequitable behavior unconnected to their claim.<sup>38</sup>

One of these cases, *In re Ahlswede*, was an Eighth Circuit decision on the appeal of the subordination of promissory note claims held by a bank that was also the trustee of the bankrupt’s spendthrift trust.<sup>39</sup> The trust instrument provided the bank with the right to offset the bankrupt’s indebtedness from trust distributions.<sup>40</sup> Presumably, the remaining trust funds were insufficient to cover the notes, or the bank did not want to wait for further distributions, as the bank submitted a claim in the trust beneficiary’s bankruptcy. The bankruptcy referee allowed the bank’s claim but subordinated it because he did not think it fair for the bank to share with other general creditors from the debtor’s nonbankruptcy remote assets when the other creditors could not look to the spendthrift trust for relief.<sup>41</sup>

The Eighth Circuit reviewed the trilogy of early Supreme Court equitable subordination cases, *Taylor v. Standard Gas & Electric Corp.* (The *Deep Rock Case*),<sup>42</sup> *Pepper v. Litton*,<sup>43</sup> and *Comstock v. Group of Institutional Investors*,<sup>44</sup> and observed that in the first two cases, the Supreme Court allowed for the subordination of a controlling shareholder fiduciary that abused the controlled corporation.<sup>45</sup> In *Comstock*, however, the Supreme Court denied the subordination because the controlling fiduciary had acted in good faith—it could not be subordinated merely because of its status as controlling shareholder.<sup>46</sup> *Comstock* noted that the *Deep Rock* rule was fashioned “[b]y the application of long-standing principles of equity... to prevent a fiduciary in such a position from enriching itself by breach of its trust.”<sup>47</sup>

The Eighth Circuit concluded that “there must be conduct either in acquiring or asserting the claim which is itself inequitable in order to subordinate a claim.”<sup>48</sup> Nothing in *Ahlswede* suggested inequitable conduct in the bank’s claims. Rather, “the supposed unfairness here results entirely from the provisions of state law recognizing spendthrift trusts and from the provisions of the Bankruptcy Act giving such trusts effect in bankruptcy proceedings.”<sup>49</sup> Accordingly, the Eighth Circuit affirmed the district court’s reversal of the referee’s subordination of the bank’s claim.

The other case dismissed by *Mobile Steel* was *Prudence Realization v. Geist*, in which the Supreme Court addressed whether subordination was proper for mortgage participation claims held by the mortgage's guarantor.<sup>50</sup> The Supreme Court noted that the mortgage participation claims were legally valid and separate from the guarantor's status as guarantor, so the claimant could share *pari passu* with other mortgage participation claim holders:

The rights asserted by Prudence Company in the mortgage are not those of a subrogee; they were acquired independently from its guaranty. They are not derived from or an incident to it. Their assertion is in no way inconsistent with any duty or obligation it assumed by its contract of guaranty.... Allowance of the Prudence Company's claim does not involve any breach of its duty as guarantor.<sup>51</sup>

*Prudence Realization* emphasized formalistic separateness, which is precisely the opposite of equity's examination of substance over form.<sup>52</sup> But in corporate law in general, formal separateness is respected unless it is abused, as demonstrated by the *Deep Rock-Pepper-Comstock* trilogy. At the very least, *Prudence Realization* and *Ahlswede* tell us that there must be inequitable conduct, not just seemingly unfair status, to warrant a subordination. What is not clear is where the line between conduct and status lies. Did the transactions in *Prudence Realization* go beyond status and into the realm of inequitable conduct? *Prudence Realization* did not address the issue in such terms. But if *Prudence Realization* is read as involving inequitable conduct in Prudence Corp.'s financial web,<sup>53</sup> then the decision forbids the subordination of a claim on account of the claimholder's unrelated inequitable conduct.

*Mobile Steel* read *Prudence Realization* and *Ahlswede* narrowly, and *Enron* relied on *Mobile Steel*'s reading:

we have found no case in which a federal court refused to subordinate a claim solely because, although inequitable conduct of sufficient magnitude to warrant subordination existed, the conduct was unrelated to the acquisition or assertion of the particular claim whose status was at issue.<sup>54</sup>

Indeed, the only contrary case that *Enron* directly confronted was *In re Westgate-California Corp.*<sup>55</sup> *Enron* cited *Westgate-California* approvingly on the power of bankruptcy courts to subordinate claims to "promote a just

and equitable distribution of the bankruptcy estate” and “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.”<sup>56</sup> The ultimate holding in *Westgate-California*, however, was to reverse the subordination of claims unrelated to the inequitable conduct because such a subordination would be punitive.<sup>57</sup> *Enron* argued that *Westgate-California*’s result was driven by the concern of subordinating the inequitable creditor for more than the amount of damage caused by his conduct.<sup>58</sup>

*Westgate-California*’s ruling was more complex than *Enron*’s presentation showed. *Westgate-California* expressed a concern about subordinating an inequitable creditor more than is necessary to offset the harm he caused, but this limitation on subordination was also spelled out in *Mobile Steel*.<sup>59</sup> *Westgate-California* added an important twist: it placed a burden of proof on the inequitable creditor to show discrete harms.<sup>60</sup> While *Westgate-California* adopted a presumption of harm from inequitable conduct, the decision’s bottom line is that subordination is not appropriate if a creditor’s harm cannot be traced to the inequitable behavior.

The Bankruptcy Code itself recognizes that claims remain separate even when held by the same party. Section 510(c) refers to the subordination of claims, not creditors.<sup>61</sup> Moreover, a claimholder is not able to aggregate all of his claims if they are of different classes.<sup>62</sup> Thus, a claimholder of an undersecured claim cannot vote the secured part with the unsecured part in the same class for a plan confirmation. Likewise, a creditor holding a priority claim and a general unsecured claim cannot bundle his claims and vote them in the same class.

*Enron* presents the case that when a creditor comes to seek relief before a court of equity, the entirety of his behavior is accounted for by the court, so inequitable behavior does have a transitive property across claims. Unfortunately, discussions of bankruptcy courts as courts of equity never address the equitable nature of bankruptcy proceedings in more than a generic manner, reciting broad phrases about equity without delving into their meaning. Moreover, the “court of equity” is an incorrect description of bankruptcy courts, which do not possess classic equity powers or jurisdiction.<sup>63</sup>

Section 510(c) is an exception, where traditional equity jurisprudence plays a role in bankruptcy, as § 510(c) calls for subordination to be made in accordance with the principles of equity.<sup>64</sup> Given the marginal support *Enron* could find in direct precedents, the bankruptcy court should have

undertaken an exploration of the historical principles of equitable subordination to determine whether subordination was appropriate. Such an examination is beyond the scope of this article, but it would start with the question of whether the principles of equitable subordination were principles of equity circa 1978 or perhaps, under *Grupo Mexicano de Desarrollo, S. A. v. Alliance Bond Fund, Inc.*,<sup>65</sup> circa 1789. It would also necessitate delving into the pre-*Deep Rock* case law and looking at how subordination was practiced in equity receiverships. Finally, it would need to consider the legal respect accorded to formally distinct relationships between the same parties in comparable situations.

These are more demanding questions than presented by a typical motion to dismiss in a bankruptcy case, but then most cases do not present as many questions of first impression with such broad implications for all of commercial law as *Enron*. *Enron* was a thoughtful opinion, but it did not always ask the right questions. The absence of a “principles of equity” analysis, combined with the questionable authority, leaves *Enron*’s holding that a claim may be subordinated for its holder’s unrelated inequitable activity on shaky ground.

### **B. Subordination of Claims in the Hands of Transferees on Account of the Transferor’s Behavior**

*Enron*’s ruling on the second issue—whether the Funds could be subordinated on account of Fleet’s behavior—was also based on questionable authority. The traditional baseline contract principle governing assignments is “*nemo dat quod non habet*”—no one gives that which they do not have. No case has ever applied *nemo dat* to a claim’s priority; it has only been used in the context of a claim’s validity,<sup>66</sup> which is an issue between the obligor and the assignee, not between the assignee and other creditors.

In *Enron*, the issue was not the rights of the assignee Funds vis-à-vis the obligor, Enron, but vis-à-vis other creditors. Defenses may travel with a claim, but equitable subordination is not a defense against a claim—it does not affect a claim’s validity. A subordinated claim is still valid and enforceable against the debtor, just as an unperfected security interest is enforceable against the debtor, even if neither affect priority vis-à-vis third parties. Subordinated claims still vote and remain eligible for sharing in a distribution, and their holders still have standing to litigate issues, unlike a party with a disallowed claim.<sup>67</sup> Subordinated claims, unlike disallowed claims, still have a seat at the table, even if they are the last to eat and nothing may be left for them. Subordination, like perfection of secu-

rity interests, affects rights only vis-à-vis other creditors. In bankruptcy, *nemo dat* falls under the rubric of claim allowance—whether there is a valid claim—not claim priority.

Functionally, to be sure, priority is often a proxy for validity. In a Chapter 11 case, the plan often provides that there will be no distribution to any class with lower priority than the general unsecured creditors, and subordinated claims are typically inferior to general unsecured claims. Subordination and disallowance should not be conflated simply because they often have a similar effect. They are different legal processes. A valid claim may be subordinated, and a claim may be disallowed even though it could not have been subordinated, e.g., a claim that is not timely filed with the court or a claim based on a disputed debt that is resolved in favor of the bankruptcy estate. Whether equitable subordination and disallowance have the same effect on distribution depends on the assets of the estate, not on any legal principle. If an estate turns out to be solvent, subordinated claims will be paid in full. Although such cases are the exception, they are illustrative of the nature of equitable subordination.

Nor is subordination necessarily complete. Section 510(c) does not require that subordinated claims have inferior status to all claims.<sup>68</sup> Thus, a subordinated claim could recover even if the debtor was not solvent at the time of distribution. In contrast, there is no recovery possible on a disallowed claim. Although equitable subordination often has the same effect as claim disallowance, they are different remedies that operate on different principles.

Whether *nemo dat* should be extended to situations involving priority is beyond the scope of this article,<sup>69</sup> but none of the authorities cited by *Enron* support such a proposition. *Enron*'s authority for allowing claim purchasers to be subordinated on account of claim seller's behavior is even more questionable than for allowing the subordination of a claim on account of its holder's unrelated behavior.

*Enron* relied on the Supreme Court's 1906 ruling in *Fidelity Mutual Insurance Co. v. Clark*<sup>70</sup> and on the Eighth Circuit's 1942 ruling in *Goldie v. Cox*<sup>71</sup> as authority for its ability to subordinate a purchaser of a claim that could have been subordinated in the hands of the seller.<sup>72</sup> *Clark*, however, actually rejected the *nemo dat* principle, and *Goldie* endorsed the principle in dicta regarding a claim *allowance* issue that had not even been appealed. These cases are thin authority for *Enron*.

