FINDING *NEMO*:
REDISCOVERING THE VIRTUES OF NEGOTIABILITY IN THE WAKE OF *ENRON*

Adam J. Levitin

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<u>ABSTRACT</u>

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. A groundbreaking opinion in Enron's on-going bankruptcy has expanded 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 related to the claims.

In a world of active bankruptcy claims trading, *Enron* raises powerful policy questions about the legal rules governing property transfers that affect the doctrinal development of bankruptcy law and the survival of a secondary market that provides important liquidity to other capital markets. This article shows how *Enron* was erroneous from both doctrinal and policy perspectives and examines the problems *Enron* has created for several distinct markets.

Enron is a reminder of the continuing value of negotiability in commercial contexts, for if the claims involved had been negotiable, they could not have been subordinated. Thus, this article considers what factors have traditionally determined when the law adopts a negotiability regime for property transfers and whether these factors make sense in today's financial markets. The article argues that in the bankruptcy claims context, the liquidity benefits of negotiability outweigh its costs. Accordingly, the article proposes a federal law of negotiability for bankruptcy claims to protect the liquidity of this vital market.

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CONTENTS

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I. INTRODUCTION

Bankruptcy claims trading is the buying and selling by creditors of claims against a bankrupt corporate debtor.[1] Although it has gone largely unnoticed by courts and legal scholars, the growth of bankruptcy claims trading has been the most important development in corporate reorganizations in the past two decades.[2] Bankruptcy claims trading is now a major, although virtually unregulated, financial industry.[3] Specialized firms with expertise in valuing and diversifying the risk of investing in bankrupt companies assist the largely institutional investors—hedge funds and investment banks—who are active players in the claims market. Although the exact size of the corporate bankruptcy claims trading market is unknown, it has been estimated to be in the hundreds of billions of dollars about a decade ago, and has seen a prodigious growth in recent years.[4]

The growth of the bankruptcy claims trading market stems from the risks and delays inherent in large Chapter 11 bankruptcies. Creditors can wait for years to receive a payout in a large Chapter 11 case, and the expected payout at the end is highly speculative. The ability to sell bankruptcy claims provides an exit opportunity for creditors who do not wish to incur the hassle and expense of the reorganization process. The ability to buy bankruptcy claims provides non-creditors an

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[1] There is also a significant market in personal bankruptcy claims. Typically these claims are sold in bundles that include claims against multiple debtors, such as the sale of a segment of a credit card company's loan portfolio. The claim buyers are not looking to purchase claims against any particular debtor, but are purchasing something more akin to a fund of claims. There are unique policy considerations to personal bankruptcy claims trading that place it beyond the scope of this article.

[2] Glenn E. Siegel, *Introduction, ABI Guide to Trading Claims in Bankruptcy: Part 2*, 11 AM. BANKR. INST. L. REV. 177 (2003).

[3] The sole industry-specific regulation is FED R. BANKR. P. 3001, which requires that proof of certain claims transfers be filed with the court. *Id.*

[4] *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.").

The seminal examination of bankruptcy claim trading can be found in Chaim J. Fortgang & Thomas Moers Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1 (1990), and its sequels, Chaim J. Fortgang & Thomas Moers Mayer, *Developments in Trading Claims and Taking Control of Corporations in Chapter 11*, 13 CARDOZO L. REV. 1 (1991), and Chaim J. Fortgang & Thomas Moers Mayer, *Developments in Trading Claims: Participations and Disputed Claims*, 15 CARDOZO L. REV. 773 (1993).

opportunity to invest in a debtor, influence the shape of a reorganization, and acquire control over the debtor or particular assets of the bankruptcy estate. Thus, creditors who seek to escape the bankruptcy case with a certain payout can sell their claims against the debtor at a discount on the expected value of a payout at the end of the case and transfer the risk on the payout to parties interested in assuming the risk of an investment. The advent of widespread claims trading now means that membership in the community of creditors may vary throughout a bankruptcy with significant effects on parties' negotiation leverage.

The existence of a large bankruptcy claims market has spillover effects on primary capital markets, a phenomenon that has received scant attention.[5] Creditors' ability to cashout at a certain value rather than remain involved through the course of a bankruptcy and receive an uncertain payout, increases their risk tolerance when originating loans, making equity investments, or purchasing debt from other creditors. Creditors' ability to assume more risk ultimately benefits borrowers in the form of lower borrowing costs. The effect of the growth of the claims trading market on reorganizations is the subject of much debate within the bankruptcy community,[6] but there have been few legal decisions related to claims trading.

By far the most important rulings on claims trading to date have come from the on-going Enron bankruptcy litigation. Creditors have long understood that any claims they submit for repayment in a bankruptcy might be valid, but nevertheless subject to subordination in the order of payment from the bankruptcy estate's limited funds, if the creditor behaved inequitably as the debtor failed. The practice of equitable subordination is intended to punish creditors who behaved

[5] *See* Ronald J. Mann, *Strategy and Force in the Liquidation of Secured Deb*t, 96 MICH. L. REV. 159 (1997) for a discussion of the dynamics of the distressed debt market.

[6] *Compare* 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) (arguing for the positive role of distressed debt investors in reorganizations) *with* Harvey R. Miller & Shai Y. Waisman, *Is Chapter 11 Bankrupt?* 47 B.C.L. REV. 129 (2005) (criticizing the effects of distressed debt investors on the chapter 11 process); 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 (2004) (same); Harvey R. Miller, *Chapter 11 Reorganization Cases and the Delaware*

inequitably; they should not be permitted to share *pari passu* with innocent creditors.

A quartet of recent opinions by the bankruptcy court in *Enron* has extended the practice of equitable subordination far beyond its traditional limits of punishing an inequitable creditor.[7] *Enron* held that innocent 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.

Enron created 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. *Enron* makes buyers worry not just about sellers' title, but also about sellers' interactions with the debtor unrelated to the claim. This increased counterparty risk raises transaction costs, which will reduce the liquidity of the bankruptcy claims market. Because of the unique position of the bankruptcy claims market as the residual capital market, a reduction in its liquidity will reduce liquidity in other capital markets, making it more expensive for distressed companies to raise capital and increasing the risk that those companies will default because they have borrowed at more onerous rates.

Enron shows that commercial law has not kept pace with commercial developments like claims trading and that essential commercial law concepts, like negotiability, need to be expanded and revised to account for new types of markets. The problems in Enron speak to a fundamental commercial law question about choice of property transfer rules. Enron was based on the commercial law principle of *nemo dat quod non habet*—you can transfer only what you have.[8] *Nemo dat* means that defenses travel with property transfers, so if bankruptcy claims would be

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Myth, 55 VAND. L. REV. 1987 (2002) (same), *and with* Tung, *supra* note 4 (considering the benefits and problems of claims trading).

[7] Enron Corp. v. Avenue Special Situations Fund II, LP (*In re* Enron Corp.), 333 B.R. 205, 211 (Bankr. S.D.N.Y. 2005); 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).

subject to equitable subordination in the hands of a transferor, they should remain so in the hands of a transferee.

Nemo dat is the default rule for property transfers, but there is a competing commercial law paradigm: negotiability. Negotiability is usually thought of in terms of Uniform Commercial Code Article 3, but it appears in other areas of law, including UCC Article 2 (sales),[9] UCC Article 7 (warehouse receipts and bills of lading),[10] UCC Article 8 (investment securities),[11] and the law of real estate mortgages and titles.[12] The essential characteristic of negotiability is that only limited defenses travel with property, so a transferee can receive more than the transferor had—a property right free of certain defenses against its enforcement. This means that there is some level of negotiability in any area of law with a good faith purchaser defense.

The great advantage of a negotiability regime is that it increases the liquidity of the debts it covers, by lowering risks for debt buyers. This comes at the expense of greater risk for debts' obligors, whose ability to defend against a debt depends on the identity of the party attempting to enforce the claim. A negotiability regime, therefore, creates an opportunity for mischief, as a bad actor can "wash" a debt that it could not enforce by selling it at full market value to a third party against whom the obligor's defenses would be cut off.

Historically, the law has differentiated between whether it adopts a *nemo dat* regime or a negotiability regime based on whether transactions are commercial or consumer.[13] Thus, intangible legal claims for money—intangible choses in action—have been treated differently by law than either tangible instruments or goods. This is because tangible instruments (and to a lesser extent goods) were assumed to be commercial, while intangible choses in action were not; they were

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[8] Literally, no one can give that which he does not have.
[9] UCC § 2-403(1) (1951); *see also* United States v. Lavin, 942 F.2d 177, 186 (3d Cir. 1991).
[10] UCC § 7-502 (revised) (2005).
[11] UCC § 8-303 (1995).
[12] *See* Grant Gilmore, *The Commercial Doctrine of Good Faith Purchase*, 63 YALE L.J. 1057, 1108 (1954).
[13] *Id.* at 1068.

assumed to be consumer debt.[14]

Accordingly, the good faith purchaser doctrine—a type of negotiability—historically protected commercial purchasers, so that "commercial transactions [could] be engaged in without elaborate investigation of property rights and in reliance on the possession of property by one who offers it for sale or to secure a loan."[15] In contrast, the law protected consumer debtors from fraud by allowing them to recover from the malfeasor.[16] Thus, UCC Article 2 provides for good faith purchaser protections for the sale of goods, a negotiability standard,[17] but limits this to commercial contexts.[18]

The law adopts negotiability as the rule for property transfers only when there is clear notice given of the departure from *nemo dat*, typically in the form of the property itself or through a notice-filing system. Thus, UCC Article 3 requires that a debt be reified into an instrument that complies with various formalities in order to be negotiable,[19] while good faith purchaser defenses are available for secured lenders and real estate purchasers because of the existence of notice-filing systems.[20]

Bankruptcy claims present a problem for the property type shibboleth. A bankruptcy claim is an intangible chose in action. The Bankruptcy Code mandates the monetization of all non-monetary claims on the bankruptcy estate.[21] Intangible choses in action have traditionally been assumed to be non-commercial.[22] The problem is that bankruptcy claims are not like traditional intangible choses in action. Instead, they have become sophisticated commercial investment vehicles, a development

[14] *Id.*
[15] *Id.* at 1057.
[16] *Id.* at 1060.
[17] UCC § 2-403(1) (1951).
[18] UCC § 2-102 (1951).
[19] UCC § 3-104 (1991). As codified in UCC § 3-104, the basic requirements of negotiability are a writing, containing an unconditional promise to pay a sum certain in currency on demand or at a definite time, made out to order or bearer, signed by the maker or drawer, and not containing promises other than inclusion of collateral, confession of judgment, or certain waivers of law.
[20] UCC § 9-322 (2001).
[21] 11 U.S.C. § 502(c)(2) (2006).
[22] Gilmore, *supra* note 12, at 1068.

that continues to cause unease within the bankruptcy community.[23] The *Enron* decisions show that the law of property transfers has not kept pace with commercial developments. It makes little sense for property transfer paradigms developed in 18th century England to govern sophisticated 21st century American commerce, and doing so has deleterious effects on the national economy.

This article argues that bankruptcy claims should be treated like other commercial transactions because the social value of increased liquidity in the claims market outweighs the harm of limited defenses. In particular, this article proposes a federal law of negotiability for bankruptcy claims that would extend a presumption of good faith to most claims purchases without imposing the high transaction costs of formalities or notice-filing. Such a rule would recognize the singular importance of liquidity in the bankruptcy claims' market as the residual capital market. Increased liquidity in the claims market lowers the cost of borrowing outside of bankruptcy, a benefit to all debtors, and cheaper borrowing decreases borrowers' bankruptcy risk, which is a benefit that accrues to all creditors.

The article begins by explaining the *Enron* decisions. It then considers the doctrinal problems of applying *nemo dat* to a situation involving the priority, rather than the validity of a debt. Next, it examines how *Enron*'s application of *nemo dat* to a priority situation has impacted the bankruptcy claims market. In light of the doctrinal and market problems with *Enron*, the article argues in favor of applying a negotiability regime to bankruptcy claims trading and proposes a general reconsideration of the rules governing what defenses travel with a property transfer in commercial contexts.

II. THE *ENRON* EQUITABLE SUBORDINATION DECISIONS

In the spring of 2001, Enron was flying high. Creditors were willing to extend it multi-billion dollar credit facilities. In May 2001, Enron entered into two loans, a $1.75 billion Long-Term

[23] *See supra* note 6.

Credit Agreement and a $1.25 billion Short-Term Credit Agreement.[24] These loans were syndicated among a number of banks, including Fleet Bank, Citibank, Credit Suisse First Boston, Deutsche Bank, and Barclays Bank ("the Seller Banks").[25]

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.[26] Between August 2002, and September 16, 2003, eleven distressed debt funds ("the Funds") had purchased $268.75 million par value of Enron bankruptcy claims that originated in the Seller Banks' participation in the May 2001 credit agreements.[27]

On September 23, 2003, Enron commenced an adversary proceeding, known as the "Megacomplaint," against ten of the banks participating in the loans, including the Seller Banks.[28] The Megacomplaint named the Seller Banks as defendants in voidable preference and fraudulent conveyance claims arising from pre-paid forward transactions.[29] The Megacomplaint also alleged that the Seller Banks aided and abetted Enron's accounting fraud to their advantage and that Enron's fraudulent financials induced other creditors to make unsecured loans to Enron they would not have otherwise made.[30] The Megacomplaint did not allege any wrongdoing in respect to the Credit Agreements, however.[31]

In January 2005, Enron commenced four additional adversary proceedings, this time against the Funds that had purchased the Seller Banks' loan participation claims.[32] Enron requested that the

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[24] *Id.*
[25] *Id.* at 211-12. Fleet has since been acquired by Bank of America.
[26] *Id.* at 211.
[27] *Id.* at 212.
[28] *Id.*
[29] *Id.* A fraudulent conveyance is a transfer of the debtor's property for inadequate consideration when the debtor is insolvent or the transfer will render him so or made with the intent to hinder other creditors. 11 U.S.C. § 548 (2006). A voidable preference is a transfer made by an insolvent debtor to a creditor during the statutory lookback period that is not in exchange for contemporaneously extended new value and results in the creditor receiving more than he would in a bankruptcy distribution. 11 U.S.C. § 547 (2006).
[30] *Id.* at 212-13.
[31] *Id.* at 213.
[32] *Id.*

Bankruptcy Court equitably subordinate the Funds' claims under 11 U.S.C. § 510(c).[33] Section 510(c) provides:

> 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.[34]

Enron's complaint did not allege that the Funds had any knowledge of the Seller Banks' 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 in the lead case, *Enron Corp. v. Avenue Special Situations Fund II, LP* ("*Enron*").[35] *Enron* involved five Funds that held $47.25 million par value in claims that originated in Fleet Bank's $53.67 million participation in the Short-Term Credit Agreement.[36] All five of the Funds purchased their claims from banks that had in turn purchased the claims from

[33] *Id.* In the alternative, Enron requested that the court disallow the Funds' claims under 11 U.S.C. § 502(d) (2006), 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.

[34] 11 U.S.C. § 510(c) (2006).

[35] The Bankruptcy Court has since denied the Funds' motion to dismiss Enron's § 502 action. Enron Corp. v. Avenue Special Situations Fund II, LP (*In re* Enron Corp.), 340 B.R. 180 (Bankr. S.D.N.Y. 2006).

