

§502(D): A Hold-Up Device In Bankruptcy on Assigned Loans and Claims

You purchased an otherwise good loan or you hold an otherwise good claim against a debtor, but you (or someone before you) purchased the loan or claim from someone who in an unrelated matter had actionable dealings with the debtor or may have received a preference or otherwise avoidable payment. If Enron prevails in a novel position it is currently litigating, you may have a §502(d) or equitable subordination problem.

The Enron chapter 11 bankruptcy is testing the limits of §502(d) of the Bankruptcy Code and the doctrine of equitable subordination. §502(d) by its terms says that a claim may be disallowed if the holder of the claim has not repaid or returned a preference or other avoidable transfer received by such holder. Under the doctrine of equitable subordination, a claim may be subordinated if the court finds that the holder of the claim engaged in inequitable conduct causing injury to creditors or the estate. But what if the original holder of the loan or claim assigned the claim to a third party who purchased the claim in good faith without knowledge that the assignor had engaged in unrelated actionable transactions with the debtor? Lawyers representing Enron are contending that if Citi or Chase or any other bank or financial institution has engaged in any transaction in which it has avoidance liability to Enron, or engaged in conduct that would justify equitable subordination of its own claims, then every loan or other transaction originated by such bank or other financial institution could be tainted under §502(d) or could be subject to equitable subordination, even in the hands of a good faith purchaser for value without notice of the claim against the original holder. This would provide the debtor the option of either seeking affirmative recovery against the actual wrongdoer or preference recipient, or disallowing or subordinating claims of third parties which were once held by that person.

Whether Enron will succeed in its effort to expand the impact of §502(d) to innocent claims purchasers is not yet clear. The argument was held only this past week, and the court has yet to rule. In the meantime, however, merely by asserting the expanded §502(d) or equitable subordination defense, Enron has successfully delayed making payments on hundreds of millions of dollars of claims that are held by parties against whom no wrongdoing is alleged. So for the foreseeable future, loan traders beware! If Enron's novel arguments become law, §502(d) or a claim of equitable subordination could be invoked to delay or foreclose entirely your recovery on purchased loans or assigned claims of a debtor that is in bankruptcy.