*Clark* involved a plot to collect on life insurance policies through a faked camping trip death in which the "deceased's" body was never re-

covered.<sup>73</sup> The policies' beneficiary, who was in on the scam, engaged an attorney to collect the insurance proceeds in exchange for an assignment of a one-third interest in the policies.<sup>74</sup> The attorney was unaware of the fraud being perpetrated through the litigation.<sup>75</sup> After the attorney won the case, the insurer learned of the fraud and sued to recover the policy payments from the beneficiary and the attorney-assignee.<sup>76</sup> The attorney argued that he was a good faith purchaser of an interest in the policies and therefore entitled to keep the proceeds.

Justice Holmes, writing for the Court, noted that the attorney had properly acquired legal title to the proceeds and that to recover the proceeds, the insurer "must show some equity before [the assignee's] legal title can be disturbed,"<sup>77</sup> namely, that the purchaser took the assignment either with notice or without having given value.<sup>78</sup> *Clark* thus rejected *nemo dat* in a good faith purchaser context. In *Clark*, a good faith assignee for value was protected as against the obligor.

*Enron* rejected the Funds' claim to be good faith purchasers because it held that they took with constructive notice. Under *Clark*'s standard, though, the Funds were without any notice, as discussed below.<sup>79</sup> So long as the claims purchase occurred before the claims were subordinated, the Funds should not have been liable for any inequitable behavior by Fleet under *Clark*.

*Goldie v. Cox* was not even a subordination case—it was a claim allowance case involving the validity, not priority of claims. In *Goldie*, the bankrupt debtor had an account with a creditor.<sup>80</sup> The creditor sold all of his bankruptcy claims against the debtor held as of a certain date.<sup>81</sup> The creditor continued to lend to the bankrupt, and the bankrupt made payments on his account to the assignor.<sup>82</sup> The bankruptcy referee had held that, under a FIFO repayment principle, the bankrupt's payments should be credited to the earlier accrued assigned account first, and that the bankrupt's payments had paid off the assigned debt.<sup>83</sup> Accordingly, the referee disallowed the assignee's claim.<sup>84</sup> The assignee did not appeal.<sup>85</sup> The Eighth Circuit dealt with the issue in a superficial dictum, noting, "there is no point in examining this matter."<sup>86</sup> The Eighth Circuit agreed with the referee's ruling, and noted that if all the claims were still held by the assignor, the payments would have been first credited to the oldest debts, so the assignee should fare likewise.<sup>87</sup> While *Goldie* expressed the general principal of *nemo dat*, it did so in dicta in the context of claim validity, not priority, and is thus of little guidance for *Enron*.

Similarly, the other line of cases cited by *Enron*, the Supreme Court's rulings in *Shropshire, Woodlife, & Co. v. Bush*<sup>88</sup> and its progeny, fails to provide much support for a blanket rule of transitive priority between assignees and assignors. In *Shropshire*, the Supreme Court held that an assigned wage claim retains its priority after assignment because the "character of the debts was fixed when they were incurred, and could not be changed by an assignment."<sup>89</sup> While *Shropshire* endorsed transitive priority, it did so in a situation that is readily distinguishable from *Enron*. Although a prioritized wage claim does not turn into a nonpriority general claim by assignment, it does not follow that a claim that *could have been* subordinated retains that quality in the hands of an assignee.<sup>90</sup> Whereas force of statute automatically and indelibly sets a wage claim's priority, equitable subordination only affects a claim's priority if a § 510(c) action is successfully taken. Until a successful § 510(c) action is prosecuted, there is no effect on a claim's priority. The fact that *statutory* priority is transitive does not tell us whether *equitable* priority is. It may well be that there are good policy reasons for applying *nemo dat* in equitable priority contexts, but *Enron* did not provide them.

### **C. Denial of Good Faith Purchaser Status to All Bankruptcy Claim Purchasers**

Finally, *Enron* held that a purchase of a bankruptcy claim cannot be in good faith because a purchaser knows that the claim comes with a risk of subordination. Such a broad rule is a striking departure from the traditional case-by-case analysis of good faith in bankruptcy cases. The Bankruptcy Code does not contain a definition of "good faith." Instead, courts have determined it on a case-by-case basis, searching for the indicia of an arm's-length transaction.<sup>91</sup> *Enron*, however, lay down a wide-reaching rule that denies good faith status to *any* transaction in bankruptcy claims.

*Enron* derived this rule from determinations of good faith in fraudulent transfer cases, in which the transferees argued that they should be protected as good faith purchasers of the transferred assets.<sup>92</sup> A prominent feature of bankruptcy's marshalling functions is the existence of provisions that allow the clawback of voidable preferences and fraudulent transfers made up to one year before bankruptcy.<sup>93</sup> Parties that receive assets from a distressed company have to assume that they are subject to clawback for up to one year. While clawback actions are taken at the discretion of the trustee, DIP, or creditors' committees, there is a presumption that they will be undertaken.

Such assumptions do not exist for equitable subordination. There is no presumption that creditors will bring an equitable subordination action, and even if a subordination action is undertaken, the remedy is at the discretion of the court, unlike for fraudulent transfer or voidable preference. There is a different level of notice involved. Indeed, the notice for clawbacks is tempered by its one-year statute of limitations. There is no temporal statutory safe harbor for equitable subordination because it was not a broad risk pre-*Enron*.

The notice difference mirrors the difference between claims with statutory priority and claims with equitable priority. Good faith involves different issues in a fraudulent transfer context than in a transfer between claimants. The better analogy to a claim transfer is the transfer of a fraudulent transfer to a secondary transferee. Provided that the secondary transferee has taken in good faith, for value, and without notice, the Bankruptcy Code provides him a defense against fraudulent transfer actions under 11 U.S.C.A. § 550(b). Although *Enron* correctly noted that § 550(b) does not contain such a defense for good faith transferees of bankruptcy claims, Congress never considered the issue, in part because there had never been a subordination of a good faith transferee before *Enron*.<sup>94</sup> Before *Enron*, no one thought that a statutory good faith purchaser defense was necessary, because there was no risk of subordination for unrelated misconduct of the previous holder of a claim.

*Enron*'s reliance on constructive notice was generally misplaced. Constructive notice is a concept that typically appears in situations involving competing priorities: security interests (including mortgages) and real estate title. These areas of law are also marked by well-developed public filing systems. Constructive notice is imputed precisely because of the existence of the filing system. A party that lends or purchases without a proper search of the appropriate filing system acts at its own peril. The availability of a filing system makes constructive notice fair.

There is no equivalent notice-filing system for bankruptcy claims trades. All claims transfers, excluding some claims transferred as security, must be filed with the court, but there is no uniform claim transfer recordation system.<sup>95</sup> Nor is there a clear need for one, as a claims transfer is not presumed to affect priority, unlike the recordation of a security interest or a deed. Claims purchasers do not rely on a bankruptcy claim notice-filing system to determine their priority. The concept of constructive notice in priority systems derives from the existence of a notice-filing system. In the absence of such a system, it makes little sense to impugn parties with constructive notice.

*Clark*, the 1906 Supreme Court case cited by *Enron*, is instructive as to what sort of notice is required to obviate a good faith defense. In *Clark*, the insurer was attempting to recover payment from the fraudulent beneficiary's assignee. The insurer argued that the assignee could not be a good faith purchaser because he had aided in the fraud by successfully prosecuting the beneficiary's suit for payment. The Supreme Court rejected that argument and held that the assignee could only be held to have notice to equities that were proven, not just alleged, at the time of the assignment:

the equities to which an assignee takes subject are equities existing at the time of the assignment and... the notice with which he is supposed to be charged as an assignee can be of nothing more.... The policies were honest contracts[,] and it was an interest in the policies which was assigned....<sup>96</sup>

The Supreme Court noted that even if the insurer had responded in the original policy collection suit with an affirmative defense alleging fraud, that would not have constituted sufficient notice to vitiate the attorney-assignee's good faith purchaser defense.<sup>97</sup>

Knowledge of a possible legal risk does not itself constitute constructive notice so as to obviate good faith purchaser status. In *Enron*, there was a possibility of subordination, just as there was a possibility of a fraud action in *Clark*. In *Enron*, the Funds purchased their claims *before* the Megacomplaint or any allegation of inequitable behavior against Fleet. This puts the Funds in as good a position as the *Clark* assignee, who received his assignment before there was any allegation of inequitable behavior. And, as *Clark* teaches, even an allegation of inequitable behavior, like the Megacomplaint, does not constitute notice. Had the Funds purchased their claims *after* the Megacomplaint, they would still not have been on notice under *Clark's* standard. Only bankruptcy claims are subject to § 510(c) actions, but all legal claims are subject to a variety of defenses and may turn out to be worthless. Given the discretionary nature of equitable subordination,<sup>98</sup> it is even harder to ascribe constructive notice to the Funds.

Moreover, before *Enron*, there had never been a subordination of arm's-length purchasers of bankruptcy claims on account of inequitable behavior unrelated to the claims by an upstream seller. To credit the Funds with constructive notice in these circumstances is a stretch, and as the Funds took for value, they should have been treated as good faith purchasers. Therefore, *Enron* should have addressed whether they were then

protected under § 550(b), by the “principles of equitable subordination” in § 510(c), or under the federal common law of bankruptcy.<sup>99</sup> Unfortunately, this was not the inquiry *Enron* undertook.

#### IV. WHAT IS THE PROPER REMEDY FOR INEQUITABLE BEHAVIOR?

##### A. The Problem of Claims Washing

Ultimately, *Enron* was not driven by precedent so much as policy, and its policy conclusions are debatable. Two related policy issues arose in *Enron*. First was whether refusing to permit subordination of transferees would encourage “claims washing.” If an inequitable creditor could avoid the consequences of its behavior by selling its claims at their unsubordinated value to an “innocent” third party, *Enron* feared that it would effectively launder the tainted claims and wash away its own inequity.<sup>100</sup> Although *Enron* declined to address the claims washing issue directly,<sup>101</sup> this issue was the elephant in the room. *Enron* noted that making third-party purchasers liable for the inequitable creditor’s behavior would force claims purchasers to: (1) demand a discount on the purchase, thus limiting the inequitable creditor’s profit; (2) demand warranties or indemnities that would keep the inequitable creditor on the hook; or (3) refuse to deal if their concerns could not be satisfied with due diligence.<sup>102</sup> The loss need not lie with the claims’ purchasers, however, as they could sue up the chain of title until the inequitable actor was eventually brought in as a defendant.<sup>103</sup> The second policy issue was whether the proper remedy was subordination or a direct action by the estate against the inequitable creditor.

The issue of claims washing is related to the remedy issue; claims washing is not a concern if an inequitable creditor can be made to pay for its misdeeds. In an ideal world, the full costs of inequitable behavior would be borne by the inequitable party. Equitable subordination of innocent claims purchasers does not effectuate such a proper cost internalization because it imposes the wrong amount of costs on the wrong party.