[36] 333 B.R. at 212.

Fleet.[37] One Fund also purchased a claim directly from Fleet.[38] Eleven days later, in opinions substantially similar to the lead case, Judge Gonzalez denied the parallel motions to dismiss in the other three cases, which involved claims originating with Barclays, Citibank, CSFB, and Deutsche Bank.[39] For purposes of clarity, this article will refer solely to the lead, published case, but the analysis applies equally to the companion cases.

Judge Gonzalez observed that there were three issues involved in the motion to dismiss: (1) whether a claim could be equitably subordinated on account of its holder's 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.[40]

Enron broke new ground on this issue, but did so on the basis of questionable authority.[41] Fleet's allegedly inequitable behavior was unrelated to the credit agreement participation claims. Before *Enron*, no court had held that claims of a non-fiduciary 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

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[37] *Id.* Among the intermediary financial institutions was Credit Suisse First Boston, which purchased and resold $29.5 million par value of Fleet's participation in the credit agreements, as well as selling form its own share of the syndication.
[38] 333 B.R. at 212.
[39] 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).
[40] Enron, 333 B.R. at 210.
[41] Adam J. Levitin, *The Limits of Enron: Counterparty Risk in Bankruptcy Claims Trading*, 15 J. BANKR. L. & PRAC. 389, 393-98 (2006).

fiduciary creditors[42] or made such statements in dictum.[43] Moreover, there are rulings refusing to subordinate creditors because the grounds for subordination were unrelated to the bankruptcy claim.[44] *Enron* expanded the doctrine of equitable subordination by holding that the claim of a non-fiduciary creditor could be subordinated on account of the creditors' unrelated behavior.

As for the second issue, Judge Gonzalez concluded that *nemo dat* applied, so "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."[45] As transferees, the Funds took only as good as Fleet had held; 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. Enron thus announced that *nemo dat* would apply to issues of priority, not just validity, in the transfer of bankruptcy claims. This too was a major expansion of equitable subordination doctrine.

On the third issue, Judge Gonzalez concluded that the statutory good faith purchaser defense in 11 U.S.C. § 550(b)[46] was limited to 11 U.S.C. § 550(a)'s enumerated preference recovery, post-petition transfer, and fraudulent transfer actions.[47] In any event, Judge Gonzalez held that the Funds could not take in good faith because they were aware of the possibility of subordination by virtue of

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[42] Wilson v. Huffman (*In re* Missionary Baptist Found.), 818 F.2d 1135 (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 (8th Cir. 1944); Taylor v. Standard Gas & Elec. Co. (The Deep Rock Case), 305 U.S. 584 (1939).
[43] Benjamin v. Diamond (*In re* Mobile Steel Co.), 563 F.2d 692, 700 (5th Cir. 1977).
[44] *In re* Ahlswede, 516 F.2d 784, 786 (9th Cir. 1975); Prudence Realization Corp. v. Geist, 316 U.S. 89 (1942).
[45] Enron, 333 B.R. at 210.
[46] 11 U.S.C. § 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.

[47] Enron, 333 B.R. at 233.

buying bankruptcy claims.[48] By declaring it impossible to purchase a bankruptcy claim in good faith, Enron confirmed that *nemo dat* is the principle governing every aspect of *all* bankruptcy claims transactions because a *nemo dat* regime cannot recognize a good faith purchaser defense.

Enron is flawed from both doctrinal and policy perspectives and is cause to reexamine the legal rules governing property transfers. The following section of this article probes the doctrinal problems with *Enron*. The article then takes up *Enron*'s market problems, after which it turns to the question of what legal rules should govern property transfers.

III. FINDING *NEMO*: THE DOCTRINAL LIMITS OF *NEMO DAT*

A. NEMO DAT: THE BASELINE RULE OF PROPERTY TRANSFERS

Nemo dat is the baseline rule of property transfers. *Nemo dat* means that a debtor has the same defenses against its original creditor as it does against the creditor's transferee. The transferee takes only as good as the original creditor had.

The alternative rule to *nemo dat* is negotiability. Negotiation of a property right (typically a debt) cuts off some of the debtor's defenses. The debtor does not have as many defenses against a transferee as it does against its original creditor in a negotiability system. Therefore, the enforceability of a debt depends on whether the original creditor or a transferee is enforcing it.

Another way to look at *nemo dat* and negotiability is in terms of what is being sold on the originating market and on the resale market. In a *nemo dat* regime, the product sold in the resale market is the same sold in the originating market plus the added risks of the originating buyer's malfeasance in the transaction. In a negotiability regime, the same product is being sold in the resale market and the originating market.

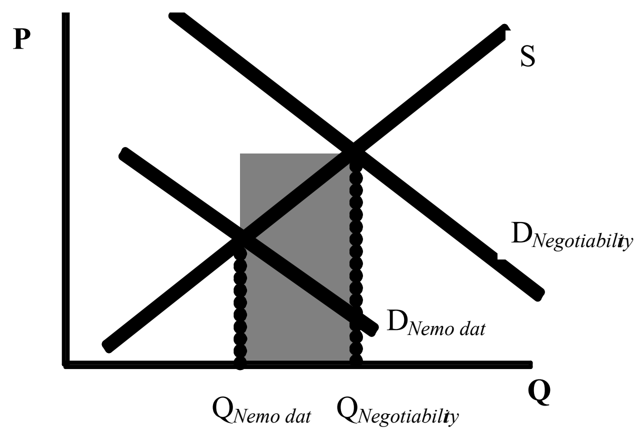
The implications of these competing paradigms are well-known. A debtor is likely to demand a discount of issuing a negotiable instrument because it is surrendering rights. Negotiability

[48] *Id*. at 235.

does not cut off any defenses the debtor has against the original creditor, but the original creditor still benefits because a negotiable debt is easier to resell. Debt purchasers are willing to pay more for a negotiable debt because they do not have to worry about whether there are defenses to the debt beyond those involving the legitimacy of the instrument into which the debt is reified. Accordingly, negotiable systems have greater resale liquidity than *nemo dat* systems.

Expressed graphically, assuming that supply and demand in the debt resale market are price sensitive, the demand curve in a debt resale market shifts to the right in a negotiable system, resulting in an increased quantity of transactions and at a higher price. The increased number of transactions from a rightward shift of the demand curve shows the increased liquidity in the resale market ($Q_{Negotiability} - Q_{Nemo\ dat}$):

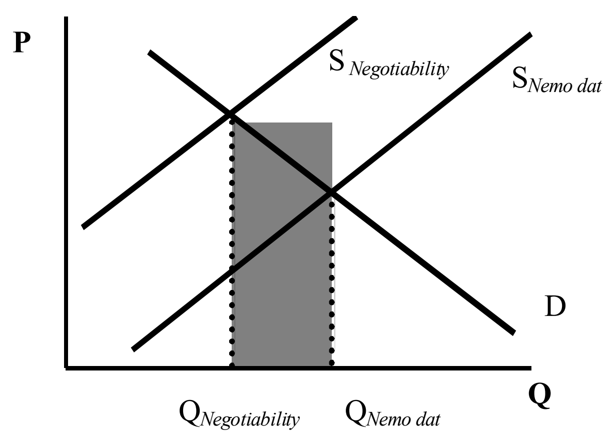
Graph 1: Increase in Resale Market Transactions Between *Nemo Dat* and Negotiability



Debtors are not unprotected in negotiable systems. They are able to protect themselves *ex-ante* via pricing, as debtors should demand a discount from creditors for issuing them negotiable debt. Debtors are also able to protect themselves *ex-post* via litigation. If the original creditor fraudulently induced the debtor into issuing a debt, the debtor could raise fraudulent inducement only as a defense against the original creditor, not that creditor's transferee. But after the transferee collected on the fraudulently induced debt, the debtor could sue the original creditor for its loss. This places an affirmative litigation burden on the debtor, and makes the debtor assume its original creditor's credit risk in the even that a transferee enforces a claim that would be barred but for negotiability. Whether this matters depends on the particulars of the parties, especially the debtor's ability to bear litigation burdens and the original creditor's solvency.

While negotiability increases the liquidity of the resale market, its net effect of negotiability on liquidity in the debt origination market is indeterminate in the abstract. In a negotiable system, sellers (borrowers) will demand a higher price (an interest rate discount) for their product (debt). Assuming that supply and demand in the lending market are price sensitive, this means that the supply curve in originating markets shifts leftward in a negotiable system, which will mean that there are fewer transactions and at a higher price. The reduced number of transactions represents a decrease in the liquidity of the originating market, as indicated by the shaded area ($Q_{\textit{Nemo dat}}$ - $Q_{\textit{Negotiability}}$):

Graph 2: Decrease in the Number of Transactions in the Debt Origination Market from shift from *Nemo Dat* to Negotiability, When Only Sellers Are Considered

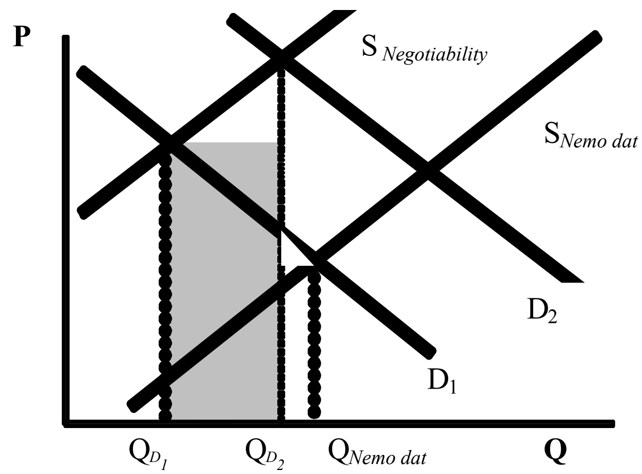


The decrease in liquidity in the originating market caused by borrowers demanding a discount is not the whole story. Whereas the net price for a borrower is the price of the loan, the net price for a lender is the price of making the loan minus the resale price. This means that borrower's leftward shift of the supply curve will be offset to some degree by a rightward shift of the demand curve (from D_1 to D_2) due to lenders' ability to offset higher costs of lending due to negotiability with increased resale prices.

The net effect of the leftward shift of the supply curve and the rightward shift of the demand curve in the originating market cannot be determined in the abstract. It could result in either greater or lesser liquidity in the originating market, but most likely at a higher price point (lower cost of borrowing) in either case.

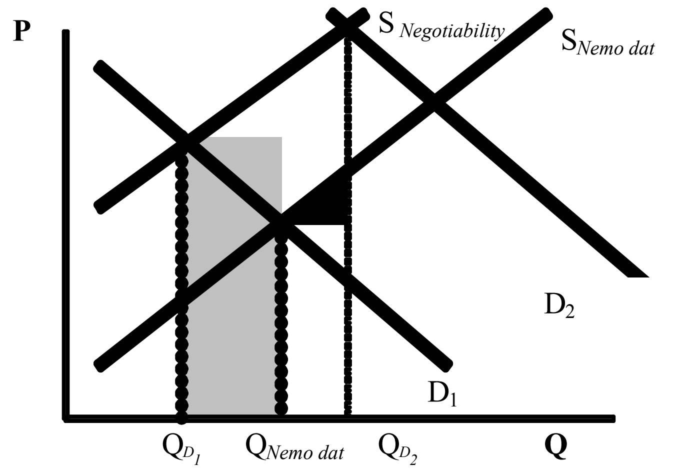
Thus, it is possible for there to be a net loss in liquidity, represented by the striped area, if $Q_{\textit{Nemo dat}} > Q_{D_2}$:

Graph 3: First Possible Effect on Debt Originating Market from Shift Between *Nemo Dat* to Negotiability



Alternatively, it is possible for there to be a net gain in liquidity, represented by the striped area, if $Q_{D_2} > Q_{\textit{Nemo dat}}$:

Graph 4: Second Possible Effect on Debt Originating Market from Shift Between *Nemo Dat* to Negotiability



This story is also likely to be complicated by idiosyncratic valuation as between debtors and creditors. Debtors are likely to place a higher value relative to creditors on price changes and a lower value on retention of defenses. Debtors enjoy a price discount immediately. The retention of defenses will be enjoyed in the future, if at all. Moreover, if the retained defense can only be used in bankruptcy, debtors' relative valuation will tilt even more strongly in favor of a presently enjoyable discount. Borrowers tend to have an optimism bias; they do not think it likely that their ventures will end up in bankruptcy. Debtors also know that management and ownership are likely to change in bankruptcy. Therefore neither present management nor present ownership will place much value on the retention of a bankruptcy-only defense.

In contrast, creditors place higher value on bankruptcy rights because when calculating the credit risk on a loan, they need to account for the minimum possible recovery, which will be the result of their position in bankruptcy. While creditors enjoy a higher lending price immediately under a *nemo dat* regime compared to a negotiability regime, it comes at the expense of increased default risk for the loans. Negotiability, on the other hand, does not cut off any defenses as against an originating creditor, but it does increase the resale value of the debt, which can be enjoyed almost immediately. The increased liquidity from negotiability allows creditors the comfort of easier resale.

The usual policy choice, then, about whether to adopt a negotiability regime involves weighing the social benefit of increased liquidity in the resale market with effects on liquidity in the originating market. The weighing of the market impacts will also depend on the identity of the market players are and debtors' ability to price for negotiability and litigate against originating creditors in a negotiability regime.

To illustrate, imagine that in a negotiability system, a consumer buys a refrigerator on an installment contract from a dealer, and the dealer immediately resells its rights under the installment contract to a finance company.[49] If the refrigerator does not work and the consumer does not pay, the consumer will have a breach of warranty defense against any attempt by the dealer to collect on the installment contract. The consumer would not have that defense against the finance company's collection action.

Of course, the consumer could have demanded a sufficient discount at point of sale, but consumers are not skilled at pricing for negotiability, lack the requisite information to do so, and may not even know that they should. Alternatively, the consumer could sue the dealer, but the consumer is ill-suited to bear the litigation burden. Even if the consumer has the resources to bring suit, there is no guarantee that the dealer is solvent or isn't fly-by-night. Concern for consumers in this sort of situation has led to the Federal Trade Commission's Holder in Due Course Rule, which allows consumers in credit contracts for the sale or lease of goods or services to assert all the defenses and claim that they could against the seller against a holder in due course of their debt.[50] When the debtor is not in a good position to protect himself, as in consumer cases, negotiability is a poor policy choice. But where debtors are able to protect themselves, negotiability bestows the benefits of resale liquidity on markets.

The evaluation of the policy choice between *nemo dat* and negotiability changes is

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[49] This scenario is derived from Albert J. Rosenthal, *Negotiability—Who Needs It?*, 71 COLUM. L. REV. 375, 379-380 (1971).
[50] 16 C.F. R. § 433.2 (2006).

complicated in bankruptcy because the debtor is no longer the real party in interest, as much as competing creditors are. In bankruptcy, not just a debt's validity, but also its priority are at issue.

B. The Differences Between Claim Priority and Claim Validity

Traditionally, *nemo dat* has only been applied to questions of a debt's validity. The Restatement (Second) of the Law of Contracts expresses the *nemo dat* principle as:

> (1) By an assignment the assignee acquires a right against the obligor only to the extent that the obligor is under a duty to the assignor; if the right of the assignor would be voidable by the obligor or unenforceable against him if no assignment had been made, the right of the assignee is subject to the infirmity.
>
> (2) The right of an assignee is subject to any defense or claim of the obligor which accrues before the obligor receives notification of the assignment, but not to defenses or claims which accrue thereafter except as stated in this Section or as provided by statute.[51]

An assignee takes *cum onere* and is subject to all the defenses that an debtor could raise against the assignor that have accrued at the time the debtor received notice of the assignment.