By focusing on the secondary problem of claims washing rather than the root problem of inequitable behavior, *Enron* failed to consider an important alternative when evaluating remedies’ efficacies. Claims washing is only a problem if there is no liability for the inequitable party. So long as the inequitable party remains liable, then it should not matter if he sells his claims.

### **B. Equitable Subordination Compared with Direct Actions by the Estate**

*Enron* considered the costs and efficacy of two alternative remedies that could prevent claims washing: equitable subordination and direct actions against the inequitable party by the estate. *Enron* concluded that between these two alternatives, equitable subordination was the preferable remedy, because “if a debtor were forced to pursue the transferor, it would defeat the goal of section 510(c) of the Bankruptcy Code, and at a minimum, hinder, dilute, or frustrate the distribution.”<sup>104</sup> *Enron* believed that making the estate undertake direct actions would be too onerous: “Burdening of the estate with the necessity of collecting damages to effectuate the remedy of equitable subordination could undermine the remedy itself.”<sup>105</sup> Further, according to *Enron*, there would be an insolvency risk posed by the inequitable party itself, so the injured creditor might not be compensated in the end.<sup>106</sup> *Enron* was also concerned that a direct action brought by the debtor would create an uncertainty regarding the funds available to the estate<sup>107</sup> and would provide lesser compensation to the innocent creditors because they would have to share the recovery from the inequitable creditor in a distribution that would include the un-subordinated inequitable creditor.<sup>108</sup>

*Enron* compared distribution scenarios between equitable subordination and direct actions brought by the estate in a lengthy footnote.<sup>109</sup> Both distribution scenarios involve an estate with \$200 in assets and five creditors, each with a \$100 claim. One of the creditors acted inequitably. In the first scenario, the inequitable creditor is subordinated, so the other four creditors each get a \$50 distribution, and the subordinated inequitable creditor gets nothing. In the second scenario, there is no subordination, and all the creditors, including the inequitable one, get a \$40 initial distribution. Then the estate brings a tort action against the inequitable creditor and recovers \$40, but this \$40 is distributed according to the plan’s pro rata distribution, so all five creditors, including the inequitable one, receive \$8 in the second distribution. Thus, in scenario two, the inequitable creditor ends up with \$8, and the other creditors get \$48 each.<sup>110</sup> As between these two scenarios, the equitable subordination one is clearly preferable because the inequitable creditor does not have a recovery. Any loss incurred by the subordinated claims purchasers can be offset by the purchasers suing up the chain of title until the inequitable creditor is eventually forced to pay.

### C. The Superior Remedy: Direct Actions by Injured Creditors

Unfortunately, these scenarios miss the point because they present a false dichotomy. *Enron* failed to consider a third type of remedy: direct tort actions brought by injured creditors rather than by the estate. A comparison of creditor actions with equitable subordination shows that they are the more precise and just remedy that ensures proper cost internalization.

Neither of the scenarios presented in *Enron* makes sense unless all the creditors (other than the inequitable one) were injured by the inequitable behavior in equal amounts. Otherwise, from a compensatory standpoint, some creditors will be overcompensated, and some will be undercompensated. If the creditors harmed by the inequitable behavior, rather than the estate, brought a direct action against the inequitable creditor, it would cure the problem of *Enron's* second scenario—a second distribution in which the inequitable creditor shares because it was not subordinated.

A direct action by an injured creditor results in much more precise justice than equitable subordination or a direct action by the estate. It prevents uninjured creditors from receiving windfalls or being forced to share the litigation burdens of an action that will not benefit them, and it prevents inequitable creditors from retaining a share of their ill-gotten gains. To illustrate, imagine that *A* and *B* both lend \$2,000 to *D*. Then *B* assists in an accounting fraud that makes *D* look more creditworthy than it really is. *C* then lends \$2,000 to *D* in reliance on the false financials, which is \$1,000 more than it otherwise would have lent. *D* then files for bankruptcy.

*D's* bankruptcy estate has \$3,000 in assets. *A* has a claim for \$2,000, *B* has a claim for \$2,000, and *C* has a claim for \$2,000. The claims of *A*, *B*, and *C* should be of equal priority, but *B* has acted inequitably to *C* by assisting in the accounting fraud and can be subordinated under § 510(c). If *B* were not subordinated, *A*, *B*, and *C* would each get \$1,000. If *B* is subordinated to *A* and *C*, however, then *A* and *C* will each get \$1,500, and *B* will get nothing.

*B* harmed *C* by \$1,000, but in the subordination scenario, *B* harmed *C* by \$1,000, so *B's* recovery is justly reduced by \$1,000. But the reduction in *B's* recovery is divided pro rata between *A* and *C*, although only *C* was harmed. While *A* may think that he is entitled to the \$1,500 distribution because his prebankruptcy expectation was \$2,000, when viewed in relation to his bankruptcy expectation of \$1,000, he has received a windfall of an additional \$500. *C* has the superior claim to the additional \$500 from *B*.

The proper way to sort this out is to have a distribution without subordination, so *A*, *B*, and *C* each receive \$1,000 from *D*, and then to let *C* sue

*B* for the \$1,000. Assuming *C* wins the suit against *B*, the net result is that *C* has \$2,000, *B* has nothing, and *A* has \$1,000. *A* and *C* both have their postbankruptcy expectation of \$1,000, and *C* also has his fraud damages of \$1,000. This is a fair result because *C* was harmed \$1,000 by *B*'s actions, not by the failure of *D*'s business per se. Bankruptcy distributions should only compensate for losses caused by the *debtor*, not for losses caused by third parties' actions.<sup>111</sup> Moreover, if *C* were to lose its suit against *B* on the merits, we should question whether *C* should be able to recover in bankruptcy what it could not recover outside of bankruptcy.

We might note, too, that if *D* turned out to be solvent at the time of distribution and could pay all claims in full, then *A*, *B*, and *C* would each come away with \$2,000. But \$1,000 of *C*'s recovery comes at the expense of the residual claimants—in this case, the equity owners of *D*—rather than from *B*, even though *B* is really the party that is responsible for compensating *C*'s loss. Whether *D*'s shareholders could recover against *C* in an *in pari delicto* situation is unclear.<sup>112</sup>

Yet another advantage direct actions have over subordination is that a recovery in a direct action depends on the amount of harm incurred, not the existence, size, and priority of the inequitable party's bankruptcy claim. Thus, if *B* harmed *C* by \$1,000, but *B* only filed a \$100 bankruptcy claim, that \$100 would present the upper limit of the recovery that would be shared by uninjured *A* and injured *C*. Indeed, if *B* did not file a claim at all, subordination would not be a possible remedy, although a direct action would remain available. Direct actions do not make creditors' recoveries depend on the amount of the inequitable party's claim. Instead, they look to compensate for the actual harm, which is a better and fuller remedy than quasi-punitive subordination.

Direct actions by injured creditors have the additional virtue of making those creditors who stand to benefit from the action carry their own litigation weight, rather than have it diffused among the residual creditors, which is what happens when the estate brings a direct action or an equitable subordination action.<sup>113</sup> When the inequitable party is no longer a claimholder and cannot be subordinated, a direct action by injured creditors against the inequitable party is a superior solution to the equitable subordination of the claims' innocent transferee.<sup>114</sup> The superiority of direct actions is particularly pronounced when one weighs in the systemic costs to market liquidity imposed by the subordination of good faith transferees.

#### **D. *Enron's* Concerns About Direct Actions**

*Enron's* concerns about the speed, certainty of distribution, and burdens of direct actions brought by the estate should apply with equal force to direct actions brought by injured creditors. Upon examination, however, these concerns are unwarranted or are insufficient reason to favor equitable subordination.

*Enron's* concerns about the speed and uncertainty of distribution<sup>115</sup> make little sense because they would apply equally, if not more so, to an equitable subordination action as to a direct action. Because equitable subordination is discretionary, it actually has a level of uncertainty that a direct action for damages does not. There is no right to a speedy bankruptcy distribution,<sup>116</sup> and there is no cause to believe that a direct action would take significantly longer to prosecute than an equitable subordination motion. Equitable subordination is an adversary proceeding.<sup>117</sup> Therefore, the Federal Rules of Civil Procedure govern in almost all respects, including pleadings, defenses, and discovery,<sup>118</sup> so similar court filings and discovery would be necessary in both cases. Indeed, an adversary proceeding might be a greater burden to litigate because of the additional level of appellate review involved if the subordination is heard on reference to the bankruptcy court. There is no reason to suppose that transaction costs would vary significantly between direct actions and subordination actions. If the same inequitable behavior injured several creditors, these creditors could all be joined in the same suit. The costs of these suits would be borne by the interested creditors, not by the creditors as a whole. Indeed, when the total litigation costs of all the scenarios are considered, a direct creditor action against the inequitable party is probably the least costly route. Not only does a § 510(c) action have its own costs, but significant litigation costs will be incurred if the subordinated innocent purchasers sue their sellers, who then sue their sellers, all the way upstream until the inequitable party is brought into the suit. While these costs are not borne by the bankruptcy estate or the residual creditors, we should nonetheless be wary of designing a remedial system that increases total transaction costs.

For these same reasons, *Enron's* concern about burdening the estate with a direct action is unmerited. A direct action should not be a significantly greater burden than an equitable subordination action, and the insolvency risk of the inequitable party is no different than the risk regularly assumed in any dealing that could result in litigation. Moreover, the es-

tate might not have Constitutional standing to bring an equitable subordination action.<sup>119</sup>

As a general policy matter, there should be a preference for remedies that remain within the ambit of a bankruptcy case over remedies that necessitate nonbankruptcy litigation. The efficacy of bankruptcy proceedings depends, in part, to the expanse of bankruptcy jurisdiction, which mandates collective proceedings. The marshaling of assets for an orderly distribution is effective only when there is exclusive jurisdiction over a sufficient body of assets. Legal rules that chip away at the scope of bankruptcy jurisdiction have significant negative systemic effects.

Whether the direct action would be an adversary proceeding or a separate action would depend on the facts involved. In most cases, it would probably not qualify for the bankruptcy jurisdiction of a district court. 28 U.S.C.A. § 1334(b) provides original subject matter jurisdiction for the district courts for “all civil proceedings arising under title 11, or arising in or related to cases under title 11.”<sup>120</sup> A direct action between two creditors would not qualify for “arising under” or “arising in” jurisdiction because it neither seeks relief available only under a Bankruptcy Code provision<sup>121</sup> nor involves the administration and structuring of the estate.<sup>122</sup> It would probably also not qualify for “related to” jurisdiction, for, as the Supreme Court noted in *Celotex Corp. v. Edwards*, “bankruptcy courts have no jurisdiction over proceedings that have no effect on the debtor.”<sup>123</sup> It might be possible, though, that a direct action could have an effect on the estate, such as altering the debtor’s “options[] or freedom of action.”<sup>124</sup>

Even assuming that there would not be bankruptcy jurisdiction over direct actions by injured creditors against inequitable parties, it does not follow that this would result in a detrimental effect on the bankruptcy system. Requiring direct actions by creditors against an inequitable claim seller over subordination actions against innocent claims purchasers does not affect the estate (and if it did, there would be bankruptcy jurisdiction); there is no impact on the estate’s assets. Such a requirement would affect only the order of distribution, an area in which the estate has no cognizable interest. Moreover, to the extent that the order of distribution is affected, requiring direct actions results in a fairer distribution than subordination of innocent claims purchasers.