Similarly, UCC Article 9, which governs secured transactions adopts *nemo dat*, in regard to the enforceability of a security interest against the debtor. UCC § 9-318(1) provides that:

> . . . the rights of an assignee are subject to
>
> (a) all the terms of the contract between the account debtor and assignor and any defense or claim arising therefrom; and
>
> (b) any other defense or claim of the account debtor against the assignor which accrues before the account debtor receives notification of the assignment.[52]

UCC § 9-318(1) mirrors the Restatement's formulation of *nemo dat*. Again, *nemo dat* is expressed as applying only to the rights of an assignee in a security agreement between the debtor and a creditor-assignor. It is not expressed in terms of priority among creditors.

[51] Restatement (Second) of the Law of Contracts § 336(1)-(2) (1981). *Compare* Restatement (First) of the Law of Contracts, § 167(1) (1962) ("An assignee's right against the obligor is subject to all limitations of the obligee's right . . . provided that such defenses . . . are based on facts existing at the time of the assignment, or are based on facts arising thereafter prior to knowledge of the assignment by the obligor.").

The major innovation in *Enron* was to apply *nemo dat* to a question of equitably determined priority, rather than in its traditional context of a question of validity or statutorily determined priority. There are different factors involved in questions of priority and validity. Likewise, there are differences between priority set before a transaction and priority set afterwards. The validity of a debt is a bilateral issue between a creditor and a debtor, whereas the priority is a multilateral issue between creditors of the same debtor. A debt's priority can be set *ex-ante*, by statute, by perfection of a security interest, or by a contractual subordination agreement. It can also be set *ex-post* by equitable subordination. *Enron* did not properly account for these differences, which are crucial determinates of choice of property transfer law.

Nemo dat is designed to protect debtors. Under *nemo dat*, the defenses available to a debtor do not vary, regardless of whether it is the original creditor or that creditor's transferee that attempts to enforce the debt. Concern over the protection of debtors is an issue that animates *nemo dat* in a validity context because validity of a debt is an issue between the debtor and a creditor.

Priority, in contrast, is an issue among creditors. When creditors' claims can only be satisfied from a limited fund, the order in which their claims are satisfied is of no legal concern to the debtor.[53] *Nemo dat* protects creditors in a priority context from valid claims receiving improved priority in the hands of transferees. This protection is justified only to the extent that a creditor has relied on other creditors' priority in its lending decisions. Therefore, if a creditor lends with the assumption that it will be last in line in a bankruptcy distribution, it does not merit the protections of *nemo dat*.

Bankruptcy is a multi-party proceeding in which creditors are typically competing with each other for recoveries from a limited (and usually inadequate) fund, so the relative priority of their

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[52] UCC § 9-318(1) (2001).

[53] When creditors' claims can be satisfied from multiple, overlapping assets, the debtor has an interest in the distribution, and is protected by the doctrine of marshalling.

claims crucial. If a creditor's claim is elevated in priority, it will increase his recovery and decrease other creditors' recoveries. As formulated in the Restatement, *nemo dat* deals only with the defenses of an debtor against a claim in the hands of an assignee. In this formulation, the principle has little bearing on *Enron.* In *Enron*, the issue was not the rights of the assignee Funds vis-à-vis the debtor, 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,[54] even if neither affects 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.[55] 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 affects rights only vis-à-vis other creditors.

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. Yet subordination and disallowance should not be conflated simply because they may 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, for example, 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,

[54] UCC § 9-203 (2001).
[55] 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).

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.[56] Thus, there could be a partial or even full recovery on a subordinated claim even if the debtor is 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.

It might be argued that issues of priority cannot be separated from issues of validity because they representative of the bankruptcy estate—the trustee or debtor in possession (DIP)—is a fiduciary of the creditors. The dual roles of trustee or DIP as representative of the estate and representative of the creditors do not mean that a validity analysis should be applied to questions of priority. A debt's priority as a result of equitable subordination does not affect a trustee or DIP in its role as representative of the creditors because equitable subordination presents trustees or DIPs with a conflict of interest between different fiduciary obligations.

Trustees and DIPs owe fiduciary duties to the estate[57] and to the unsecured creditors[58] because the trustee (or DIP) acts as their representative.[59] The fiduciary duties owed to the estate require the trustee or DIP to maximize the estate's value by recovering preferences and fraudulent conveyances.[60] Equitable subordination, in contrast, does not increase the size of the estate. Instead, equitable subordination actions typically present the trustee or DIP with a conflict of fiduciary duties.

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[56] Enron, 333 B.R. at 217-18.
[57] *See* 11 U.S.C. § 323 (2006).
[58] *See, e.g.*, Coleman v. Cmty. Trust Bank (*In re* Coleman), 426 F.3d 719, 729 (4th Cir. 2005); *In re* Mushrooms Transp. Co., 382 F.3d 325, 339 (3d Cir. 2004); Commodore Int'l Ltd. v. Gould (*In re* Commodore Int'l Ltd.), 262 F.3d 96, 98 (2d Cir. 2001); Peterson v. Scott (*In re* Scott), 172 F.3d 959, 967 (7th Cir. 1999); *In re* Marvel Entm't Group, Inc., 140 F.3d 463, 474 (3d Cir. 1998).
[59] Koch Refining v. Farmers Union Cent. Exch., Inc., 831 F.2d 1339, 1342-43 (7th Cir. 1987)

The trustee or DIP owes fiduciary duties equally to all its creditors. But equitable subordination does not benefit all unsecured creditors equally.[61] Equitable subordination litigation brought by the trustee or DIP comes at the expense of all unsecured creditors, but the benefits do not accrue to all unsecured creditors equally.

The conflict of interest is underscored by the comparison of equitable subordination with fraudulent conveyance and voidable preference actions. The Supreme Court has held that a trustee is subrogated to all individual creditors' rights to bring fraudulent conveyance actions.[62] The trustee must act for the benefit of all creditors equally, however. This is not a problem in fraudulent conveyance actions because the recovered transfer goes to the bankruptcy estate and thus benefits all creditors. There is no equivalent holding for equitable subordination because § 510(c) permits subordination to benefit select creditors by allowing subordination to be partial, rather than complete demotion.[63] If the subordinated party remains less than fully subordinated, then no party of lower priority has benefited from the subordination. Even when subordination is complete, it does not benefit all creditors, except in the unusual situation in which the subordinated party had higher priority than all other creditors.

When a DIP seeks equitable subordination, it is not acting in the interests of all unsecured creditors or the estate as a whole. Instead, it is forcing some creditors to shoulder the cost of a benefit that will accrue only to other creditors. This is not the mere exercise of business judgment and is barred by the Supreme Court's decision in *Caplin v. Marine Midland Grace Trust Co. of New*

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[60] *See, e.g.*, Coleman, 426 F.3d at 729; Mushrooms, 382 F.3d at 339; Commodore, 262 F.3d at 98; Peterson, 172 F.3d at 967; Marvel Entm't, 140 F.3d at 474.
[61] *In re* Vitreous Steel Prods. Co., 911 F.2d 1223 (7th Cir. 1990).
[62] Moore v. Bay, 284 U.S. 4 (1931).
[63] 11 U.S.C. § 510(c) (2006). The distinct treatment of fraudulent conveyances and equitable subordination has been criticized. *See* David Gray Carlson, *The Logical Structure of Fraudulent Transfers and Equitable Subordination*, 45 WM. & MARY L. REV. 157 (2003) (arguing that both types of actions should be viewed in terms of effecting a transfer to the injured creditors). *But see* Adam J. Levitin, "Rough Justice? The Nature of Equitable Subordination and Problems of Constitutional Standing," working paper, May 11, 2006, at 16 n.66, *available at* http://ssrn.com/abstract=900444.

York, which held that a trustee cannot prosecute claims that belong to only a subset of creditors.[64] Indeed, it is debatable whether trustees and DIPs even have Constitutional standing to bring equitable subordination actions.[65] The interest of a trustee or DIP in ensuring a fair distribution does not turn questions of priority—the relationship among creditors—into one of validity—the relationship between a creditor and the debtor.

Enron wrongly conflated questions of priority and validity in its consideration of whether to apply *nemo dat*. *Goldie v. Cox*,[66] the case that *Enron* cited for the principle that "transferees should [not] enjoy greater rights than the transferor,"[67] was a validity case, not a priority case. In *Goldie*, the bankrupt had a DIP account with a creditor.[68] The creditor sold all of his bankruptcy claims held as of a certain date.[69] The creditor continued to lend to the bankrupt, and the bankrupt made payments on his account to the assignor.[70] 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.[71] Accordingly, the referee disallowed the assignee's claim.[72] The assignee did not appeal.[73] The Eighth Circuit dealt with the issue in superficial dictum, noting that "there is no point in examining this matter."[74] 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

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[64] 406 U.S. 416 (1972). *See also* E.F. Hutton & Co., Inc., v. Hadley, 901 F.2d 979 (11th Cir. 1990); Williams v. Cal. First Bank, 859 F.2d 664 (9th Cir. 1988); *In re* Ozark Restaurant Equip. Co, 816 F.2d 1222 (8th Cir. 1987).
[65] Levitin, *supra* note 63, at 15-21. This is not to say that DIPs do not have a strategic interest in the order of priorities. A creditor's priority affects its leverage with the estate in negotiating DIP operations and negotiating a plan, and a DIP may want to favor certain creditors in order to curry post-bankruptcy relationships. *Id.* at 14-15.
[66] 135 F.2d 695, 720 (8th Cir. 1942).
[67] Enron, 330 B.R. at 223.
[68] Goldie, 135 F.2d at 720.
[69] *Id.*
[70] *Id.*
[71] *Id.*
[72] *Id.*
[73] *Id.*
[74] *Id.*

likewise.[75]

There was no subordination issue in *Goldie*; the question was of claim allowance. *Goldie* does not tell us that the Funds should have been subordinated in *Enron*. Claim allowance is an issue of validity, not priority, and falls squarely within the traditional ambit of *nemo dat*. Whether *nemo dat* should be extended to priority is a more complex issue.

IV. SHOULD *NEMO DAT* APPLY TO BANKRUPTCY CLAIMS' PRIORITY?

A. NEMO DAT IS CONTRARY TO THE PRINCIPLES OF EQUITY

1. Why the Principles of Equity Matter

Any attempt to answer whether *nemo dat* should apply to priority resulting from equitable subordination should begin with the text of § 510(c). Section 510(c) provides that, after notice and a hearing, the court may:

> 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 . . ..[76]

While "equitable" is often used in the Bankruptcy Code as a synonym for "fair" or "just,"[77] it

[75] *Id.*

[76] 11 U.S.C. § 510(c) (2006).

[77] *See* 11 U.S.C. § 365(d)(5) (2006) (trustee is to perform all obligations of the debtor on an unexpired lease of personal property unless court decides otherwise "based on the equities of the case."); 11 U.S.C. § 502(j) (2006) (reconsideration of allowed or disallowed claim is to be made "according to the equities of the case"); 11 U.S.C. § 510(c)(1) (2006) (claims may be subordinated "under principles of equitable subordination"); 11 U.S.C. § 524(g)(2)(B)(ii)(III) (2006) (asbestos channeling injunction may only be issued if pursuit of claims outside of plan would likely threaten "plan's purpose to deal equitably with claims and future demands"); 11 U.S.C. § 524(g)(4)(B)(ii) (2006) (injunction issued in conjunction with chapter 11 plan only if "the court determines. . .such injunction. . .is fair and equitable"); 11 U.S.C. § 524(h)(1)(A) (2006) (referencing the "fair and equitable" requirements of 11 U.S.C. § 1129(b)); 11 U.S.C. § 552(b)(1) (2006) (after acquired property clauses in security agreements are valid except to the extent that the court orders otherwise after notice and a hearing "based on the equities of the case."); 11 U.S.C. § 552(b)(2) (2006) (limitation on post-petition effect of after-acquired property clauses of security agreements to be "based on the equities of the case"); 11 U.S.C. § 557(d)(2)(D) (2006) (disposition of grain or proceeds of grain may be by "such other method as is equitable in the case"); 11 U.S.C. § 723(d) (2006) (determination of distribution of surplus recovered by a partnership trustee against general partners shall be equitable); 11 U.S.C. § 1112(d)(3) (2006) (conversion of case from chapter 11 to chapter 12 must be equitable); 11 U.S.C. § 1113(b)(1)(A) (2006) (debtor rejecting a collective bargaining agreement shall make a proposal for modifications in employee benefits and protections that assures that "all creditors, the debtor, and all of the affected parties are treated fairly and equitably"); 11 U.S.C. § 1113(c)(3) (2006) (collective bargaining agreements to be rejected only if "the court finds. . .the balance of the equities favors rejection"); 11 U.S.C. § 1114(f)(1)(A) (2006) (debtor modifying retiree benefits must assure that "all creditors, the debtor, and all of the affected parties are treated fairly and equitably"); 11 U.S.C. § 1114(g)(3) (2006) (modification of payment of retiree benefits if

has a particular meaning in § 510(c), as indicated by the phrase "principles of equitable subordination."

As the legislative history of § 510(c) makes clear, the "principles of equitable subordination" is a term of art referring to historic Anglo-American traditions of courts of equity, and subordination of claims in bankruptcy must be viewed in light of these traditions. Although bankruptcy courts are often called "courts of equity," this is an inaccurate description because bankruptcy courts lack classic equity powers and jurisdiction.[78]

Section 510(c) is an exception, where traditional equity jurisprudence plays a role in bankruptcy. The Senate Report of the Bankruptcy Reform Act of 1978, which enacted § 510(c), noted that:

> The bill provides, however, that any subordination ordered under this provision must be based on principles of equitable subordination. These principles are defined by case law, and have generally indicated that a claim may normally be subordinated only if its holder is guilty of misconduct. As originally introduced, the bill provided specifically that a tax claim may not be subordinated on equitable grounds. The bill deletes this express exception, but the effect under the amendment should be much the same in most situations since, under the judicial doctrine of equitable subordination, a tax claim would rarely be subordinated.[79]

Similarly, the House Report noted that § 510(c) permits the subordination of claims and interests on equitable grounds:

"all creditors, the debtor, and all of the affected parties are treated fairly and equitably, and [a modification of the order] is clearly favored by the balance of the equities"); 11 U.S.C. § 1114(l) (2006) (court may reinstate retiree benefits that have been modified unless the equities favor modification); 11 U.S.C. § 1129(b)(1) (2006) (cramdown plan must be "fair and equitable" to be confirmed); 11 U.S.C. § 1129(b)(2) (2006) (defining what "fair and equitable" includes for the purposes of § 1129(b)(1)); 11 U.S.C. § 1170(e)(1) (2006) (approval of abandonment of railroad line requires "a fair arrangement at least as protective of the interests of employees as that established under section 11326(a) of title 49"); 11 U.S.C. § 1172(c)(1) (2006) (approval of railroad reorganization plan requires "a fair arrangement at least as protective of the interests of employees as that established under section 11326(a) of title 49"). *See also* 11 U.S.C. § 1228(b)(1) (2006) and 11 U.S.C. § 1328(b)(1) (2006) ("circumstances for which the debtor should not justly be held accountable" for failure to make payments under a plan); 11 U.S.C. § 524(c)(3)(B) (2006) and 11 U.S.C. § 524(c)(6)(A)(i) (2006) (no "undue hardship"); 11 U.S.C. § 557(f)(1) (2006) ("in the interests of justice"). Many historically equitable doctrines, such as good faith, *see* 11 U.S.C. § 1129(a)(3) (2006), fraud, *see* 11 U.S.C. § 548 (2006), and laches, *see* 11 U.S.C. § 524 (2006), are incorporated throughout the Code, but without allowing judicial discretion.