### **E. The “Soft” Nature of Equitable Subordination**

Whether direct actions make for a proper comparison with equitable subordination depends on whether the inequitable actor would remain li-

able for a direct action. In most cases, the inequitable actor would presumably be liable if it acted inequitably. If the inequitable actor was part of a fraud against a creditor, there should be traditional measures of liability, which will entail traditional defenses.

Liability for equitable subordination is not coextensive with tort or fraud liability, however. Equitable subordination is a vague and ill-defined standard.<sup>125</sup> Behavior that is legal and beyond reproach outside of bankruptcy may nonetheless result in subordination.<sup>126</sup> Moreover, statutes of limitations will not protect against equitable subordination, although laches is presumably a viable defense.

The soft nature of equitable subordination should make us wary of subordination as a remedy in general. It bears all the problems of traditional equity jurisprudence, so aptly criticized in the 17th century as unpredictable and dependent on the whim of the chancellor:

Equity is A Roguish thing, for Law wee have a measure known what to trust too. Equity is according to the conscience of him that is Chancellor, and as that is larger or narrower, soe is equity. Tis all one as if they should make the Standard for the measure wee call A foot, to be the Chancellors Foot; what an uncertain measure would this be; One Chancellor ha's a long foot another A short foot a third an indifferent foot; this the same thing in the Chancellors Conscience.<sup>127</sup>

The problems created by equity's fuzzy nature are magnified for claims purchasers. While equitable subordination is allowed for by § 510(c), courts should hesitate to expand the remedy's scope to situations in which parties cannot easily protect against its vagueness. It is extremely difficult to calculate subordination risk and thus properly price warranties, indemnities, and sureties. Pricing difficulties are likely to be compounded by parties' risk aversion, which might in turn be exacerbated by their attorneys' risk aversion in dealing in such a fuzzy area. Likewise, subordination risk presents unusual diligence problems, because it is such a grey area, particularly if it is expanded to allow for subordination of claims purchasers for an upstream seller's behavior unrelated to the claim. Few law firms would put themselves on the line with a strongly worded opinion letter guaranteeing nonsubordination. The judgment call involves too many facts and nuances and depends on the proverbial and unknowable Chancellor's foot. Although this will not matter in most transactions because equitable subordination is too remote a risk, it will

matter in transactions in bankruptcy claims, credit default risks, and distressed debt.

There are reasons to be skeptical of equitable subordination as a remedy in general. Nonetheless, requiring direct actions by injured creditors against the actual wrongdoer instead of subordination of innocent claims purchasers does not affect the availability of subordination actions within their traditional scope—against a claim on account of a creditor’s own inequitable behavior related to the claim. 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. Limiting the scope of the equitable subordination remedy ensures more just results that better approximate the ideal situation in which all parties internalize their externalities. Requiring direct actions by injured creditors ensures that injured creditors do not externalize their litigation costs and risks, and it ensures that inequitable parties are forced to internalize the full measure of their inequitable behavior.

#### **V. COUNTERPARTY RISK IN BANKRUPTCY CLAIMS & ENRON’S SYSTEMIC COSTS ON MARKET LIQUIDITY**

There are many legitimate reasons why a creditor would sell a bankruptcy claim. As *Enron* recognized, creditors sell their claims:

to avoid the administrative hassle and costs of bankruptcy proceedings; or to establish a tax loss on their investment; or meet the regulatory requirements, including Basel Accord capital requirement, auditing rules for balance sheet asset write-offs or mark-to-market accounting requirements for securities.<sup>128</sup>

Many creditors do not want to be claimholders throughout a bankruptcy because of the legal and opportunity costs involved. Many creditors are therefore happy to sell their claims at a discount, which has resulted in a claims trading market estimated to be in the hundreds of billions of dollars.<sup>129</sup>

The existence of a market in bankruptcy claims is important for the health of distressed debt (and indirectly all debt and equity) markets. If there were no bankruptcy claims market, creditors would be more reluctant to deal with distressed or high-risk companies because of the possibility that they would be left holding bankruptcy claims and forced to incur the expense and inconvenience of being claim holders. The existence of the secondary market increases the liquidity of regular debt and equity markets and makes it easier for companies to raise capital. Therefore, any

legal rule that decreases the liquidity of the bankruptcy claims market affects nonbankruptcy markets and makes it harder for distressed companies to raise capital, which exacerbates financial distress and makes bankruptcies more likely.

*Enron* has decreased liquidity throughout capital markets by creating a new type of counterparty risk. Counterparty risk is the risk entailed by dealing with a particular transaction partner—in this case, the risk that the transaction partner is selling an impaired asset. Post-*Enron*, claims purchasers must worry not just about sellers' title, but also about sellers' interactions with the debtor unrelated to the claim. This concern extends not just to the direct seller, but also to all holders up the chain of title, as *Enron* involved the subordination not just of primary, but also of secondary and tertiary transferees.<sup>130</sup> Under *Enron*, the identity of a trading partner matters, as does the identity of every previous holder of a claim. The identity and actions of all parties up the chain of title continues to matter throughout the duration of a bankruptcy; there is no statute of limitations on equitable subordination, unlike for preferences and fraudulent transfers.<sup>131</sup>

Bankruptcy claims traders are extremely sophisticated financial players who regularly engage in risk valuation. *Enron* counterparty risk presents a unique problem for the market, though. There is a qualitative difference to subordination risk and claims traders do not know how to account for it. Claims purchasers lack reliable information for calculating the statistical probability of subordination of a particular claim. They do not have sufficient information about any particular upstream claimholder's actions, and even if they did, they cannot calculate the magnitude of damages caused by the inequitable behavior. And in electronic OTC markets, like bond trading, the trades are typically anonymous, so it is impossible to learn about upstream holders.

Nor can claims purchasers evaluate the residual value of claims, should they turn out to be tainted. If a claim is subordinated, the purchaser can sue up the chain of title until the inequitable party is brought into the litigation. Ultimately, the value of such a suit depends on the creditworthiness of the subordinated purchaser's transferor. If the transferor is insolvent, the claims purchaser will have a claim in the transferor's bankruptcy—and a likely recovery of cents on the dollar. Claims purchasers do not typically have sufficient information on counterparties' creditworthiness—the transaction is an asset purchase, not a loan, so detailed financial diligence is neither offered nor expected. Even the most sophisticated financial actors do not know how to account for *Enron's* counterparty subordination risk.

It is hard to evaluate the tradeoff between increased bankruptcy risk for all creditors and increased counterparty risk for claims purchasers on the one hand versus increased protection from inequitable creditors in bankruptcy on the other. Neither the increased bankruptcy risk nor the value of protection from claim washing can be quantified. The arbitrariness of this tradeoff makes *Enron* a questionable decision from a market perspective. It forces creditors to accept legally mandated “insurance” against claim washing at the price of more debtors filing for bankruptcy.

Neither creditors nor debtors would likely opt into such an “insurance” system voluntarily. Creditors have other methods of protecting themselves. Ex-ante options include secured debt, sureties, and credit derivatives, while ex-post, they can undertake direct actions against the inequitable parties. Creditors cannot easily anticipate which side of the equitable subordination divide they might find themselves, but they are not likely to assume that they have engaged in wrongdoing. Finally, most creditors would prefer that their debtors remain out of bankruptcy to greater protections for themselves in bankruptcy. The same is true of debtors. Neither a debtor’s management nor its ownership would prefer greater protection for creditors in bankruptcy to a lower risk of bankruptcy because in a bankruptcy, the management and ownership are frequently replaced.

It is also probably impossible to conduct adequate diligence against *Enron*’s counterparty risk in some situations, such as when the claims seller is a large financial institution that could have interacted with the borrower in myriad ways over a lengthy period. A bank like Fleet or any of the intermediary transferees in *Enron* could have served as an underwriter of a debtor’s securities offerings, a broker or market maker in the debtor’s securities, a trustee for the debtor’s pension plan, a participant in a loan to the debtor, a direct lender to the debtor, or as the debtor’s adviser on a merger or acquisition. Given the merger trend among financial institutions, a claim seller’s inequitable behavior could have been committed by what was then a separate institution, making diligence harder because of non-uniform records and limited institutional memory. Moreover, diligence is extremely difficult for equitable subordination because equitable subordination does not require illegal behavior. Frequently, subordination is for legal but untoward acts. It is not realistic to expect junior associates in document rooms to have the judgment to discern what is equitable and what is not within a legal gray area.

*Enron* will also have a marginal effect on who is involved in the reorganization drama. The past decades have seen the rise of distressed debt

investors—so-called “vulture” or “phoenix” funds, like the Funds in *Enron*. Distressed debt investors have come to play an increasingly important role in reorganizations, which has generated considerable debate as to whether their presence furthers or hinders the reorganization process.<sup>132</sup> *Enron* will limit the involvement of distressed debt investors, although one suspects that the impact will be marginal. The proper role for distressed debt investors is a policy decision, not a legal one, and is better addressed by Congress than a court.

*Enron* will also affect the balance of power within reorganizations. The increased counterparty risk will increase the leverage of debtors and creditors’ committees when negotiating with claims purchasers, further reducing the power of distressed debt investors in reorganizations. Whether this is a positive result depends on one’s view of the influence of distressed debt investors on reorganizations, but it represents a reversal of the increasing strength of distressed debt investors in the reorganization process.

*Enron* will also affect the liquidity and pricing of different types and sizes of bankruptcy claims differently. *Enron* increases the value of claims that travel with subordination indemnities or warranties, like loan participation claims, relative to those that do not, like bonds and trade claims, although one has to question what these indemnities and warranties are worth in light of the expense that would be involved in litigating them. It will increase the relative value of diversified synthetic instruments like securitizations and may encourage the development of securitized bundles of bankruptcy claims. It also places new emphasis on the creditworthiness of the indemnitor. Claims purchasers will now have cause to look into seller’s finances, or take out insurance, in the form of credit default swaps on the seller, adding transaction costs to deals.

It is unclear how *Enron* will affect claims trading in terms of size of claims purchases. Most likely, it will make small claims less liquid. Some claims purchasers may choose to protect themselves from subordination risk by diversifying to minimize the impact of any particular subordination. This strategy would call for purchasing smaller claims. Yet, distressed investors often invest to achieve negotiating leverage and shape the outcome of a reorganization plan or gain an advantage in the sale of an estate asset. In such situations, a small claim is of limited value, as it will provide insufficient leverage. *Enron* alters the dynamics of the bankruptcy claims market, which is an essential part of the health of all capital markets.