[78] Adam J. Levitin, *Toward a Federal Common Law of Bankruptcy: Judicial Lawmaking in a Statutory Regime*, 80 AM. BANKR. L.J. 1, 24 (2006). *See* also Marcia Krieger, *"The Bankruptcy Court is a Court of Equity": What Does that Mean?* 50 S.C. L. REV. 275 (1999).

[79] S. REP. NO. 95-989, at 74 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5860.

> this section is intended to codify case law . . . and is not intended to limit the court's power in any way. The bankruptcy court will remain a court of equity . . . . The court's power is broader than the general doctrine of equitable subordination, and encompasses subordination on any equitable grounds.[80]

While the House Report stated that § 510(c) power is broader than the general doctrine, it did not spell out *how* it is broader, as pre-existing equitable subordination doctrine appears to have allowed subordination for any sort of inequitable behavior; there are not exceptions evident in caselaw.

Finally, the legislative history includes statements by the legislative leaders on the Bankruptcy Reform Act, Representative Don Edwards (D-Cal.) and Senator Dennis DeConcini (D-Ariz.). They observed that § 510(c)

> is intended that the term "principles of equitable subordination" follow existing case law and leave to the courts development of this principle. To date, under existing law, a claim is generally subordinated only if holder of such claim is guilty of inequitable conduct, or the claim itself is of a status susceptible to subordination, such as a penalty or a claim for damages arising from the purchase or sale of a security of the debtor. The fact that such a claim may be secured is of no consequence to the issue of subordination. However, it is inconceivable that the status of a claim as a secured claim could ever be grounds for justifying equitable subordination.[81]

Several points are apparent from the legislative history. First, Congress intended for equitable subordination to occur under equitable principles. Second, Congress understood these principles to be those that existed in pre-Code caselaw. Third, Congress understood that these principles typically require the *holder*, rather than the transferor, of the claim to be guilty of misconduct.[82] The exception to this principle is when the nature of the claim itself is inequitable, but Congress wanted to be clear that there was nothing *per se* inequitable about taxes or secured

[80] H.R. REP. NO. 95-595, at 359 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6315.
[81] 124 Cong. Rec. H11089 (daily ed. Sept. 28, 1978) (statement of Rep. Edwards), *reprinted in* 1978 U.S.C.C.A.N. 6436, 6452 (1978); 124 Cong. Rec. S17406 (daily ed. Oct. 6, 1978) (statement of Sen. DeConcini), *reprinted in* 1978 U.S.C.C.A.N. 6505, 6521.
[82] Fortgang & Mayer, *Trading Claims and Taking Control*, *supra* note 4, at 9-13 (noting the existence of claims trading before 1978).

claims.[83] While it is not clear what sort of claim would be *per se* inequitable, one suspects that it might include claims that are "contrary to public policy" or somehow categorically disfavored, like punitive damages or penalties. The Supreme Court, however, has since held that types of claims may not be categorically subordinated,[84] because doing so would infringe on Congress' priority scheme.[85] In any case, neither the basic principle nor the exception existed in *Enron*.

The statements of the legislative leaders add a twist.[86] They noted courts were to develop the law of equitable subordination. That is, equitable subordination need not remain frozen in its 1978 state;[87] federal common lawmaking is explicitly authorized.[88] But there are clearly limits placed by the text of § 510(c), particularly that the development must be within the principles of *equitable* subordination. The legislative history does not contemplate a free license to subordinate claims and interests whenever it suits a judge. The subordination must bear some relation to what is equitable.

Examples of how the law could develop beyond its state in 1978 within the realm of equity might be the subordination of claims for parties that did not commit the inequitable conduct, but were aware of it, had a duty to report or prevent it, and failed to do so. This might include an attorney who failed to go up the ladder to report a fraud. Another possibility of development within the bounds of equity would be the subordination of a claim by a party who would be liable to the debtor under a gross negligence standard, but only committed simple negligence. Thus, it might be

[83] 11 U.S.C. § 510(c) (2006).
[84] Noland v. United States, 517 U.S. 535, 540-41 (1996).
[85] 11 U.S.C. § 507 (2006).
[86] We should be cautious about making too much out of the legislative history of § 510(c), particularly the statements of individual legislative leaders. In *Noland*, 517 U.S. at 540, the Supreme Court considered the legislative history of § 510(c), but disregarded the statement that equitable subordination allows for the subordination of claims of particular statuses, such as penalties; instead, the Supreme Court reversed the subordination of a tax penalty claim.
[87] Query what impact, if any, there is on § 510(c) from the Supreme Court's ruling 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. *Grupo Mexicano de Desarrollo, S. A. v. Alliance Bond Fund, Inc.*, 527 U.S. 308 (1999). For a consideration of the applicability of *Grupo Mexicano* to bankruptcy, *see* Levitin, *supra* note 78, at 50-57. 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.
[88] *See* Levitin, *supra* note 78, at 66-78, regarding federal common lawmaking authority in bankruptcy.

proper to subordinate the indemnification claim of a negligent officer or director against a corporation whose charter provides for officer and director indemnification except in cases of gross negligence or willful misconduct. The corporation would still indemnify the officer or director, but the priority of the claim would be lower.

The limitation of equitable principles on the development of equitable subordination is confirmed by the identical statements of Representative Edwards and Senator DeConcini that, "Since the House amendment authorizes subordination of claims only under principles of equitable subordination, and thus incorporates principles of existing case law, a tax claim would rarely be subordinated under this provision of the bill."[89] Claims may only be subordinated *equitably*, and there is nothing inherently inequitable about a tax claim or a secured claim.[90] The inequity will usually be by the holder of the claim. At least as envisioned by the legislative leader, it would be only the rare type of claim that would be categorically inequitable, and the Supreme Court has since said that subordination may not occur solely because of the categorical nature of a claim, such as a tax penalty claim.[91] Thus, equity provides the limits of subordination. While the law of subordination may develop, this development must exist within the confines of the "principles of equitable subordination."

The text and legislative history of § 510(c) tell us that subordination must be done under the principles of equitable subordination. These principles can develop, but they are bounded by the fact that subordination must be equitable. In § 510(c), equitable means not only fair, but fair within the sense of what a court of equity would do.

2. Nemo Dat Did Not Apply in Equity Historically

There are two sources for the principles of equity: case law and equity maxims. Both counsel against the application of *nemo dat* to priority resulting from equitable subordination. For

[89] 124 Cong. Rec. H11095, H11113 (Sept. 28, 1978).
[90] S. REP. NO. 95-989, at 74 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5860.

there to be a question of priority, there have to be multiple parties competing for control over a limited fund. Such suits were never resolved in law courts, but in chancery.[92] The core areas of equity jurisdiction are all areas involving division of a limited asset: bankruptcy estates, estates of deceased persons, trusts, land rights.[93] *Nemo dat* is a common law doctrine; historically it did not apply in equity.[94] This means that *nemo dat* has never historically been applied to issues of priority.

3. Equity Acts In Personam

Equity maxims—glowing phrases that summarize the principles of chancery decisions—are another source for the principles of equity.[95] Equity maxims have been more or less canonized, albeit with some slight variation. While we should not make too much out of these old and opaque phrases,[96] these maxims are important not only because § 510(c) itself tells us to look to the "principles of equitable subordination," but because they encapsulate centuries of judicial wisdom. Although their interpretation is an open matter, they are important guideposts for our present jurisprudence and adherence to them ensures that equitable subordination remains equitable, and does not become a bunion on the Chancellor's foot, a problem noted by the 17th century commentator John Selden:

> 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.[97]

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[91] Reorganized CF&I Fabricators, 518 U.S. at 229.
[92] *See* Harman v. Masoneilan Int'l, Inc., 442 A.2d 487, 498 (Del. 1982) (citing 2 STORY, COMMENTARIES ON EQUITY JURISPRUDENCE § 1300 at 647 (14th Ed. 1918)); Bovay v. H. M. Byllesby & Co., 38 A.2d 808,813 (Del. 1944) ("The execution of a trust and the following and administering of trust funds are immemorial heads of equity jurisprudence."); Hayden v. Thompson, 71 F. 60, 62 (8th Cir. 1895).
[93] *See* P.V. BAKER & P. ST. J. LANGAN, SNELL'S EQUITY 1 (29th ed. 1990).
[94] Holt v. The Am. Woolen Co., 150 A. 382, 383 (Me. 1930); Emerson v. European & N. Am. R. Co., 67 Me. 387 (Me. 1877); Mitchell v. Winslow, 17 F. Cas. 527, 531 (C.C.D. Me. 1843) (No. 9,673) (Story J.).
[95] Jack B. Weinstein & Eileen Hershenov, *The Effect of Equity on Mass Tort Law*, 1991 U. ILL. L. REV. 269, 273-75 (1991).
[96] *See* Jeremiah Smith, *The Use of Maxims in Jurisprudence*, 9 HARV. L. REV. 13 (1896).
[97] *See* JOHN SELDEN, TABLE TALK 43 (Pollock ed., 1927) (spelling, capitalization, and punctuation original).

Without the benefit of maxims and precedent, it is hard to know what principle would guide equity, and therefore equitable subordination, if not a judge's own personal priority scheme.

One commentator has noted that "it would not be difficult to reduce [all of the equity maxims to two:] 'Equity will not suffer a wrong to be without a remedy', and 'Equity acts on the person.'"[98] These two maxims, particularly the later one, often given as "equity acts *in personam*,"[99] highlight a fundamental problem with *Enron*, because *Enron* decided the first issue—whether Fleet could be subordinated for actions unrelated to the claim—on an *in personam* basis, but decided the second issue—whether the Funds could be subordinated for holding a claim that could have been subordinated in Fleet's hands—using an *in rem* logic.

Generally, the *in personam* maxim has been understood to address jurisdictional questions.[100] The maxim itself bears no indication that it is so restricted, and, historically, equity *has* exercised *in rem* jurisdiction.[101] All of trust law, where the trust is the *res*, bears testament to this, and bankruptcy is itself essentially an *in rem* proceeding[102] dealing with the *res* of the bankruptcy estate, itself a trust. A reconsideration of the *in personam* maxim is necessary, therefore.

A sensible approach is to take the maxim literally and not imply a jurisdictional aspect. In *Ernst v. The White Motor Credit Corp.*,[103] the Bankruptcy Court for the Southern District of Ohio did just this. The court refused to grant equitable perfection to a security interest misfiled in good faith in the wrong county (and thus unperfected) because perfection would affect third parties,

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[98] BAKER & LANGAN, *supra* note 93, at 27.
[99] *Id.*; EDWARD D. RE & JOSEPH R. RE, REMEDIES 30 (5th Ed. 2000); PETER CHARLES HOFFER, THE LAW'S CONSCIENCE: EQUITABLE CONSTITUTIONALISM IN AMERICA (1990), 11-12 (quoting RICHARD FRANCIS, MAXIMS OF EQUITY (1726)).
[100] *See* Hart v. Sansom, 110 U.S. 151, 154 (1884). Moreover, some courts and commentators have argued that the maxim is not even correct as a positive statement of English equity jurisprudence regarding jurisdiction. Union Sulphur Co. v. Tex. Gulf Sulphur Co., 32 F.2d 517, 518 (S.D. Tex., 1929); William F. Walsh, *Development in Equity of the Power to Act In Rem*, 6 N.Y.U. L. REV. 1 (1928).
[101] *Id.* at 3.
[102] Cent. Va. Cmty. Coll. v. Katz, 126 S.Ct. 990, 996-97 (2006); Tenn. Student Assistance Corp. v. Hood, 541 U. S. 440, 448 (2004).
[103] Ernst v. The White Motor Credit Corp., (*In re* Villars), 28 B.R. 289 (Bankr. S.D. Ohio 1983).

including the trustee in bankruptcy, who was the debtor's successor in interest.[104] The court noted that, "It would be absolutely incongruous to apply equitable principles to defeat the rights of third parties who were in no way involved in the questioned transaction. Equity acts *in personam*, not *in rem*."[105]

The *in personam* maxim can reasonably be understood to mean that equity looks at the person, not at the claim. Such an interpretation is consistent with other equity maxims. Perhaps the best-known equity maxim is that "One who comes into equity must come with clean hands."[106] This maxim means equitable relief will not be granted to parties who have engaged in misconduct.[107] The clean hands maxim reminds us that equity looks at the entire picture, not just the specific claim. The inequitable behavior that creates unclean hands need not be the act before the court. Equity acts *in personam* by looking at the entirety of the *personae* before the court.[108]

This tells us that the first issue in *Enron*—whether the loan participation claims could be subordinated in Fleet's hands for Fleet's unrelated wrongdoing—was consistent with the principles of equity, even if it was based on questionable authority.[109] If Fleet engaged in inequitable behavior toward Enron, then any claims in Fleet's hands should be subject to equitable subordination, regardless of whether Fleet was the original holder of the claims or a transferee.[110]

There is also a negative implication to the clean hands maxim: equity will not punish those

[104] UCC § 9-203(2) (2001). Under Article 9, perfection or lack thereof relates only to the priority of a claim over other secured creditors' interests in the collateral, not to the creditor's rights vis-à-vis the debtor.
[105] Ernst, 28 B.R. 289. Several courts have adopted similar stances in cases dealing with equitable subrogation. Subrogation is a legal fiction of an assignment or transfer that allows one party to stand in the shoes of another party in reference to a claim. Subrogation is intended to provide meritorious creditors who have paid the debt of another relief against loss. Rinn v. First Union Nat'l Bank of Md., 176 B.R. 401, 407 (D.Md. 1995). It is a doctrine that originates in equity and is governed by equitable principles. Compania Anonima Venezolana de Navegacion v. A.J. Perez Export Co., 303 F.2d 692, 697 (5th Cir. 1962).
[106] BAKER & LANGAN, *supra* note 93, at 27.
[107] Jones v. Bodley, 39 A.2d 413, 416 (Del. Ch. 1944).
[108] Comstock, 335 U.S. at 238 (Murphy, J., dissenting) ("Equity looks in all directions.").
[109] Levitin, *supra* note 41, at 393.
[110] Nonetheless, it should be noted that the first half of *Enron* stands on shaky precedent. Judge Gonzalez repeatedly emphasized that there was no precedent barring him from subordinating Fleet, 333 B.R. at 219, 219 n.4, 220, 222, but this hardly means that the contrapositive is true and that subordination would be proper.

who have clean hands. This implication can be tied to a third equity maxim, "Equity is equality."[111] Bankruptcy incorporates this maxim in its distribution scheme by treating all claims within a class alike in regard to distribution.[112] Subordination is an exception to equal treatment of claims that should otherwise be in the same class. In this sense, a party that seeks to avoid subordination must have clean hands if it wants the equitable treatment of equality with like claims.