## VI. WHAT ARE THE LIMITS OF *ENRON'S* REACH?

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. Although *Enron* itself dealt with a relatively limited fact pattern, no one is sure what its limits are. 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.

### A. Credit Default Swaps

*Enron* increases counterparty risk in the derivative market in credit default swaps. Credit default swaps are an OTC derivative that insures against a borrower's default through the sale of the default risk separate from ownership of the loan.<sup>133</sup> A lender (the protection buyer) enters into a credit default swap with a party (the protection seller) that promises to purchase the loan at par if the borrower (the reference entity) defaults during the typically short-term duration of the swap contract. Thus, if bank *X* is worried about a loan made to *Enron*, it could enter into a credit default swap with bank *Y*, which would have to pay *X* the par value of the loan upon default, and *Y* would become the owner of the defaulted loan. More typically, *X* would retain ownership of the loan and would instead purchase *Enron* bonds with a face value equal to that of the loan, which it would then transfer to *Y*. In perfect market conditions, the market value of the bonds will be the same as that of the loan itself.<sup>134</sup> Credit default swaps give lenders the ability to transform low-quality debt into high-quality debt by substituting the default risk of the swap counterparty for that of the reference debtor.<sup>135</sup>

If bank *Y* has to investigate every party with which it enters into credit default swaps to determine that it is not a "bad actor" in relation to the borrower, it will raise the price of credit default swaps, and thus the cost of borrowing, which will in turn prevent some otherwise beneficial transactions from occurring. Credit default swaps have grown into a major OTC derivatives market in the past decade. At the end of 2005, there were \$17.1 trillion in notional outstandings for credit default swaps.<sup>136</sup> Credit default swaps are important for the liquidity of the bankruptcy claims market, because they provide an exit market for small bondholders, whose positions are purchased by protection buyers to cover their swap obligations. The availability of credit default swaps also helps creditors limit their lending exposure, thereby lowering costs to borrowers. Not

only does *Enron* increase the cost of raising capital by restricting liquidity in the bankruptcy claims market, it does so too by raising the cost of credit insurance devices like credit default swaps.

### B. Loan Participations

*Enron* also creates problems for loan participations. The standardized loan participation transfer documentation only includes upstream chains of title,<sup>137</sup> warranties of good behavior<sup>138</sup> and non-impairment,<sup>139</sup> or indemnities<sup>140</sup> for the transfer of distressed loans. Loans trading at par or near par (to approximately \$0.90 on the dollar) lack such protections. The distressed loan market is less liquid because of purchaser protections, and this hurts distressed companies' ability to raise capital and makes bankruptcies more likely.

Purchaser protections, including chains of title, on a distressed loan participation extend only to the time the loan began to trade using distressed documentation.<sup>141</sup> Most debt does not begin its life as distressed, so the purchaser of distressed debt can only trace chains of title up to the time that the debt became distressed and has no guarantees regarding the behavior of holders when the debt was not distressed. In the case of *Enron*, the Short Term Credit Agreement was not distressed debt when issued. Had Fleet sold its share of the participation when it was still trading at par, the Funds might never have known that Fleet had held the participation, much less been able to conduct diligence on Fleet.

Of course, one could change the practices of loan participation trading to make par loans trade with the same standardized protections as distressed debt. This would decrease the par market's liquidity, and there would be a problematic transition period. The exact liquidity impact is hard to gauge, but it appears that many claims trades fail because of an unwillingness to agree on purchaser protections because parties are risk adverse. As Chaim Fortgang and Thomas Moers Mayer have noted, "The importance of such representations, warranties and indemnities should not be underestimated. Failure to agree on these provisions has destroyed a surprisingly large number of deals after claims buyers and claims sellers agreed on economic terms."<sup>142</sup> Equitable subordination is traditionally a rare and unusual remedy,<sup>143</sup> but one that parties would nonetheless want protection against because it can result in a total loss.

*Enron* correctly noted that, in theory, the market price for bankruptcy claims should adjust itself to address this risk.<sup>144</sup> The bankruptcy claims market, like the credit default swap and loan participation markets, is

made up of extremely sophisticated players who can protect themselves via pricing, insurance, and derivatives. Still, one has to wonder whether the market can properly discount for the risk of subordination. Parties' natural risk aversion may lead to imperfect pricing, causing otherwise mutually beneficial transactions to fail, and thereby restricting liquidity in the claims market and thus the ability of distressed companies to raise capital.<sup>145</sup> This is yet another way that *Enron* raises the cost of raising capital and increases financial distress for troubled companies.

### **C. The Slippery Slope Toward Increased Counterparty Risk in All Capital Market Transactions**

*Enron* also creates a slippery slope that could increase counterparty risk on capital market transactions. *Enron* noted that it also applied to prepetition agreements to purchase a bankruptcy claim:

... based on the Court's previous analysis, no legal or policy basis supports the premise that transferees of bonds or notes should be treated differently than those holding the transferred loan claims. All post-petition transferees assume the risk that their claims may be subject to subordination.... 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 the bankruptcy of a party to such agreement should fair [sic] no better than a post-petition purchaser of claims.<sup>146</sup>

At first glance, this dictum is very sensible. As long as the purchaser is aware that he is purchasing bankruptcy claims, it should not matter whether he agreed to purchase them before or after a bankruptcy petition was filed. The purchaser has consciously assumed the same risks in both cases and therefore should be treated the same.

The problem with extending *Enron* to prepetition agreements to purchase bankruptcy claims is that a prepetition agreement to purchase bankruptcy claims is difficult to distinguish from a normal prepetition debt purchase. A prepetition debt purchase always includes the purchase of a bankruptcy claim. In the case of distressed debt (or equity in a failing company) the likelihood of the debt or equity becoming a bankruptcy claim or interest is high. Why should a vulture fund that purchases distressed debt on the eve of bankruptcy be treated differently than another fund that purchases claims postpetition? The intervening formality of a bankruptcy filing is not a good enough reason for disparate treatment.

Once *Enron* is extended to prepetition agreements to purchase bankruptcy claims, it becomes difficult to differentiate it from any other prepetition debt purchase or for that matter, from prepetition securities or derivatives purchases. *Enron*'s trajectory implicates all capital market transactions, and in publicly traded markets, diligence is simply impossible. Indeed, that is why publicly traded securities are negotiable instruments, although one should query whether that status provides protection from subordination. Whether a court would ever countenance the subordination of a purchaser of publicly traded security or derivative for the unrelated behavior of a virtually anonymous prior holder is doubtful, but *Enron* sets the table for such a subordination, and no creditor wants to be the test case.<sup>147</sup>

So far, there has not been a noticeable market change in response to *Enron*, but that may change if it is upheld on appeal. Diligence is likely to increase as to past holders' identities and dealings with the debtor and to sellers' financial ability to make good on warranties or indemnities. Purchase negotiations are likely to focus more on indemnities, warranties, and sureties. Insurance, derivatives, and structured finance solutions designed to hedge against subordination may even appear. And concerned creditors are likely to seek waivers of subordination or file declaratory judgment actions, both of which would impose costs on bankruptcy estates. Until *Enron*'s limits are clarified, it will create uncertainty throughout financial markets.

## VII. REFCO: A FIRST GLIMPSE AT THE EFFECTS OF ENRON

Developments in the *Refco* bankruptcy provide an early look at how *Enron* is playing out in market behavior and show how seriously *Enron* has affected the claims trading market. *Refco* shows that subordination risk is treated as qualitatively different from the regular business risks against which sophisticated actors like claims traders routinely protect themselves.

*Refco* was a financial services company that ran a major commodities and futures brokerage. In October 2005, shortly after *Refco*'s IPO, its newly hired controller discovered that *Refco*'s CEO and chairman had hidden some \$430 million in bad debts from the company's auditors and investors. These debts had been hidden by arranging for *Refco* to make quarterly loans to other financial institutions, which would then reloan the money to a company controlled by *Refco*'s CEO that was named to appear as if it were a *Refco* subsidiary. This false subsidiary would then purchase the bad debts from *Refco*, using *Refco*'s own money in effect. On *Refco*'s books, it appeared as if *Refco* had an asset in the form of

loans to creditworthy, independent financial institutions, so Refco was able to avoid acknowledging and writing off the bad debts, which would have left Refco with negative equity.

Refco filed for bankruptcy on October 17, 2005. One of the intermediary institutions, the Austrian Bank BAWAG P.S.K. Bank für Arbeit und Wirtschaft und Österreichische Postsparkasse Aktiengesellschaft (BAWAG), filed various bankruptcy claims against Refco. In April 2006, as BAWAG's involvement in Refco's fraud came out, Refco's creditors filed suit against BAWAG, creating a situation similar to *Enron*, in which a claimant was accused of injuring other claimants.<sup>148</sup> *Enron* expected trading claims potentially tainted by an inequitable creditor to continue with an appropriate risk discount. This is not what occurred in *Refco*. As soon as there was rumor of BAWAG's alleged misdeeds, all claims that had ever passed through BAWAG's hands became radioactive, before the other Refco creditors filed suit against BAWAG. No one would purchase them for any price because of the fear of subordination or disallowance.<sup>149</sup> The fear of BAWAG claims was so great that reputable financial institutions took the drastic step of refusing to close confirmed trades in BAWAG-tainted claims.<sup>150</sup> Holders of BAWAG claims found themselves unable to unload their positions or to mark the claims to market because there was no market for these claim.<sup>151</sup> Even if these purchasers had bargained for indemnities, they could not collect them, because no subordination had yet occurred.<sup>152</sup> Purchasers that expected to be short-term claim holders found themselves trapped in positions of uncertain duration.<sup>153</sup>

Normally, in a commoditized market like bankruptcy claims trading, a situation like BAWAG's creates a profit-rich opportunity that some party will have the risk appetite to explore. BAWAG claims would be so heavily discounted that there would be much more profit potential. One major financial institution, which has requested to remain anonymous, closely considered buying the BAWAG claims for precisely this reason and had its attorneys examine the matter. In light of *Enron*, the attorneys could not get comfortable enough to sign off on a deal. The subordination risk was too great for the financial institution to purchase the claims, regardless of the price. Indeed, because there were questions about BAWAG's own financial stability, the possibility of recourse against BAWAG in the event of a subordination was of little comfort to the potential purchaser.

What *Refco* shows is that *Enron* is not a sui generis problem. As *Enron* plays itself out in more cases, the market will take the subordination risk much more seriously. Moreover, Fleet and BAWAG were, relatively

speaking, small players. If an agent bank, lead underwriter, or market maker is alleged to have acted inequitably in a future bankruptcy, it could affect a far greater percentage of the total dollar amount of claims on the debtor. Although bankruptcy claims traders' business involves protecting against possible risks, equitable subordination is one that these sophisticated market players are unwilling to leave to chance, in part because of the soft, discretionary nature of the action. Market behavior shows that *Enron* counterparty risk is qualitatively different from other risks.

There is a coda to *Refco* that raises an intriguing subsidiary question. BAWAG settled its claims with the Refco creditors, the Department of Justice, and the SEC for \$675 million, half of which will go to the bankruptcy estate.<sup>154</sup> BAWAG admitted to involvement in some of Refco's schemes.<sup>155</sup> The settlement includes mutual releases—Refco will drop its claims on the bankruptcy estate, and the estate and creditors will drop their claims against Refco. This still leaves open the fate of claims purchased from BAWAG between Refco's bankruptcy filing in October 2005, and the market freeze on BAWAG claims in April 2006. Does the release of BAWAG cleanse its claims? Or are the purchasers still on the hook under *Enron*? The question is troubling. Arguably, since BAWAG only released the claims it still had against Refco, Refco's release should only be construed as extending to BAWAG itself. BAWAG claims purchasers should garner no protection from the settlement. But the settlement is also intended to make Refco and its creditors whole. Thus, if the settlement were in satisfaction of any injury inflicted by BAWAG, subordination of BAWAG claims purchasers under *Enron* would be a punitive action that would result in a windfall to other creditors. The extent of *Enron* counterparty risk is only beginning to become apparent.

### VIII. ENRON'S INVERSE COUNTERPARTY RISK: THE "SHORT-AND-DISTORT"

The drastic market reaction to *Enron* counterparty risk creates an inverse counterparty risk in which sellers must fear buyers. *Enron* has created the possibility of market manipulation through a variant of the "short-and-distort," a mirror image "pump-and-dump." A potential claims purchaser could easily manipulate the claims market to achieve a bargain purchase by putting out word of inequitable behavior by claims' originator(s), who would themselves not be harmed unless they were still claimholders. A potential purchaser would not have to state any false facts; implications and suggestions could well do the job. As *Refco* shows, even without filing a lawsuit, mere innuendo of creditor impropri-

ety could cause a sharp decline in any claims that had potentially been held by that creditor. Indeed, *Refco* shows that the claims would become unsellable—except to the party that originated the rumor, which would swoop in to buy at a steep discount.

While a “short-and-distort” stratagem is possible in all markets, it would be far more effective in the claims trading market. OTC markets like claims trading lack price stabilizers like specialists and market makers. Additionally, in a regular market, negative information about a security will cause the security’s price to fall, but it will not usually result in a cessation of trading. Moreover, negative information about a publicly traded company’s operations is usually verifiable: did earnings meet expectations? Did a clinical trial fail? Has a government investigation commenced? These are black-and-white questions. It is much harder to answer whether a company acted so inequitably that its claims will be subject to subordination.

The most important distinction from other markets, though, is that existing law does not protect claims sellers from a short-and-distort. Federal or state securities laws have not been applied to bankruptcy claims trading to date, although that could change,<sup>156</sup> and classic common law fraud does not cover a short-and-distort. In the typical fraud situation, the seller makes the misrepresentation to the purchaser. In a bankruptcy claim short-and-distort, it is the purchaser that makes misrepresentations. Moreover, these representations are never directly to the seller and never in the context of transaction negotiations. A seller to a distorter would not be able to recover its loss under securities laws or common law.

Nor would equitable subordination or claim disallowance be adequate remedies for a seller to a distorter. While these remedies would have a deterrent effect against distortion, they would only punish the purchaser. Subordination and disallowance do not compensate the seller, and they create a windfall for other creditors. There are no clear means of legal redress for the seller in a short-and-distort. At best, the seller could bring an action for unjust enrichment, but that is a hard case to make in an arm’s-length transaction between two sophisticated parties. As claims traders start to realize the market manipulation risk created by *Enron*, the liquidity of the claims trading market is likely to further contract, because sellers must now also be aware of buyers. *Enron* counterparty risk has thus come full circle, to where buyers are afraid of sellers and sellers are afraid of buyers.

## IX. CONCLUSION

*Enron* created a new level of counterparty risk that will decrease liquidity in the claims trading market, which will spill over 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.

### Research References:

Norton Bankr. L. & Prac. 2d § 90:6; Bankr. Serv., L Ed §§ 25:436 25:442  
West's Key Number Digest, Bankruptcy ⇄ 2967 to 2968

### NOTES

1. In re Enron Corp., 333 B.R. 205, 211, 45 Bankr. Ct. Dec. (CRR) 181 (Bankr. S.D. N.Y. 2005).
2. Enron, 333 B.R. at 211.
3. Enron, 333 B.R. at 211-12.
4. Enron, 333 B.R. at 211.
5. Enron, 333 B.R. at 212.
6. Enron, 333 B.R. at 212.
7. Enron, 333 B.R. at 212.
8. Enron, 333 B.R. at 212. Fleet has since been acquired by Bank of America.
9. Enron, 333 B.R. at 212.
10. Enron, 333 B.R. at 212.
11. Enron, 333 B.R. at 212-13.
12. Enron, 333 B.R. at 213.
13. Enron, 333 B.R. at 213. Enron also commenced three separate adversary proceedings against nine Funds (including three of the ones that purchased claims originating with Fleet) that purchased claims from the participations of Barclays, Citibank, Credit Suisse First Boston, and Deutsche Bank in the credit agreements. The bankruptcy court denied the Funds' motions to dismiss in these parallel adversary proceedings. *Enron Corp. v. Springfield Assocs., LLC* (In re Enron Corp.), No. 05-01025 (Bankr. S.D.N.Y., Nov. 28, 2005); *Enron Corp. v. Bear, Stearns & Co., Inc.* (In re Enron Corp.), No. 05-01074 (Bankr. S.D.N.Y., Nov. 28, 2005); *Enron Corp. v. Bear, Stearns & Co., Inc.* (In re Enron Corp.), No. 05-01105 (Bankr. S.D.N.Y., Nov. 28, 2005). Together with the Fleet participation, the par value of all the claims involved is \$268.75 million. Barclays is on the line for \$92.5 million in claims sale, Citibank for \$50 million, CSFB for \$29 million, and Deutsche Bank for \$50 million.
14. Enron, 333 B.R. at 213. Enron also requested that, in the alternative, the court disallow the Funds' claims under 11 U.S.C.A. § 502(d), which provides:

the court shall disallow any claim of any entity from which property is recoverable under section 542, 543, 550, or 553 of this title or that is a transferee of a transfer avoidable under section 522(f), 522(h), 544, 545, 547, 548, 549, or 724(a) of this title, unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable under section 522(i), 542, 543, 550, or 553 of this title.

15. 11 U.S.C.A. § 510(c) (2006).
16. Judge Gonzalez later denied the motion to dismiss the § 502(d) claim disallowance action. In re Enron Corp., 340 B.R. 180, 46 Bankr. Ct. Dec. (CRR) 71 (Bankr. S.D. N.Y. 2006).
17. Enron, 333 B.R. at 210.
18. Enron, 333 B.R. at 210.
19. 11 U.S.C.A. § 550(a)-(b) (2006) provides:
  - (a) Except as otherwise provided in this section, to the extent that a transfer is avoided under section 544, 545, 547, 548, 549, 553(b), or 724(a) of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from—
    - (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or
    - (2) any immediate or mediate transferee of such initial transferee.
  - (b) The trustee may not recover under section (a)(2) of this section from—
    - (1) a transferee that takes for value, including satisfaction or securing of a present or antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided; or
    - (2) any immediate or mediate good faith transferee of such transferee.
20. Enron, 333 B.R. at 233, 235.
21. Matter of Missionary Baptist Foundation of America, 818 F.2d 1135, 16 Collier Bankr. Cas. 2d (MB) 1461, Bankr. L. Rep. (CCH) P 71853 (5th Cir. 1987); L & M Realty Corp. v. Leo, 249 F.2d 668, 672 (4th Cir. 1957); In re Kansas City Journal-Post Co., 144 F.2d 791 (C.C.A. 8th Cir. 1944); Taylor v. Standard Gas & Electric Co., 305 U.S. 584, 59 S.Ct. 96, 83 L. Ed. 369 (1938).
22. Matter of Mobile Steel Co., 563 F.2d 692, 700, 15 C.B.C. 1 (5th Cir. 1977).
23. In re Ahlswede, 516 F.2d 784, 786 (9th Cir. 1975); Prudence Realization Corp. v. Geist, Prudence Realization Corp. v. Geist, 316 U.S. 89, 62 S. Ct. 978, 86 L. Ed. 1293 (1942) (1942).
24. Enron, 330 B.R. at 219, 220, 222.
25. Mobile Steel, 563 F.2d at 700.
26. Mobile Steel, 563 F.2d at 700.
27. In re Kansas City Journal-Post Co., 144 F.2d 791 (C.C.A. 8th Cir. 1944).
28. L & M Realty Corp., 249 F.2d at 672.
29. Taylor, 305 U.S. 584.
30. Kansas City Journal-Post, 144 F.2d at 804 (citing Barlow v. Budge, 127 F.2d 440, 444-46 (C.C.A. 8th Cir. 1942) (in turn emphasizing the fiduciary relationship)); L & M Realty Corp., 249 F.2d at 670 (subordinated creditors were also sole shareholders of undercapitalized corporation, so their loans were really capital contributions).
31. Meinhard v. Salmon, 249 N.Y. 458, 464, 164 N.E. 545, 62 A.L.R. 1 (1928) (Cardozo, J.).
32. Restatement (Second) of Trusts §243 (1957); Restatement (Second) of Agency § 469 (1957).