Similarly, the maxim that "he who seeks equity must do equity,"[113] emphasizes that equity may not be used for inequitable ends. Just as equity will not aid the wicked, it will not punish the innocent.[114] *Nemo dat* sometimes results in punishing the innocent. If a creditor obtained a debt by fraud and then sold the debt to a good faith purchaser, denying the purchaser the ability to enforce the debt penalizes the purchaser, even if he can still hope to recover from his seller. *A fortiori*, then that applying *nemo dat* to issues of priority in an equitable subordination context, where the subordination was on account of behavior unrelated to the claim, involves punishing innocent claims purchasers. The *Enron* equitable subordination was contrary to the principles of equity. *Nemo dat* should not apply to situations in which priority is set equitably after creditors have extended value.

4. The Principles of Equity Imply a Good Faith Purchaser Defense

The principles of equity not only argue against applying *nemo dat* to the transferability of equitable priority determined after the transfer; they also argue for allowing the good faith purchaser defense. A good faith purchaser defense is an exception to *nemo dat* because the good faith purchaser is protected from defenses that could be raised against the original creditor. The Funds

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[111] BAKER & LANGAN, *supra* note 93, at 27.
[112] 11 U.S.C. §§ 1123(a)(4), 1222(a)(3), 1322(a)(3) (2006).
[113] BAKER & LANGAN, *supra* note 93, at 27.
[114] Equity's reluctance to be used as an instrument to harm the innocent derives from its historical origins as a quasi-ecclesiastical court that made its appeal to the conscience of the parties and was known as "the king's conscience."[114] WILLIAM BLACKSTONE, 3 COMMENTARIES ON THE LAW OF ENGLAND, Ch. 4, *46 (1758). *See* Marcia Krieger, *"The Bankruptcy Court is a Court of Equity": What Does that Mean?* 50 S.C. L. REV. 275, 279 (1999). As it developed, "[e]quity is a moral sense of fairness based on conscience." William T. Quillen & Michael Hanrahan, *A Short History of the Delaware Court of Chancery, 1792-1992*, 18 DEL. J. CORP. L. 819, 821 (1993). Notably, only *personae*, not *res* have consciences. A person can be guilty; an object cannot. Imparting a taint to an inanimate object like a bankruptcy claim is inconsistent with the basic nature of equity. Similarly, our commonly shared moral and legal sense cautions that we

attempted to make a good faith purchaser defense on the basis of § 550(b) of the Code, which provides that the trustee or DIP may not avoid certain liens or recover a preference, setoff, post-petition transaction, or fraudulent transfer against a good faith taker for value either from an immediate transferee or from the taker's subsequent good faith transferees.[115]

The Bankruptcy Court rejected this argument under the principle *expressio unius est exclusio alterius* because § 550(b) only creates a good faith exception to transfers that could be avoided under §§ 544, 545, 547, 548, 549, 553(b), and 724(a), not to claims subordinatable under § 510(c).[116] The Bankruptcy Court noted that the types of transactions protected under § 550(b) were transactions between a good faith purchaser and the bankruptcy estate.[117] Section 550(b) protects the ownership rights of purchasers *from the estate*. Section 510(c), in contrast, deals only with priority, not ownership rights, and the Funds were looking for protection as good faith purchasers from a prior claimant on the estate, rather than from the estate itself. The Bankruptcy Court correctly divined that § 550(b)'s good faith purchaser protections are meant to encourage parties to deal with the bankruptcy estate; it is not meant to encourage (or one might add discourage) claims trading. Accordingly, the Bankruptcy Court held that there was no reason to imply a good faith purchaser defense to § 510(c) actions on the basis of § 550(b)'s provisions.[118]

There are a couple of alternative explanations, not considered by the Bankruptcy Court, for why § 550(b) does not provide a statutory good faith purchaser defense to equitable subordination that do not preclude a non-statutory basis for such a defense. First, when Congress drafted the Bankruptcy Code, it did not conceive of a situation in which a good faith purchaser of a bankruptcy claim could be subordinated under the principles of equitable subordination. There was no need for an explicit statutory grant of a good faith defense, because there was no anticipated harm. Equitable

can only hold a person accountable for his own actions, absent special duties.
[115] 11 U.S.C. § 550(b) (2006).
[116] Enron, 333 B.R. at 233. *See* 11 U.S.C. § 550(a) (2006).
[117] Enron, 333 B.R. at 233.

subordination was never conceived of as affecting parties down a chain of title, only the party that acted inequitably itself. Accordingly, § 510 was not grouped in the Code with the provisions that affect transferred claims and obligations in subchapter III of Chapter 5.

More importantly, a good faith defense is implied within § 510(c) by the phrase "principles of equitable subordination." Good faith is an equitable defense[119] that one would expect to be encompassed within the principles of equitable subordination. Congress did not want to assume the daunting task of codifying equity jurisprudence—it was far easier to direct the courts to do what they have traditionally done. This means protecting good faith purchasers in equitable actions. The absence of a statutory good faith purchaser defense against equitable subordination in § 550(b) does not preclude an implied equitable defense in § 510(c).[120]

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[118] *Id.*

[119] *See*, *e.g.*, Batiansila v. Advanced Cardiovascular Sys., Inc., 952 F.2d 893, 894 (5th Cir. 1992).

[120] It is worth noting that a good faith purchaser defense does exist for purchasers of claims from federal deposit insurers. When federal deposit insurers such as the Federal Deposit Insurance Corporation (FDIC) and the Federal Savings and Loan Insurance Corporation (FSLIC) take over a failed financial institution, they are subrogated to bankruptcy claims held by the institution. These federal agencies are protected as subrogors against a number of claims that could have been brought against the financial institutions themselves by the federal holder-in-due-course (FHDC) doctrine, derived from *D'Oench, Duhme & Co. v. FDIC*[120] and Federal Deposit Insurance Act of 1950 § 2(13)(e). 12 U.S.C. § 1823(e) (2006). Moreover, purchasers from a FHDC receive FHDC protection. FDIC v. Newhart, 892 F.2d 47 (8th Cir. 1989); Porras v. Petroplex Sav. Assoc., 903 F.2d 379 (5th Cir. 1990).

The FHDC doctrine has been used to protect against claims of fraud in the inducement, *In re* Hood, 95 Bankr. 696, 701 (Bankr. W.D. Mo. 1989), but has been held not to protect against preference actions because they arise under a federal statute. First City Fin. Corp. v. FDIC (*In re* First City Fin. Corp.), 61 Bankr. 95, 97 (Bankr. D.N.D. 1986); La Mancha Aire, Inc. v. FDIC (*In re* La Mancha Aire, Inc.), 41 Bankr. 647 (Bankr. S.D.N.Y. 1984). The Fifth Circuit has noted in dicta, however, that the doctrine would shield against equitable subordination, itself a federal cause of action. Holt v. FDIC (*In re* CTS Truss, Inc.), 868 F.2d 146, 150 (5th Cir 1989). *But cf.* Kingsway Revocable Trust v. FSLIC (*In re* C.P.C. Dev. Co. No. 5), 113 Bankr. 637, 641-43 (Bankr. C.D. Cal. 1990) (bad acts of S&L could be imputed to FSLIC as receiver for purposes of equitable subordination). *See* Fortgang & Mayer, *Developments in Trading Claims and Taking Control of Corporations in Chapter 11*, *supra* note 4, at 15, for the strange history of CTS Truss. As originally published, the CTS Truss opinion had as an alternative holding, rather than as a dictum, that an innocent purchaser of a claim cannot be subordinated, regardless of whether it was a private party or the FDIC. Holt v. FDIC (*In re* CTS Truss, Inc.), 859 F.2d 357, 359-60 (5th Cir. 1988), *modified*, 868 F.2d 146 (5th Cir. 1989). In any case, though, the FDIC was not an ordinary innocent purchaser. It was required to take over the failed bank in question by statute.

There are unique policy impetuses behind the FHDC doctrine. The government is subrogated not by choice by statutory duties. If the government finds itself holding a worthless claim, it is ultimately the taxpayers who bear the cost. Moreover, it would be inequitable to attribute the wrongdoing of a failed financial institution to the government agency that is required to step into its shoes as part of its insolvency proceedings. Accordingly, the government gets special treatment elsewhere as a creditor in bankruptcy, be it priority status of certain claims or the exemption to the automatic stay for regulatory actions. There are different policy issues that come into play in the federal holder-in-due-course doctrine, but its existence shows that the sky will not fall if a purchaser in good faith defense is found in § 510(c).

B. THE BANKRUPTCY CODE ADOPTS NEMO DAT FOR PRIORITY IN A LIMITED CIRCUMSTANCE

In considering whether *nemo dat* applies to bankruptcy claims' priority, a factor that must be considered is the Bankruptcy Code's treatment of priority of subrogated claims. Unfortunately, it is hard to draw generalizations from this limited context. Section 507(a) of the Code elevates the priority of nine types of unsecured claims.[121] Section 507(d), however, provides that the subrogor of a holder of any of seven of the nine types of § 507(a) claims is not subrogated to the elevated priority of the claim.[122] Instead, the subrogor has the status of a general unsecured creditor, even though the subrogee had higher priority:

> An entity that is subrogated to the rights of a holder of a claim of a kind specified in subsection (a)(3) [wage claims], (a)(4) [employee benefit claims], (a)(5) [farmers' and fishermen's claims], (a)(6), [personal down payment claims] (a)(7) [alimony and child support claims], (a)(8) [tax claims], or (a)(9) [federal depository insurer claims] of this section is not subrogated to the right of the holder of such claim to priority under such subsection.[123]

The two types of claims for which a subrogee *is* subrogated to 507(a) priority are (1) those claims for the administrative expenses of the bankruptcy estate under § 503,[124] which are prioritized under §507(a)(1),[125] and (2) claims for unsecured claims filed under § 502(f) for debts incurred in involuntary bankruptcies between the filing of the involuntary petition and the order for relief,[126] which are prioritized under § 507(a)(2).[127]

While there might be cause to distinguish between a good faith purchaser and a subrogor, who does not necessarily take for value, § 507(d) appears to be an exception to a general rule regarding transfers of priority of bankruptcy claims. The scope of this general rule is not clear: does § 507(d) imply subrogation to priority in all other situations or just for § 507(a)(1) and (a)(2) claims?

The better reading is the later one. Section 507(d) only announces a divergence in

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[121] 11 U.S.C. § 507(a) (2006).
[122] 11 U.S.C. § 507(d) (2006).
[123] 11 U.S.C. § 507(d) (2006).
[124] 11 U.S.C. § 503 (2006).
[125] 11 U.S.C. § 507(a)(1) (2006).

subrogation to specifically prioritized claims, not from a general principle that a claims' priority is indelible. This narrow reading is probably preferred, and not just on the principle that the specific controls over the general. Section 507(a)(1) and (a)(2) claims are prioritized for different policy reasons from the other types of § 507(a) claims, and § 507(d) apparently distinguishes on this basis. Section 507(a)(1) gives special priority to §503 administrative expense claims. Administrative expenses of a bankruptcy estate are given priority status as an incentive to taking the risk of extending value to an insolvent entity.

Likewise, § 507(a)(2) gives special priority to § 502(f) claims for debts incurred between the filing of an involuntary bankruptcy petition and the order for relief. Section 502(f) claims are similar to administrative expenses, as they too are debts incurred by the bankruptcy estate post-petition. Section 502(f) claims involve value that is extended to the estate, not the debtor. Allowing subrogors of administrative creditors to receive the administrative creditors' priority ensures the resale value of administrative claims. This keeps administrative claims liquid and makes them more valuable, which encourages creditors to extend post-petition value to debtors.

The other types of § 507(a) claims, like those for wages, alimony, child support, and taxes, are claims of creditors that extended value before bankruptcy. These types of claims are not likely to be resold—they are either held by unsophisticated parties that lack access to the claims trading market or by the government. These claims receive elevated priority because of Congress' social policy judgment that they are more worthy than other unsecured creditors who extended value pre-petition. The factor giving priority for these claims is also intimately connected with the identity of the initial claim holder. Congress wanted to treat spouses and children of bankrupts different from other parties. The same for employees, farmers, fisherman, and the government. The reason they receive the priority inheres in them and cannot be transferred; it is an *in personam* characteristic.

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[126] 11 U.S.C. § 502(f) (2006).

It is hard to know what to glean from § 507(d), but it is a stretch to read it as implying a general indorsement of *nemo dat* in regard to priority in bankruptcy. Indeed, § 507(d) involves its inverse of *nemo dat*. Rather than conveying *more* than one has, § 507(d) means that § 507(a) parties, other than those with § 503 and § 502(f) claims, convey *less* than they have. Section 507(d) simply does not address whether a subrogor gets a subrogee's priority for claims that do not have § 507(a) priority, much less whether this applies to situations beyond subrogation, such as good faith purchasers for value. The better reading of § 507(d) is that it does not speak to *nemo dat* as a general matter in terms of priority of bankruptcy claims, only to a limited question of statutory priority.

C. Nemo Dat Applies only if There Is Justified Reliance on Priority

Because *nemo dat* is the default rule of property transfers, debtors are justified in relying upon it.[128] If I take out a loan from the bank, I expect that any defense I have against the bank's enforcement of the debt will also be available to me against anyone the bank sells the loan to. *Nemo dat* protects borrowers' justified expectations. When the law opts out of a *nemo dat* regime, it is only with clear notice, so borrowers do not rely on the ability to raise the same defenses against their lenders' transferees as they do against their lender. The notice provided by negotiability systems is designed to alert borrowers to demand a price reduction in order to part with their rights.

Whether *nemo dat* should apply to questions of priority in bankruptcy depends on whether there was justified reliance by creditors. As a general matter, *nemo dat* is the principle adopted by the law because it is an important protection for obligors against malfeasance by assignors. Suppose *A* sells *B* a debt *A* claims that he is owed by *C*. If *C* does not actually owe *A* the debt, we would not want *C* to be liable to *B* for it, much less let *A* walk away with his profit from the resale. Accordingly, *nemo dat* is the baseline rule of law, so *C* can raise any defense against *B* that he can

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[127] 11 U.S.C. § 507(a)(2) (2006).

[128] There is an obvious circularity to this reasoning. If *nemo dat* were not the default rule there would be no just reliance.

against *A*. Thus, *C* does not end up paying a debt that he does not owe. Nor is *B* left with the loss. *B* has various contract and tort claims against *A*, so *A* does not end up profiting unjustly. *Nemo dat* means *caveat emptor* for transferees like *B*, but a transferee of a debt is usually not a consumer, but a sophisticated party that is capable of protecting itself.

Where the law varies from the *nemo dat* paradigm, it is only with clear notice that changes what constitutes justified reliance. As a general matter, the law strives to protect parties' justified expectations. This principle is what animates the application of *nemo dat* or negotiability in non-bankruptcy contexts.