33. The ultimate precedent for *Mobile Steel* and *Enron* is troubling as a subordination case, since it treated subordination and disallowance as interchangeable remedies. Taylor, 306 U.S. at 324.
34. Missionary Baptist Found., 818 F.2d 1135.
35. Missionary Baptist Found., 818 F.2d at 1146.
36. Missionary Baptist Found., 818 F.2d at 1146.
37. Missionary Baptist Found., 818 F.2d at 1146.
38. Mobile Steel, 563 F.2d at 700.
39. Ahlswede, 516 F.2d at 786.
40. Ahlswede, 516 F.2d at 786.
41. Ahlswede, 516 F.2d at 786.
42. Taylor v. Standard Gas & Elec. Co., 306 U.S. 307, 306 U.S. 618, 59 S. Ct. 543, 83 L. Ed. 669 (1939) (1939).
43. Pepper v. Litton, 308 U.S. 295, 60 S. Ct. 238, 84 L. Ed. 281 (1939).
44. Comstock v. Group of Institutional Investors, 335 U.S. 211, 68 S. Ct. 1454, 92 L. Ed. 1911 (1948).
45. Ahlswede, 516 F.2d at 788.
46. Ahlswede, 516 F.2d at 788.
47. Comstock, 335 U.S. at 229.
48. Ahlswede, 516 F.2d at 788.
49. Ahlswede, 516 F.2d at 788.
50. Prudence Realization Corp. v. Geist, 316 U.S. 89, 62 S. Ct. 978, 86 L. Ed. 1293 (1942).
51. Prudence Realization, 316 U.S. at 96-97.
52. P.V. Baker & P. St. J. Langan, Snell's Equity 27 (29th ed. 1990) ("Equity looks to the intent rather than to the form.").
53. See Prudence Realization Corp. v. Ferris, 323 U.S. 650, 651, 65 S. Ct. 539, 89 L. Ed. 528 (1945); In re The Westover, Inc., 82 F.2d 177, 178 (C.C.A. 2d Cir. 1936).
54. Enron, 333 B.R. at 219 (quoting Mobile Steel, 563 F.2d at 700-01).
55. In re Westgate-California Corp., 642 F.2d 1174, 1177, 7 Bankr. Ct. Dec. (CRR) 705, Bankr. L. Rep. (CCH) P 67939 (9th Cir. 1981).
56. Enron, 333 B.R. at 220 (citing Westgate-California, 642 F.2d at 1177).
57. Westgate-California, 642 F.2d at 1174-79.
58. Enron, 333 B.R. at 221 (citing Westgate-California, 642 F.2d at 1178).
59. Mobile Steel, 563 F.2d at 701.
60. Westgate-California, 642 F.2d at 1178.
61. 11 U.S.C.A. § 510(c).
62. 11 U.S.C.A. § 1122(a).
63. Adam J. Levitin, Toward a Federal Common Law of Bankruptcy: Judicial Lawmaking in a Statutory Regime, 80 Am. Bankr. L.J. 1, 90 (2006). See also Marcia Krieger, "The Bankruptcy Court is a Court of Equity": What Does that Mean? 50 S.C. L. Rev. 275 (1999).
64. 11 U.S.C.A. § 510(c) (2006).
65. Grupo Mexicano de Desarrollo S.A. v. Alliance Bond Fund, Inc., 527 U.S. 308, 119 S. Ct. 1961, 144 L. Ed. 2d 319, Bankr. L. Rep. (CCH) P 77943, 1999 A.M.C. 1963 (1999) (holding in a non-bankruptcy situation that the inherent equity powers of a district court are those that were exercised by the English chancery courts in 1789). For a consideration of the applicability of *Grupo Mexicano* to bankruptcy, see Levitin, Toward a Federal Common Law of Bankruptcy: Judicial Lawmaking in a Statutory Regime, 80 Am. Bankr. L.J. 1, 53-60 (2006). If *Grupo Mexicano* is

not applicable to bankruptcy, it might still apply to § 510(c) actions because of the “principles of equitable subordination” language, although the implication from the legislative history was that this was to reflect the principles as they had developed up until 1978 and that further development was within contemplation of the drafters.

66. Restatement (Second) of the Law of Contracts § 336(1)-(2) (1981).

67. See Daniel C. Cohn, Subordinated Claims: The Classification and Voting Rights Under Chapter 11 of the Bankruptcy Code, 56 Am. Bankr. L.J. 293, 308-11 (1982).

68. Enron, 333 B.R. at 217-18.

69. For a consideration of the problems of *nemo dat* in a priority context, see Adam J. Levitin, “Finding *Nemo*: The Virtues of Negotiability in the Wake of the *Enron* Equitable Subordination,” working paper, May 14, 2006, available at <http://ssrn.com/abstract=910571>.

70. Fidelity Mut. Life Ins. Co. v. Clark, 203 U.S. 64, 74, 27 S. Ct. 19, 51 L. Ed. 91 (1906).

71. Goldie v. Cox, 130 F.2d 695, 720 (C.C.A. 8th Cir. 1942).

72. Enron, 333 B.R. at 223.

73. The 1902 Supreme Court case dealt with the adequacy of the evidence of his death by drowning in the Pecos River in the Texas brush when no body was recovered. In the 1902 case, the Supreme Court upheld the circuit court’s affirmation of the judgment that there was proof of Hunter’s death. Clark, 203 U.S. 64.

74. Clark, 203 U.S. at 72.

75. Clark, 203 U.S. at 72.

76. Clark, 203 U.S. at 72.

77. Clark, 203 U.S. at 73.

78. Clark, 203 U.S. at 73.

79. See *infra*, section III.C.

80. Goldie, 130 F.2d at 720.

81. Goldie, 130 F.2d at 720.

82. Goldie, 130 F.2d at 720.

83. Goldie, 130 F.2d at 720.

84. Goldie, 130 F.2d at 720.

85. Goldie, 130 F.2d at 720.

86. Goldie, 130 F.2d at 720.

87. Goldie, 130 F.2d at 720.

88. Shropshire, Woodliff & Co. v. Bush, 204 U.S. 186, 27 S. Ct. 178, 51 L. Ed. 436 (1907).

89. Shropshire, 204 U.S. at 189.

90. See also *In re Missionary Baptist Foundation of America, Inc.*, 667 F.2d 1244, 1247, 8 Bankr. Ct. Dec. (CRR) 1054, 5 Collier Bankr. Cas. 2d (MB) 1462 (5th Cir. 1982) (holding wage claims retained priority in hands of assignee check indorsee); *Carnegie v. Georgia Higher Educ. Assistance Corp.*, 691 F.2d 482, 483, 7 Ed. Law Rep. 26 (11th Cir. 1982) (holding that a nondischargeable student loan remains nondischargeable in hands of assignee); *In re Zipco, Inc.*, 157 F. Supp. 675, 677 (S.D. Cal. 1957), judgment *aff’d*, 259 F.2d 561 (9th Cir. 1958) (holding wage claims retained priority in hands of assignee stockholder); *In re Dorr Pump & Mfg. Co.*, 125 F.2d 610, 611 (C.C.A. 7th Cir. 1942) (holding wage claims retained priority in hands of assignee director and shareholder). But see *Securities and Exchange Commission v. Albert & Maguire Securities Co., Inc.*, 560 F.2d 569, 570, Fed. Sec. L. Rep. (CCH) P 96129, 22 U.C.C. Rep. Serv. 1055 (3d Cir. 1977) (holding that a bank assignee of a customer’s claim in a Securities Investor Protection Act liquidation is not subrogated to the customer’s priority if the equities are contraindicative). Courts have also held that assignees retain assignors’ rights, e.g., *Citibank, N.A. v. Tele/ Resources, Inc.*, 724 F.2d 266, 269 (2d Cir. 1983) (holding that assignee succeeds to assignors’

defenses); *In re Elliott*, 385 F. Supp. 1194, 1196 (M.D. La. 1974) (finding that assignee acquires all transferor's rights of action).

91. *In re Sherman*, 67 F.3d 1348, 1355, 27 Bankr. Ct. Dec. (CRR) 1237, 34 Collier Bankr. Cas. 2d (MB) 655, Bankr. L. Rep. (CCH) P 76671 (8th Cir. 1995).

92. *Enron*, 333 B.R. at 234-35 (citing *In re M & L Business Mach. Co., Inc.*, 84 F.3d 1330, 1336, 29 Bankr. Ct. Dec. (CRR) 188, 36 Collier Bankr. Cas. 2d (MB) 996 (10th Cir. 1996); *Max Sugarman Funeral Home, Inc. v. A.D.B. Investors*, 926 F.2d 1248, 1257, 24 Collier Bankr. Cas. 2d (MB) 1414, Bankr. L. Rep. (CCH) P 73841 (1st Cir. 1991); *In re Richmond Produce Co., Inc.*, 195 B.R. 455, 142 A.L.R. Fed. 715 (N.D. Cal. 1996)).

93. 11 U.S.C.A. §§ 547, 548 (2006).

94. Federal depositary insurers have faced subordination as statutory subrogors, but they are protected by the *O'Doench* doctrine, derived from *D'Oench, Duhme & Co. v. Federal Deposit Ins. Corporation*, 315 U.S. 447, 62 S. Ct. 676, 86 L. Ed. 956 (1942), codified in the Federal Deposit Insurance Act of 1950 § 2(13)(e) at 12 U.S.C.A. § 1823(e) 2006).

95. Fed. R. Bankr. P. 3001(e) (2006).

96. *Clark*, 203 U.S. at 74.

97. *Clark*, 203 U.S. at 74.

98. *In re AutoStyle Plastics, Inc.*, 269 F.3d 726, 45 U.C.C. Rep. Serv. 2d 964, 744, 2001 FED App. 0378P (6th Cir. 2001) (equitable subordination is not mandatory, even if all elements of *Mobile Steel* test are met).

99. Levitin, *Toward a Federal Common Law of Bankruptcy: Judicial Lawmaking in a Statutory Regime*, 80 Am. Bankr. L.J. 1, 70-92 (2006).

100. *Enron*, 333 B.R. at 225.

101. *Enron*, 333 B.R. at 226.

102. *Enron*, 333 B.R. at 229-230, 230 n.15.

103. Because the claims at issue in *Enron* were bank loan participation claims, the Funds could also sue Fleet directly under Loan Trading and Syndication Association rules.

104. *Enron*, 333 B.R. at 226.

105. *Enron*, 333 B.R. at 226.

106. *Enron*, 333 B.R. at 226.

107. *Enron*, 333 B.R. at 227.

108. *Enron*, 333 B.R. at 227.

109. *Enron*, 333 B.R. at 227 n.11.

110. *Enron*, 333 B.R. at 227 n.11.

111. This is not undercut by *in pari delicto* situations, such as *Enron*, in which a debtor has allegedly engaged in fraudulent conduct with various fiduciaries. Any recovery that the estate can receive from the fiduciaries passes through the estate and becomes part of the assets for pro rata distribution, rather than going directly to the specific creditors injured by the fraud.

112. Alternatively, the inequitable creditor's share of a distribution could be placed in a constructive trust for distribution to the injured creditors. While this might not provide the full measure of compensation to the injured creditors, it would prevent uninjured creditors from receiving compensation.

113. Query whether a trustee or DIP has Constitutional standing to bring an equitable subordination action, as they do not have an injury in fact—the injury is a creditor's. See Adam J. Levitin, *Rough Justice? The Nature and Limits of Equitable Subordination*, working paper, May 31, 2006, at 13-20, available at <http://ssrn.com/abstract=900444>.

114. If the estate rather than an individual creditor were harmed by the inequitable behavior, claim disallowance would be the proper route, as a set-off, not subordination. Indeed, in Enron, the DIP also moved to disallow the claims of the allegedly inequitable party. Enron, 333 B.R. at 213.

115. Enron, 333 B.R. at 226-27.

116. To the extent that claims purchasers are protected representations, warranties, and indemnities, subordination will only engender more litigation about the extent of these representations, warranties and indemnities, while if in markets in which they are unavailable, innocent purchasers will either litigate or be left holding the loss. But see Tanvir Alam, *Fraudulent Advisors Exploit Confusion in the Bankruptcy Code: How In Pari Delicto Has Been Perverted to Prevent Recovery for Innocent Creditors*, 77 Am. Bankr. L.J. 305, 326 (2003) (“Finality is a cornerstone of the [bankruptcy] process. Forcing victims to go outside the bankruptcy case injects needless uncertainty and stalls the process.”).