For example, UCC Article 3 requires that instruments comply with various formal requirements to be negotiable.[129] The formal indicia inform a potential holder in due course[130] that he may enforce his instrument subject only to the "real" defenses of infancy, incapacity, illegality, duress, fraud in the factum, discharge in insolvency, other known discharge, suretyship defenses, statute of limitations, material alteration of the instrument, and forgery. "Real" defenses go to the validity of the instrument itself, as opposed to the creation transaction, and to whether the obligor knew or had the capacity to know it was creating a negotiable instrument, and thus surrendering certain defenses. The holder in due course is not subject to the so-called "personal" defenses, namely simple contract defenses, like breach of contract, breach of warranty, fraud in the inducement, lack of consideration, failure of consideration, theft, failure of a condition precedent, mistake, unconscionability, impossibility, and waiver.[131] Thus, a debtor who issues a negotiable instrument is not justified in relying on having personal defenses against a holder in due course. Conversely, a party that purchases a negotiable instrument in good faith is justified in relying on

[129] UCC § 3-104 (1991).
[130] The Holder in Due Course is one who obtains an instrument for value and without notice UCC § 3-302(1991). The Holder in Due Course is just the good faith purchaser in a UCC Article 3 guise, and good faith in the UCC is nothing more than "honesty in fact and the observance of reasonable commercial standards of fair dealing." UCC § 1-201(21) (2004).
[131] UCC § 3-305 (1991).

protections as a holder in due course.

The justified reliance principle also determines whether *nemo dat* will apply in areas of law involving priority, such as real estate deeds and security interests (including mortgages). Real estate and security interest both have notice-filing systems. When a real estate deed or security interest is properly filed or perfected, the law imputes constructive notice of its priority to other parties. When the deed or security interest is not properly filed or perfected, no notice is imputed. The priority of a recorded deed is generally determined by a first in time, first in right rule, so a prospective buyer should search the title filing system to determine if someone other than the seller has recorded the deed. *Nemo dat* protects the reliance of buyers who search the title system.

Thus, if *A* sells Blackacre to *B*, who does not record the deed, and *A* subsequently sells Blackacre to *C*, a good faith purchaser who records the deed, *C* has title to Blackacre, not *B*. *B* is left only with tort and contract claims against *A*. A search of the recording system tells *C* that it is safe for him to rely on *A* having good title.[132] Because *B* did not properly record the deed, no notice is implied to *C*, so *nemo dat* does not apply, and *A* could transfer more to *C* than he actually had. If, on the other hand, *B* had recorded the deed before *C*, *nemo dat* would apply in a priority context. *A* would have nothing to convey to *C*, and *B* would have priority over *C*.

A similar situation occurs security interests. A security interest only gives its holder priority over other creditors when it is perfected.[133] For a security interest to be perfected is has to be properly filed in the UCC recordation system[134] or in the physical control of the secured party.[135] As with real estate, the priority of a perfected security interest is determined by automatic operation of law, generally under a first in time to perfect, first in right rule.[136] This means that other would-be creditors can rely on a search through the UCC filing system to determine what their priority would

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[132] *C* will also be protected by warranties of title and the like.
[133] UCC §§ 9-201(a), 9-317 (2001).
[134] UCC § 9-308 (2001). Certain types of security interests perfect upon attachment. UCC § 9-309 (2001).
[135] UCC § 9-314 (2001).

be and make lending decisions based upon this research. Moreover, perfected security interests retain their priority when the collateral is transferred to a another party.[137] Therefore, lenders are on constructive notice of perfected security interests.

A party's reliance on its priority as a result of a search of the UCC system is only justified if the priority of the security interests is static. If a creditor could sell its security interest and the purchaser could receive higher priority than the original creditor, then parties would not be secure in their security's priority. Similarly, if an purchaser of a security interest could receive lower priority than the seller, the liquidity of secured debts would be limited. Accordingly, *nemo dat* is the principle that applies to the priority of *perfected* security interests.

This contrasts with the priority of *unperfected* security interests. If *A* had an unperfected security interest in *B*'s widgets, *A* could assign its security interest to *C*, who could then perfect it by making the proper filing. *C* would thus end up with better than *A* gave. If creditor *D* had lent to *B* before *A* and also had an unperfected security interest in the widgets, *D* would have stood equal with *A* in a bankruptcy, but *D* would stand behind *C* once *C* had perfected. In both real estate title and security interests, *nemo dat* governs transfers of priority only if there is an appropriate filing in a constructive notice-filing system upon which other purchasers or creditors can rely. *Nemo dat* does not apply when there is no justified reliance because either the form of the debt provides the debtor with notice that he is surrendering rights or there is not a proper filing in a notice-filing system.

The justified reliance principle also guides the application of *nemo dat* in bankruptcy law. While no court before *Enron* had ruled on the whether *nemo dat* applied to equitably determined priority, the Supreme Court has held that *nemo dat* applies to statutorily determined priority (with the obvious exclusion of § 507(d)). In *Shropshire, Woodlife, & Co. v. Bush*, the Court held that an assigned wage claim retained its § 507(a)(3) priority after assignment because the "character of the

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[136] UCC § 9-322 (2001).

debts was fixed when they were incurred, and could not be changed by an assignment."[138]

The priority of a claim is for wages is fixed by statute when it accrues. Other creditors have notice of what the wage claim's priority is and lend on this knowledge. Similarly, a purchaser of the wage claim can rely on the claim's priority in determining its expected value. All creditors are on notice of statutory priority before they lend, just as they are of the priority of a recorded deed or perfected security interest. Accordingly, their reliance on the priority is justified and *nemo dat* is an appropriate legal standard because it protects the creditors' justified reliance.

In contrast, a claim's equitable priority is not fixed when the debt is incurred. Indeed, whether to equitably subordinate a claim is reserved for the court's discretion, as is the amount of the subordination.[139] And, under *Enron*, because a claim may be equitably subordinated for its holder's unrelated behavior, the inequitable behavior that would alter the claim's priority could occur after the debt is incurred. Equitable priority is not a fixed characteristic of a claim. Accordingly, creditors never lend in reliance of priority resulting from a future equitable subordination. While a claims purchaser might theoretically purchase claims that have already been subordinated, once claims' equitable priority has been determined, there is notice and *nemo dat* should apply. The point is manifest: claims purchasers should not bear reduced priority because the claims *could* have been subordinated in the hands of a previous holder. As long as the claims were not actually subordinated

[137] UCC § 9-325 (2001).
[138] 204 U.S. 186, 189 (1907). *See also* Wilson v. Brooks Supermarket, Inc. (*In re* Missionary Baptist Found., Inc.), 667 F.2d 1244, 1247 (5th Cir. 1982) (holding wage claims retained priority in hands of assignee check indorsee); Carnegia v. Ga. Higher Educ. Assistance Corp., 691 F.2d 482, 483 (11th Cir. 1982) (holding that a non-dischargable student loan remains non-dischargeable in hands of assignee); *In re* Zipco, Inc., 157 F. Supp. 675, 677 (S.D. Cal. 1957) (holding wage claims retained priority in hands of assignee stockholder), *aff'd sub nom*. Bass v. Shutan, 259 F.2d 561, 563 (9th Cir. 1958); Dorr Pump & Mfg. Co. v. Heath (*In re* Dorr Pump & Mfg. Co.), 125 F.2d 610, 611 (7th Cir. 1942) (holding wage claims retained priority in hands of assignee director and shareholder). *But see* SEC v. Albert & Maguire Sec. Co., 560 F.2d 569, 570 (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 contradindicative). 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).
[139] *E.g.*, Gregory v. Finova Captial Corp, 2006 U.S. App. Lexis 6117, *16 n.3 (4th Cir. 2006); Bayer Corp. v. Mascotech, Inc. (*In re* Autostyle Plastics, Inc.), 269 F.3d 726, 744 (6th Cir. 2001) (equitable subordination is not mandatory, even if

in the previous holder's hands, their equitable priority was not fixed, so it should not transfer with the claims, especially when the previous holder's inequitable behavior was unrelated to the claims in question.

The justified reliance principle shows that *Enron* erred in applying *nemo dat* to the priority of the Fleet loan participation claims. Even if the loan participation claims could have been subordinated in Fleet's hands, they should not have been subordinated in the Funds'. None of Enron's creditors relied on the Seller Banks' subordination when lending. In *Enron*, the loan participations were first lien secured.[140] Other creditors, therefore, were on constructive notice on the debt's existence in terms of their bankruptcy priority and had to assume that they were of lower priority. Any reliance on the loans' existence was in terms of *Enron*'s leverage and thus its bankruptcy risk and potential unsecured assets in bankruptcy, not the other creditors' priority in bankruptcy. Any harm incurred by other creditors was not from the existence of Fleet's claim[141] or its priority, but from its alleged inequitable action. The proper remedy for this situation is a tort action against the inequitable party.[142]

Direct tort actions by the injured creditors present the best remedy for inequitable behavior by a former creditor that has sold its claims because it results in proper cost internalization. Because not all creditors were necessarily injured by the inequitable behavior, only the ones who were injured should benefit from a suit. If a direct suit is brought by the bankruptcy estate or a subordination action is undertaken, other, uninjured creditors might reap a windfall. Moreover, direct suits by injured creditors force the inequitable party to internalize the costs of its behavior, rather than imposing the costs on innocent claims purchasers who must sue up the chain of title to make good their loss.

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all elements of *Mobile Steel* test are met); Aetna Bank v. Dvorak (*In re* McDonald Creek Dev. Co.), 176 B.R. 160, 166 (N.D. Ill. 1994); Allied Tech., Inc. v. R.B. Brunemann & Sons, Inc., 25 B.R. 484, 499 (Bankr. S.D. Ohio 1982).

[140] Enron, 333 B.R. at 212.

[141] If the claim were the product of sufficiently bad behavior, it should be disallowed.

D. THE LIMITATIONS OF LEAST-COST AVOIDER ANALYSIS

The justified reliance principle often coincides with the economic goal of identifying the least-cost avoider of the problem and placing the risk-burden on that least-cost avoider. Thus, the least-cost avoider of a misunderstanding in a deed or security interest notice-filing system is the party that received its property right first, but failed to record it. Accordingly, that party bears the risk of a subsequent purchaser or interest holder recording first and obtaining title or priority. Similarly, the maker of a note is in the best position to control whether the note is negotiable or not, so the maker bears the risk of having limited defenses against transferees of the note if she does not ensure that the note is non-negotiable.

But there are cases in which there either is no least-cost avoider or the least-cost avoider is indeterminate, and in these cases, legal, rather than economic principles dictate allocation of risk. This is the case with equitable subordination of bankruptcy claims. Only the claims' purchaser is in a position to investigate whether the claims are tainted, but it is not clear whether this can be successfully done on a cost-efficient basis. Even if it can, the failure of the purchaser to take care results not only in a loss to the purchaser, but also in a windfall to other creditors, who did not rely on the equitably subordinated priority of the claims when they lent. Equitable subordination may aim to punish, but the subordination of a transferee punishes an innocent party, not the wrongdoer, *and* creates a windfall for other creditors.

Equitable subordination of bankruptcy claims in the hands of good faith transferees pits two fundamentally innocent parties against each other: the transferee and the other creditors. As between innocents, bankruptcy law divides risk in other cases. Thus, the risk of a preferential payment being voided is on the payee, but only for 90 days (one year in the case of insiders).[143] Thereafter, the risk of assets leaving the estate in a preferential payment switches to the other

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[142] Levitin, *supra* note 41, at 404-411.
[143] 11 U.S.C. § 547(b) (2006).

creditors. While this sort of risk sharing works for preferences, it is not practical for equitable subordination. A relatively straightforward forensic accounting can determine whether a payment was a preference or not, so it is reasonable to force the innocent creditors to be vigilant for 90 days. But inequitable behavior is much harder to define and discern. Often, equitable subordination actions are brought well into the course of Chapter 11 bankruptcies as investigations proceed. The temporal division of risk that the Code employs for preferences is not practical for equitable subordination because of the prolonged uncertainty it would produce. A bright-line rule that protects transferees would eliminate such costly uncertainty. The principle that ultimately guides such a rule is that of justified reliance, not the least-cost avoider.

E. What Constitutes Justified Reliance on Priority?

While the justified reliance principle is the guide for determining whether *nemo dat* applies to a property transfer, the question remains as to what constitutes justified reliance. Put another way, when is a party on notice of equitable priority?

The Restatement (Second) on Contracts and UCC Article 9 both answer this question in terms of when the equities accrue. A transferee is only subject to the equities that accrue before the obligor receives notice of the transfer.[144] The Restatement and the UCC do not explain when equities accrue. The Supreme Court's 1906 ruling in *Fidelity Mutual Insurance Co. v. Clark*,[145] one of the principal cases relied upon by *Enron* as support for the application of *nemo dat*,[146] illustrates when equities accrue.

In *Clark*, a Texan named Hunter and his widowed sister, Mettler, contrived to defraud

[144] Restatement (Second) of the Law of Contracts § 336(2) (1981); UCC § 9-318(1) (2001). *Compare* Restatement (First) of the Law of Contracts, § 167(1) (1962) ("An assignee's right against the obligor is subject to all limitations of the obligee's right . . . provided that such defenses . . . are based on facts existing at the time of the assignment, or are based on facts arising thereafter prior to knowledge of the assignment by the obligor.").
[145] 203 U.S. 64, 74 (1906) (Holmes, J.).
[146] Enron, 333 B.R. at 223.

Fidelity.[147] Hunter took out three life insurance policies on himself from Fidelity, and named Mettler, as beneficiary.[148] Hunter was then falsely reported as dead, although the body was never found,[149] and Mettler engaged an attorney, Clark, to collect the insurance proceeds. Clark, unaware of the scheme, took an assignment of a one-third interest in the policies as his fee.[150] Clark then further assigned and mortgaged his interest[151] before winning a collection judgment for Mettler against Fidelity.[152]

After paying out the policies, Fidelity learned that reports of Hunter's death had been greatly exaggerated. Fidelity then sued to recover the payments under the policies from Mettler and the various assignees.[153] Clark and his subsequent assignees argued that he was a good faith purchaser of the one-third interest in the policy and that he was therefore entitled to keep the proceeds.

Justice Holmes, writing for the Court, noted that Clark had properly acquired legal title to the proceeds, and, to recover the proceeds, Fidelity "must show some equity before [Clark's] legal title can be disturbed,"[154] which meant showing that Clark took the assignment either with notice or without having given value.[155] Because Clark clearly gave value in the form of his services, Fidelity argued that he took with notice of the equities in the case. The Court disagreed, noting that

> 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 . . ..[156]

This is the same rule as the Restatement and the UCC Article 9. Unlike the Restatement or UCC,

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[147] Clark, 203 U.S. at 72.
[148] Fidelity Mut. Life Assoc. v. Mettler, 185 U.S. 308 (1902).
[149] 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. *Id.*
[150] Clark, 203 U.S. at 72.
[151] *Id.* at 72-73.
[152] *Id*. at 73.
[153] *Id.* at 72.
[154] *Id*. at 73.
[155] *Id.*
[156] *Id.* at 74.

Clark shows how the rule applies. The Supreme Court emphasized that "notice of the denial that Hunter was dead, in the suit on the policy" was not notice of the fraud because Clark believed Mettler's case.[157] Indeed, the Court noted that even if Fidelity had responded in the original collection suit with an affirmative defense alleging fraud, it would not have constituted sufficient notice to Clark to vitiate his good faith purchaser defense.[158]

Clark refines *nemo dat* to mean that an assignee stands in no better position than the rights of the assignor as they exist *at the time of the assignment.*[159] The fact that an assignor is *later* found to have engaged in behavior that would have impugned the rights transferred had they been in the assignor's hands does not apply against the assignee, if the assignee took for value and without notice.[160] An assignee does not take subject to contingent equities. Equities accrue when they are proven, rather than when they are theoretical or alleged.

This means that Fleet's negative equities did not accrue in *Enron* until the court had determined that Fleet could be subordinated, so they did not attach to the loan participation claims. In *Enron*, the Funds purchased the claim before there was any allegation, much less proof, of inequitable behavior by Fleet. Thus, the equities did not accrue with the filing of the Megacomplaint nor at the time of Fleet's behavior, unless the Funds were aware of Fleet's actions and believed them to taint its claims. Under *Clark*, the Funds should not be subject to the contingent equities of the claim, only to those actually shown. *A fortiori*, they should not be subject to Fleet's equities unrelated to the claim.

F. Can a Bankruptcy Claim ever be Purchased in Good Faith?

Enron might still be differentiated from *Clark* because it held that the Funds could not be

[157] Clark, 203 U.S. at 74.
[158] *Id.*
[159] Clark, 203 U.S. at 74. *See generally*, Grant Gilmore, *The Assignee of Contract Rights and His Precarious Security*, 74 YALE L.J. 217 (1964).
[160] Clark, 203 U.S. at 74.

good faith purchasers because they had purchased bankruptcy claims. Even if there were a good faith purchaser defense to § 510(c), the Funds could not avail themselves of it because by purchasing bankruptcy claims, they had notice of the possibility of subordination. "The purchase of a claim itself[] evidences the transferee's willingness to assume the risks attendant to a bankruptcy proceeding,"[161] so a transferee of bankruptcy claims "is on notice that any defense or right of the debtor, including equitable subordination, may be asserted against that claim."[162]

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 arms-length transaction.[163] There was no evidence of the Fund's active, knowing collusion in an attempt to launder Fleet's claims.[164] Instead, *Enron* held that the very nature of bankruptcy claims trading precluded good faith purchases because buyers were always on notice of the possibility of subordination.[165]

Rather than showing why the Funds should not be good faith purchasers, *Clark* shows that they were. The Funds purchased their claims *before* the Megacomplaint. This puts them in as good a position as Clark, who received his assignment before there was any allegation of inequitable behavior.

Nor does the possibility of subordination does not distinguish *Enron* from *Clark*, because there was also the possibility of a fraud action in *Clark*. Although only bankruptcy claims are subject to § 510(c) actions, all legal claims for money—choses in action—are subject to a variety of defenses and may turn out to be worthless. Accordingly, the class action plaintiffs' bar regularly syndicates interests in lawsuits, as if they were loan participations, in order to diversify their litigation portfolios precisely because of the risk that any particular suit will be dismissed and have

[161] Enron, 333 B.R. at 229.
[162] *Id.* at 235.
[163] Brown v. Third Nat'l Bank (*In re* Sherman), 67 F.3d 1348, 1355 (8th Cir. 1995).
[164] *Id.* at 213.
[165] *Id.* at 229, 234-35.

no value. Given the discretionary nature of equitable subordination,[166] the Funds were arguably on even less notice than Clark about the impairment to chose in action they purchased. A legal risk, even when litigation has commenced, does not constitute notice under *Clark*.

Moreover, there was not a known legal risk of subordination before the *Enron* decision.[167] The Bankruptcy Court was unable to cite a case in which the inequitable behavior of a party *unrelated* to a bankruptcy claim was grounds for subordination of the claim in the hands of a secondary or tertiary transferee. *Enron* broke new legal ground, and in order to do so it required a presumption that the legal ground had already been broken. The Funds should not have been excluded from good faith purchaser status solely because they purchased bankruptcy claims. They took the claims for value and without notice that the claims were subordinatable.

Enron appears to have adopted an irrebutable presumption[168] that bankruptcy claims cannot be traded in good faith in order to prevent "claims washing," the selling at full market value of a subordinatable claim by an inequitable actor to a party in whose hands the claim could not be subordinated. The development of the claims market has greatly affected the dynamics of corporate reorganizations, and is viewed with askance by many practitioners and judges whose formative professional experiences pre-date mass claims trading.[169] Whatever one thinks about the influence

[166] *See*, *e.g.*, Bayer Corp., 269 F.3d at 744 (equitable subordination is not mandatory, even if all elements of *Mobile Steel* test are met).
[167] Enron's Memorandum of Law in Opposition to Defendants' Motions for Leave to Appeal form the Bankruptcy Court's Decisions Concerning Equitable Subordination of Transferred Claims, No. 05-01029 (Bankr. S.D.N.Y. Feb. 28, 200[6]), at 8, cites Fortgang & Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, *supra* note 4, at 14, as evidence that the risk of subordination of transferred claims was well known since 1990. Fortgang and Mayer, however, cited only one case, *Goldie v. Cox,* 135 F.2d at 720, discussed *supra* page 22, which does not actually support the proposition, and also included a "but see" citation to a more recent decision, *Holt v. FDIC (In re CTS Truss, Inc.)*, 868 F.2d 146 (5th Cir. 1989). The paucity of supporting case law should give pause to treating Fortgang and Mayers as making a definitive positive statement of law.
[168] 333 B.R. at 226.
[169] For example, in the companion decision to *Enron* that denied the Funds' motion to dismiss Enron's action to disallow the Funds' claims under 11 U.S.C. § 502(d), Judge Gonzalez declared that "the claims trading market is not a fundamental part of the bankruptcy process, its policies, historical roots, or purpose." Enron Corp. v. Avenue Special Situations Fund II, LP (*In re* Enron), 340 B.R. 180, 204 (Bankr. S.D.N.Y. 2006). This statement is inaccurate. Claim trading has deep historic roots in bankruptcies and equity receiverships. Fortgang & Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, *supra* note 4, at 9-13. It is true, however, that the Bankruptcy Code was not

of claims trading on the reorganization process, it is not clear why there should be an irrebutable presumption of bad faith for claims trades.

Setting aside hoary concerns about champerty, maintenance, and barratry,[170] even in an old-fashioned equity context, there is no reason to presume lack of good faith when trading claims post-petition, as the same economic transaction could have occurred pre-petition. Should it really matter that the Funds acquired the loan participation claims post-petition in the form of bankruptcy claims, rather than as pre-petition distressed debt? In the later case, the Funds would have be purchasing, if not a bankruptcy claim, then at least a high likelihood of holding a bankruptcy claim.

There are legitimate reasons for claims purchases, as *Enron* itself recognized.[171] To tar all claims purchases with the irrebutable presumption of bad faith is a significant policy decision that a court should hesitate to do without serious consideration. A good guidepost for what constitutes good faith in commercial transactions is the UCC. The UCC defines good faith as "honesty in fact and the observance of reasonable commercial standards of fair dealing."[172] By this definition, the Funds were good faith purchasers of Fleet's loan participation claims.

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drafted with claims trading in mind, but the Bankruptcy Rules have allow for claims trading and have been revised to make claims trading easier. FED. R. BANKR. P. 3001 (2006).

Emphasizing the historic marginality of claims trading in the bankruptcy process misses the reality of today—claims trading is an essential feature of the reorganization process, and limitations on it have real effects, not just on individual reorganizations, but on the bankruptcy process in general and on capital markets as a whole. To declare that claims trading is not a fundamental part of the bankruptcy process' policies or purpose is to presume that one knows the unstated policies of bankruptcy and knows the ultimate impact of claims trading. There is a lively debate within the academic and practitioner community about both what the policy goals of bankruptcy are and should be, *see* Douglas G. Baird, *Bankruptcy's Uncontested Axioms,* 108 YALE L.J. 573, 574-580 (1998) (giving a taxonomy of the debate), and about the effects of claims trading on reorganizations. *See supra* note 6. However a particular judge feels about who the winners and losers are as a result of increased claims trading should not determine the outcome of legal questions.

170 Elliot Assocs., L.P., v. Banco de la Nacion, 194 F.3d 363 (2d Cir. 1999) (holding New York state champerty statute does not apply to bankruptcy claims trading). Many courts no longer recognize causes of action for champerty, maintenance, or barratry, holding that they have been replaced by actions for malicious prosecution and the like. *E.g.*, Hardick v. Homol, 795 So. 2d 1107, 1112 (Fla. Dist. Ct. App. 2001); PSI Metals, Inc. v. Firemen's Ins. Co. of Newark N.J., 839 F.2d 42, 43 (2nd Cir. 1998) (applying New York law); Tosi v. Jones, 685 N.E.2d 580, 583 (Ohio Ct. App. 3d 1996); McCullar v. Credit Bureau Sys., Inc., 832 S.W.2d 886, 887 (Ky. 1992); Sec. Underground Storage, Inc. v. Anderson, 347 F.2d 964, 969 (10th Cir. 1965) (applying Kansas law); *but see* Weigel Broad. Co. v. Howard Topel, 1985 U.S. Dist. LEXIS 23862, No. 83-C-7921 (N.D. Ill. 1985) (holding that, under Illinois law, a cause of action for maintenance exists but explaining that it is so rare in modern times that the law on the subject is neither settled nor clear).

171 Enron, 333 B.R. at 226.

172 UCC § 1-201(20) (2004) (adopted by Idaho, Texas, and Virginia). The older version of the UCC, still in force in 46 states, defines good faith as "honesty in fact in the conduct or transaction concerned." UCC § 1-201(19) (year).

We should not lightly brush aside of the concerns of abusive claims trading. Rather than adopt an irrebutable presumption of bad faith for all bankruptcy claims purchases without any reason for distinguishing them from pre-petition distressed debt purchases, we should adopt a rebuttable presumption of good faith. This presumption could have certain exceptions, such as claims trading by fiduciaries of the debtor, claims trading to gain corporate control of the debtor, resale-sellbacks, and claims trading in which the purchaser has neither conducted any diligence nor acquired a warranty of equitable behavior. In such circumstances, the burden of showing good faith should rest on the claims' purchaser or the court should undertake a more exacting scrutiny of the transaction. Moreover, in when a claims purchaser has acquired the claims as part of a transaction or connected series of transactions that results in its acquisition of substantially all assets of former claims holder, it should assume the same equities and priority of the former holder.[173] Alternatively, bankruptcy law could imply a warranty of equitable behavior in all claims trades, which would have to be explicitly disavowed. Either way would be more sensible than declaring an entire market to be tainted by bad faith.

Enron was a flawed decision from a doctrinal matter. It applied *nemo dat* to a situation in which the rule's protections are not needed. *Nemo dat* should be applied only to questions of priority when there was (at least theoretically) justified reliance on priority set before a decision to lend. Because equitable subordination always affects priority *after* creditors have lent, there can never be justified reliance, so *nemo dat* should not apply to equitable subordination.

The doctrinal problems with *Enron* have real world consequences. As the next section shows, *Enron*'s erroneous application of *nemo dat* has had serious negative consequences on liquidity in the bankruptcy claims market. Because of the unique role of the bankruptcy claims market as the residual capital market, these liquidity problems have been amplified into other capital

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[173] *See* Comm'r of Internal Revenue v. Court Holding Co., 324 U.S. 331, 334 (1945) (looking to substance over form of

markets, and generally increase borrowers' bankruptcy risks. *Enron* applied *nemo dat* to priority with the aim of protecting, but it actually hurt them by making debtors more likely to default and file for bankruptcy.

V. *NEMO DAT*'S SYSTEMIC COSTS ON MARKET LIQUIDITY THROUGH *ENRON*[174]

A. THE UNIQUE ROLE OF THE BANKRUPTCY CLAIMS MARKET IN PROMOTING LIQUIDITY IN CAPITAL MARKETS

Liquidity in the bankruptcy claims market is important to creditors for numerous legitimate reasons. 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.[175]

Many creditors do not want to be claim holders throughout a bankruptcy because of the legal and opportunity costs involved, and are happy to sell their claims at a discount.

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 of uncertain value and forced to incur the expense and inconvenience of being claim holders. The bankruptcy claims market allows creditors to exit the bankruptcy process before plan confirmation. This makes creditors more willing to extend credit in the first place. The existence of the secondary market in bankruptcy claims thus 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 non-bankruptcy markets and makes it harder for distressed companies to raise capital, which exacerbates

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transaction for taxation purposes).

[174] This section (V) derives from Levitin, *supra* note 41.

[175] Enron, 333 B.R. at 226 n.8.

financial distress and makes bankruptcies more likely.

Enron has decreased liquidity in the throughout capital markets by promulgating a legal rule that 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.[176] 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. The risk is not divided between the parties through a statute of limitations; unlike for preferences[177] and fraudulent transfers,[178] there is no statute of limitations on equitable subordination.

The doctrinal 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. Adopting a *nemo dat* regime for bankruptcy claims' priority, has effects that spill over into other markets. *Enron*'s counterparty risk has raised the cost of transactions not just in the bankruptcy claims market, but in several other credit markets. Increased transaction costs means that there will be fewer transactions on the margins and thus the liquidity of the credit markets will contract. 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.

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[176] *Id.* 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. The iniquity, or in this case, the inequity, of the fathers is visited upon the sons to (at least) the third and fourth generation.
[177] 11 U.S.C. § 547 (2006).
[178] 11 U.S.C. § 548 (2006).

B. ***Enron's Effect on Other Markets***

1. The Bankruptcy Claims Trading Market

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. Inequitable behavior is judged by a "soft," in-the-eye-of-the-beholder standard. Whether a party behaved inequitably is a judgment call, not a matter of black letter law. Thus, 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 claim holder'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 trade-off 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 trade-off 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. Nor can creditors cannot easily anticipate which side of the equitable subordination divide they might find themselves, but are not likely to assume that they have engaged in wrongdoing. Finally, most creditors would prefer not to deal with a bankruptcy than have greater protections in bankruptcy. The same is true of debtors. Neither debtors' management nor 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 mediary transferees in *Enron*, could have served as a 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 the people who actually do the diligence—junior associates in document rooms—to have the judgment to discern what is equitable and what is not. It is a legal grey area.[179]

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, and there is considerable debate as to whether their presence furthers or hinders the reorganization process.[180] *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 might also impact venue choice.[181] All things being equal, distressed debt investors are more likely to purchase claims of a bankruptcy in a district that has not adopted *Enron.* This means that more distressed debt investment will flow to jurisdictions like Delaware, if *Enron* is upheld in the Southern District of New York and the Second Circuit. Debtors that want to avoid dealing with distressed investors would likely prefer filings in the Southern District of New York, but if the choice of filing is influenced by a large creditor (usually the DIP-lender-to-be), and this lender wants to have many exit possibilities, venues other than the Southern District will be more appealing.

[179] Risk aversion and agency problems may also complicate attempts to diligence against equitable subordination.
[180] *See supra* note 6.
[181] *See* LYNN M. LOPUCKI, COURTING FAILURE: HOW COMPETITION FOR BIG CASES IS CORRUPTING THE BANKRUPTCY COURTS (2005).

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, which will decrease the marginal number of 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.

2. 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.[182] 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.[183] 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.[184]

If bank *Y* has to investigate every party with which it enters into credit default swaps to determine that they are 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.[185] 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.