117. Fed. R. Bankr. P. 7001(8) (2006). See also *In re Danbury Square Associates, Ltd. Partnership*, 153 B.R. 657, 661 (Bankr. S.D. N.Y. 1993).

118. Fed. R. Bankr. P. 7001 et seq. (2006).

119. Levitin, *Rough Justice? The Nature and Limits of Equitable Subordination*, working paper, May 31, 2006, at 13-20, available at <http://ssrn.com/abstract=900444>.

120. 28 U.S.C.A. § 1334(b) (2006).

121. *In re ACI-HDT Supply Co.*, 205 B.R. 231, 30 Bankr. Ct. Dec. (CRR) 478, 37 Collier Bankr. Cas. 2d (MB) 908 (B.A.P. 9th Cir. 1997).

122. *Matter of Wood*, 825 F.2d 90, 97, 17 Collier Bankr. Cas. 2d (MB) 743, Bankr. L. Rep. (CCH) P 71955 (5th Cir. 1987).

123. *Celotex Corp. v. Edwards*, 514 U.S. 300, 308 n.6, 115 S. Ct. 1493, 131 L. Ed. 2d 403, 27 Bankr. Ct. Dec. (CRR) 93, 32 Collier Bankr. Cas. 2d (MB) 685, Bankr. L. Rep. (CCH) P 76456, 31 Fed. R. Serv. 3d 355 (1995). *Celotex* upheld jurisdiction over an injunction proceeding that did not directly involve the debtor.

124. *Pacor, Inc. v. Higgins*, 743 F.2d 984, 994, 12 Bankr. Ct. Dec. (CRR) 285, Bankr. L. Rep. (CCH) P 70002 (3d Cir. 1984).

125. Whether the vagueness of equitable subordination might invalidate § 510(c) involves an analysis beyond the scope of this article.

126. E.g., *In re Mayo*, 112 B.R. 607, 650, 11 U.C.C. Rep. Serv. 2d 632 (Bankr. D. Vt. 1990).

127. See John Selden, *Table Talk* 43 (Pollock ed., 1927) (spelling, capitalization, and punctuation original).

128. Enron, 333 B.R. at 226 n.8.

129. E.g., Frederick Tung, *Confirmation and Claims Trading*, 90 Nw. U. L. Rev. 1684, 1685 (1996) (noting estimate of the claims trading market “as high as \$300 billion”); Robert K. Rasmussen and David A. Skeel, Jr., *The Economic Analysis of Corporate Bankruptcy Law*, 3 Am. Bankr. Inst. L. Rev. 85, 101 n.71 (1995); Robert D. Drain and Elizabeth J. Schwartz, *Are Bankruptcy Claims Subject to the Federal Securities Laws?*, 10 Am. Bankr. Inst. L. Rev. 569, 569-70 (2002) (noting “formation of numerous distressed debt funds with assets in excess of \$1 billion.”).

130. Enron, 333 B.R. at 212. The iniquity, or in this case, the inequity, of the fathers is visited upon the sons to (at least) the third and fourth generation.

131. 11 U.S.C.A. §§ 547 (voidable preferences) and 548 (fraudulent transfers).

132. Cf. Paul M. Goldschmid, *Note, More Phoenix Than Vulture: The Case For Distressed Investor Presence in the Bankruptcy Reorganization Process*, 2005 Colum. Bus. L. Rev. 191 (2005) with Harvey R. Miller & Shai Y. Waisman, *Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-First Century?*, 78 Am. Bankr. L.J. 153, 181 (2004).

133. See Stephen J. Lubben, *Credit Derivatives and the Future of Chapter 11*, working paper, June 4, 2006, available at <http://ssrn.com/abstract=906613>.

134. Lubben, Credit Derivatives and the Future of Chapter 11, working paper, June 4, 2006, available at <http://ssrn.com/abstract=906613> at 30-31.

135. Lubben, Credit Derivatives and the Future of Chapter 11, working paper, June 4, 2006, available at <http://ssrn.com/abstract=906613> at 29.

136. International Swap and Derivative Association, 2005 Year-End Market Survey.

137. Upstream transactions are covered by the following provision in the standard forms of the Loan Syndication & Trading Association (LSTA). If the transaction is a secondary assignment, the seller:

makes the representation and warranty set for in Section B of the Transaction Specific Terms as to the type of Predecessor Transfer Agreements executed in connection with Seller's purchase of the Transferred Rights. With respect to the portion (if any) of the Transferred Rights that Seller or any Prior Seller acquired pursuant to Predecessor Transfer Agreements relating to distressed loans, Seller has provided to Buyer (A) true, correct and complete copies of each such Predecessor Transfer Agreement to which Seller is a party and (b) to the extent and in the form received by Seller from Immediate Prior Seller, any other Predecessor Transfer Agreements specified in the Annex.

LSTA, Loan Syndication & Trading Association's Standard Terms and Conditions for Distressed Trade Confirmations, § 4.1(r)(ii) (May 2005) (emphasis added).

138. For "flip" transactions involving a riskless party that purchases a loan participation and turns around to sell it within one business day of settlement, or "step-up" transactions, in which a seller "steps-up" to guarantee a previous distressed trade improperly made on par/near par documentation, LSTA, Publication Memorandum: New Forms of Distressed Purchase and Sale Agreement, Par/Near Par and Distressed Trade Confirmations and Trade Checklist, May 2005, at 2), the distressed debt warranty against acts and omissions that would cause equitable subordination, LSTA, Loan Syndication & Trading Association's Standard Terms and Conditions for Distressed Trade Confirmations, § 4.1(h)(i) (May 2005), *inter alia*, is extended to include acts and omissions of scheduled prior sellers, LSTA, Loan Syndication & Trading Association's Standard Terms and Conditions for Distressed Trade Confirmations, § 4.1(h)(ii).

139. LSTA, Loan Syndication & Trading Association's Standard Terms and Conditions for Distressed Trade Confirmations, § 4.1(w) (May 2005). "Impairment" is defined to include equitable subordination. LSTA, Loan Syndication & Trading Association's Standard Terms and Conditions for Distressed Trade Confirmations, § 4.1(w) (May 2005).

140. LSTA, Loan Syndication & Trading Association's Standard Terms and Conditions for Distressed Trade Confirmations, § 6.1 (May 2005).

141. See *supra* note 138. If the loan traded on par documentation when it should have traded on distressed documents, if the seller is willing to make "step-up" representations. See *supra* note 138.

142. Chaim J. Fortgang & Thomas Moers Mayer, Trading Claims and Taking Control of Corporations in Chapter 11, 12 *Cardozo L. Rev.* 1, 19 (1990).

143. Bayer, 269 F.3d at 745; *Matter of Cajun Elec. Power Co-op., Inc.*, 119 F.3d 349, 356, 31 *Bankr. Ct. Dec. (CRR)* 333, *Bankr. L. Rep. (CCH)* P 77486 (5th Cir. 1997); *United States Abatement Corp. v. Mobil Exploration & Producing U.S. (Matter of U.S. Abatement Corp.)*, 39 F.3d 556, 561, 26 *Bankr. Ct. Dec. (CRR)* 360, 32 *Collier Bankr. Cas. 2d (MB)* 761, *Bankr. L. Rep. (CCH)* P 76208 (5th Cir. 1994); *In re First Alliance Mortg. Co.*, 298 B.R. 652, 666-67 (C.D. Cal. 2003).

144. *Enron*, 333 B.R. at 230 n.15.

145. Even if the market can address subordination risk overall, there will be specific mispricing, and it would take a significant number of discounted claims purchases for an individual purchaser to be protected properly by the market through diversification, even if the individual could properly quantify the risk to determine the necessary level of diversification. Although insurance

or derivative devices, such as an equitable subordination swap, would provide protection, query whether such markets would develop.

146. *Enron*, 333 B.R. at 230 n.15.

147. *Enron* also opens the door to the abusive use of equitable subordination as a sword, and not a shield. See *In re Owens Corning*, 419 F.3d 195, 216, 45 Bankr. Ct. Dec. (CRR) 36, Bankr. L. Rep. (CCH) P 80343 (3d Cir. 2005), as amended, (Oct. 12, 2005) and cert. denied, 126 S. Ct. 1910 (U.S. 2006) and cert. denied, 126 S. Ct. 1910 (U.S. 2006) (substantive consolidation must be used as a shield, not a sword). An expansion of equitable subordination would allow some creditors to squeeze out other creditors and not result in an equitable outcome.

148. Motion, Pursuant to 11 U.S.C.A. §§ 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. Apr. 21, 2006).

149. Brief of Amici Curiae in Support of Defendants' Second Motion for Leave to Bring Interlocutory Appeal, at Appendix A, Exhibit 1 at 1 (Declaration of Elliot Ganz in Support of Brief of Amici Curiae), Adv. Pro. 05-01074, 05-01105 (Bankr. S.D.N.Y. May 30, 2006).

150. Brief of Amici Curiae in Support of Defendants' Second Motion for Leave to Bring Interlocutory Appeal, at Appendix A, Exhibit 1 at 1 (Declaration of Elliot Ganz in Support of Brief of Amici Curiae), Adv. Pro. 05-01074, 05-01105 (Bankr. S.D.N.Y. May 30, 2006). One major broker-dealer, which has requested to remain anonymous, closed its trades in BAWAG originated paper, but it was more comfortable assuming BAWAG's credit risk because it had insurance in the form of credit default swaps on BAWAG's debt. Of course, if BAWAG did not default, but simply disputed its liability to purchasers of the subordinated debt, the credit default swaps would probably not be triggered.

151. Brief of Amici Curiae in Support of Defendants' Second Motion for Leave to Bring Interlocutory Appeal, at Appendix A, Exhibit 1 at 1 (Declaration of Elliot Ganz in Support of Brief of Amici Curiae), Adv. Pro. 05-01074, 05-01105 (Bankr. S.D.N.Y. May 30, 2006).

152. Brief of Amici Curiae in Support of Defendants' Second Motion for Leave to Bring Interlocutory Appeal, at Appendix A, Exhibit 1 at 1 (Declaration of Elliot Ganz in Support of Brief of Amici Curiae), Adv. Pro. 05-01074, 05-01105 (Bankr. S.D.N.Y. May 30, 2006).

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154. Larry Neumeister, Bawag to pay \$675 to settle Refco charges, AP, June 5, 2006.

155. Dan Wilchins, BAWAG to pay \$675 mln in Refco settlement, Reuters, June 6, 2006.

156. Robert D. Drain & Elizabeth J. Schwartz, Are Bankruptcy Claims Subject to the Federal Securities Laws?, 10 Am. Bankr. Inst. L. Rev. 569 (2002) (concluding that bankruptcy claims are not subject to federal securities laws).