3. Loan Participations

Enron also creates problems for loan participations. The standardized loan participation

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[182] *See* Stephen J. Lubben, "Credit Derivatives and the Future of Chapter 11," working paper, June 4, 2006, *available at* http://ssrn.com/abstract=906613.
[183] *Id.* at 30-31.
[184] *Id.* at 29.
[185] International Swap and Derivative Association, 2005 Year-End Market Survey.

transfer documentation only includes upstream chains of title,[186] warranties of good behavior[187] and non-impairment,[188] or indemnities[189] for the transfer of distressed loans. Loans trading at par or near par (to approximately 90 cents 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.[190] 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. The purchaser has no guarantees regarding the behavior of prior 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

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[186] 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).

[187] 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, *id.*, § 4.1(h)(ii).

[188] *Id.*, § 4.1(w) (May 2005). "Impairment" is defined to include equitable subordination. *Id.*

[189] *Id.*, § 6.1 (May 2005).

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 both 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."[191] Equitable subordination is traditionally a rare and unusual remedy,[192] 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.[193] 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 beneficially transactions to fail, and thereby restricting liquidity in the claims market and thus the ability of distressed companies to raise capital.[194] This is yet another way that *Enron* raises the cost of raising capital and increases financial distress for troubled companies.

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[190] *See supra* note 186. 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 186.
[191] Fortgang & Mayer, *Trading Claims and Taking Control of Corporations in Chapter* 11, *supra* note 4, at 19.
[192] Bayer, 269 F.3d at 745; Official Comm. of Unsecured Creditors v. Cajun Elec. Power Coop. by & Through Mabey (*In re* Cajun Elec. Power Coop.), 119 F.3d 349, 356 (5th Cir. 1997); United States Abatement Corp. v. Mobil Exploration & Producing U.S. (*In re* United States Abatement Corp.), 39 F.3d 556, 561 (5th Cir. 1994); Austin v. Chisick (*In re* First Alliance Mortg. Co.), 298 B.R. 652, 666-67 (C.D. Cal. 2003).
[193] 333 B.R. at 230 n.15.
[194] 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.

4. The Slippery Slope to 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 pre-petition 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 no better tha[n] a post-petition purchaser of claims.[195]

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 pre-petition agreements to purchase bankruptcy claims is that a pre-petition agreement to purchase bankruptcy claims is difficult to distinguish from a normal pre-petition debt purchase. A pre-petition debt purchase always includes the purchase of a potential bankruptcy claim if the debtor goes bankrupt. 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 post-petition or one that arranges pre-petition to purchase claims post-petition? The intervening formality of a bankruptcy filing is not a good enough reason for disparate treatment.

Once *Enron* is extended to pre-petition agreements to purchase bankruptcy claims, it becomes difficult to differentiate it from any other pre-petition debt purchase or, for that matter,

[195] Enron, 333 B.R. at 230 n.15.

from pre-petition 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 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.[196]

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 as 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 or the decision is overturned, it will create uncertainty throughout financial markets.

C. <u>REFCO</u>: EARLY EVIDENCE OF THE EFFECTS OF <u>ENRON</u>

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

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[196] *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 (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.

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 was 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, 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.[197] *Enron* expected claims potentially tainted by an inequitable creditor to continue trading with an appropriate risk discount.[198] 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.[199] 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.[200] Holders of

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[197] Motion, Pursuant to 11 U.S.C. §§ 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).
[198] Enron, 333 B.R. at 230 n.15.
[199] 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).
[200] *Id.* 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

BAWAG claims found themselves unable to unload their positions or to mark the claims to market because there was no market for these claim.[201] Even if these purchasers had bargained for indemnities, they could not collect them because no subordination had yet occurred.[202] Purchasers that expected to be short-term claim holders found themselves trapped in positions of uncertain duration.[203]

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 was much more profit potential. At least 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 the *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 chance, in part because of the soft, discretionary nature of the action. Market behavior shows that *Enron* counterparty risk is qualitatively different from

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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.

[201] *Id.*

[202] *Id.*

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.[204] BAWAG admitted to involvement in some of Refco's schemes.[205] 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.

D. Market Manipulation Risk in Claims Trading

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

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203 *Id*.
204 Larry Neumeister, *Bawag to pay $675 to settle Refco charges*, AP, June 5, 2006.
205 Dan Wilchins, *BAWAG to pay $675 mln in Refco settlement*, REUTERS, June 6, 2006.

suggestions could well do the job. As *Refco* shows, even without filing a lawsuit, mere innuendo of creditor impropriety 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,[206] 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 arms-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.

VI. REDISCOVERING THE VIRTUES OF NEGOTIABILITY

A. WHY NEGOTIABILITY STILL MATTERS

Enron was an erroneous decision from doctrinal and policy perspectives. It has serious negative market consequences on that are only beginning to become apparent. The key lesson from *Enron* is the continuing importance of negotiability. For years, scholars have argued that at best, negotiability doesn't matter any more, or that it is even harmful.[207] It has been out of vogue with scholars for several decades, although the study of negotiability systems used to occupy some of the brightest stars in the American legal firmament: Story, Ames, Gilmore.[208]

Enron, however, shows that this fossilized branch of the law still matters today in ways no one previously realized. It also raises questions about when negotiability, rather than *nemo dat*, should be the default rule and what the requirements for negotiability should be. Traditionally, these questions were answered in reference to the type of property interest involved.[209] Some level of negotiability was imputed to bills of exchange and goods because these moved in the commercial

[206] 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).
[207] *See, e.g.*, Ronald J. Mann, *Searching for Negotiability in Payment and Credit Systems*, 44 UCLA L. REV. 951, 961 (1997) ("At least in the payment and credit contexts . . . negotiability is an outmoded and decaying relic.") ("In this modern age of multiple and rapid transactions in a national and perhaps global market, negotiability's emphasis on the physical document is a hindrance rather than a benefit."); Rosenthal, *supra* note 49, at 401.
[208] *See* Larry T. Garvin, *The Strange Death of Academic Commercial Law*, 68 OHIO ST. L.J. ___ (2007), available at http://ssrn.com/abstract=922743.
[209] Gilmore, *supra* note 12, at 1068.

world where parties were presumably more sophisticated and able to protect themselves and where liquidity was important.[210] Choses in action—legal claims for money—which would include consumer debts, remained a *nemo dat* system because of concern for consumers losing defenses because of an assignment.[211] As new markets have arisen, however, the traditional property type divisions no longer accurately reflect a consumer/commercial divide. The remainder of this article considers how the law of property transfers should address evolving commercial reality in reference to bankruptcy claims.

B. Can a Bankruptcy Claim Be Negotiable?

Negotiability is a creature of state law. Typically, UCC Article 3 determines an obligation's negotiability.[212] Fleet's participation in the credit agreements with Enron was not a negotiable debt. A line of credit like those extended to Enron cannot met UCC Article 3's requirements because, at the very least, it does not involve a sum certain.[213] Would it have mattered, though, if the debt underlying the claims purchased by the Funds was negotiable under UCC Article 3? Would *Enron* have applied to claims based on negotiable debts? If so, then a bankruptcy claim can never be negotiable. If not, *Enron* would mean that what is negotiable at state law remains negotiable in bankruptcy.

Enron's ruling that the Funds could not be good faith purchasers because they were purchasing bankruptcy claims[214] means that negotiability under state law is not honored in

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[210] *Id.*

[211] Traditionally consumer debtors bargained in part for a relationship with a specific creditor. A consumer who struck a deal with a creditor he knows to be laid back wouldn't want to find his debt resold to a loan shark. In this day and age of securitization of consumer debt obligations, though, consumers can no longer expect that their debts will remain in the hands of the originating creditor.

[212] UCC § 3-102 (1991); UCC § 3-103 (1951). Article 3 does not cover money; payment orders governed by UCC Article 4A; documents of title, governed by UCC Article 7; and investment securities, governed by UCC Article 8. UCC § 3-104(1951) and Comment 2 to UCC § 304 (1991) however, indicating that it is possible for there to negotiable instruments outside of Article 3. *See* Gilmore, *supra* note 12, at 1108. *But see* UCC § 3-805 (1951) (UCC Article 3 applies to some instruments that do not meet § 3-104 negotiability requirements).

[213] UCC § 3-104 (1991).

[214] Enron, 333 B.R. at 235.

bankruptcy. Although the claims might have been negotiable, negotiability has no meaning if there cannot be a good faith purchaser. *Enron* imposed a different standard of good faith for the purchase of a bankruptcy claim than for the purchase of the underlying debt. The original UCC, still in force in forty-six states, defines good faith as "honesty in fact,"[215] while the revised UCC, adopted by three states so far, defines it as "honesty in fact and the observance of reasonable commercial standards of fair dealing."[216] In either case, the Funds would have easily qualified as good faith purchasers. *Enron* means that state law treatment of negotiability and good faith does not carry over into bankruptcy.

As a general matter, though, state law property rights are respected in bankruptcy. As the Supreme Court noted in *Butner v. United States*, "Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding."[217] Thus, security interests, determined by UCC Article 9—state law—are given force in bankruptcy, albeit with some limitations.[218] It makes little sense, then, that UCC Article 3's definition of certain property interests would not also be respected in bankruptcy.

Butner failed to recognized, however, that not all property rights are creations of state law. Some property rights, like copyrights, patents, and federal judgments, are creations only of federal law. Likewise, bankruptcy claims involve property rights that are the creation of federal, not state law.[219] A bankruptcy claim is different from the underlying debt. The Bankruptcy Code's definition of "claim" is broader than a debt. The Code defines a "claim" as a

> (A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal,

[215] UCC § 1-201(19) (1951).
[216] UCC § 1-201(20) (2001) (emphasis added).
[217] 440 U.S. 48, 55 (1979).
[218] 11 U.S.C. § 544 (2006) (the strong-arm powers of trustee mean that security interests have to hold up against a hypothetical, not an actual rival creditor).
[219] *See generally* Levitin, *supra* note 78, at 71-74, regarding bankruptcy as a uniquely federal interest.

equitable, secured, or unsecured; or

(B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured.[220]

A claim includes disputed, contingent, and unliquidated payment obligations. Thus, a bankruptcy claim does not need an underlying enforceable pre-petition debt. Nor does simply holding a debt create a bankruptcy claim. A claim must be timely filed with the court,[221] and post-petition transfers of the claim must also be registered with the court.[222]

A bankruptcy claim also differs from a pre-petition debt in terms of the relationships it implicates. The voting system for Chapter 11 and Chapter 13 plans[223] means that creditors are not simply in a bilateral relationship with the debtor. Instead, they become part of a multilateral involuntary community of creditors, so claims trades and the relative priority of claims have an impact on third parties. The relational aspect of a bankruptcy claim, as well as its more expansive definition and filing requirements, distinguish it from a pre-petition debt.

Finally, while the property rights involved in a debt are a product of state law, there are additional rights that vest in a bankruptcy claim that exist only as a matter of federal law. A bankruptcy claim entitles its holder to plan disclosure and voting rights, distribution rights, and rights to bring actions under Bankruptcy Code provisions. To be sure, a pre-petition obligation also includes a package of bankruptcy rights,[224] but those rights attach as a matter of federal, not state

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220 11 U.S.C. § 101(5) (2006).
221 11 U.S.C. § 502(a) (2006).
222 FED. R. BANKR. P. 3001(e)(2) (2006).
223 11 U.S.C. §§ 1129, 1329 (2006).
224 Justice Holmes famously observed that "The duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it,—and nothing else." Oliver Wendell Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 462 (1897). Justice Holmes, however, wrote in 1897, when there was no bankruptcy law in the United States. Had he written a year later, he might have described the duty to keep a contract as a prediction that you must pay damages if you do not keep it *or file for bankruptcy and pay damages in bankruptcy at cents on the dollar*. *See also* Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 778-779 (1987). Bankruptcy is now the background term to every contract, to every debt, to all obligations and relationships in society, excluding those few with parties denied bankruptcy

law. Federal bankruptcy law displaces state collection law upon the granting of an order for relief.[225] Therefore, it should not matter whether the debt underlying a bankruptcy claim was negotiable or not. Federal law should govern the treatment of bankruptcy claims.

Enron mandated a uniform federal rule of non-negotiability of bankruptcy claims that means state law negotiability status has no impact in bankruptcy because there cannot be good faith claims purchasers to benefit from negotiability's protections. While *Enron* was correct in intuiting that federal law should govern the transfer of bankruptcy claims, it erred in what that law should be, and that error has had significant negative impacts on capital markets. This article proposes a federal law of negotiability for corporate bankruptcy claims that will overturn *Enron* and protect the liquidity of the corporate bankruptcy claims market.[226]

C. A Proposed Federal Law of Negotiability for Bankruptcy Claims

A federal law of negotiability for bankruptcy claims could be accomplished in three ways. First, § 550(a) of the Bankruptcy Code could be amended to include § 510(c) in its list of actions for which § 550(b) provides a good faith purchaser defense. A legislative solution would have the virtues of being immediate and uniform. Alternatively, either Congress or the courts could define bankruptcy claims could be as securities, which would lend them negotiability, but would impose onerous regulatory burdens on the market.

A third way would be for courts to craft a federal common law of negotiability of bankruptcy claims. Because Congress has not addressed the issue directly, there is room of the courts to create a federal common law of bankruptcy claims trading that presumes negotiability of claims, regardless of formalities.[227] Indeed, *Enron* itself was federal common lawmaking.

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relief, *see* 11 U.S.C. §§ 109, 727(a)(8)-(9) (2006), or those obligations that are non-dischargeable. *See* 11 U.S.C. § 523 (2006).

[225] *See* Levitin, *supra* note 78, at 72.

[226] As observed in note 1, supra, personal bankruptcy claims trading raises different policy issues, and *nemo dat* is probably not appropriate outside of a commercial context.

[227] *See* Levitin, *supra* note 78, at 66-77, regarding federal common law in bankruptcy.

Federal common law would not yield immediate or necessarily uniform results. But it might produce a more nuanced rule over time than a legislative solution. The danger of codification of negotiable instrument law, as Grant Gilmore recognized, is that codification frequently becomes "a strait jacket to confine" new types of commercial activity.[228]

The proposed rule would presume good faith in most bankruptcy claims purchases under an "honesty in fact and reasonable standards of commercial dealing" standard like the revised UCC.[229] The exceptions to this presumption would be claims trading by fiduciaries of the estate, resale-sellbacks, and situations in which the claims' purchaser had acquired the claims along with substantially all assets of the former holder. For good faith claims purchasers, the rule would cut-off other "personal" defenses and attacks, including equitable subordination, by other creditors and the estate against good faith purchasers of bankruptcy claims.

The proposed rule would not cut off the estate's defenses with the filing of a bankruptcy petition. Rather, if the claim is based on what was a negotiable debt at state law, then those state law protections should continue to apply to a creditor who acquired the claim before bankruptcy. Thus, if a creditor who acquired a pre-petition would be a holder in due course under state law, he should have the same protection under bankruptcy law. On the other hand, if the creditor purchased a non-negotiable debt pre-bankruptcy, he should not get the protections of a holder in due course, even if he would qualify had the debt been negotiable at state law. The post-petition transferee of either of these creditors, however, should take the claim free of personal defenses, to which equitable subordination may be added.

The proposed rule would not require any formalities for negotiability to attach. A federal rule of negotiability for bankruptcy claims would dispense with the need to make claims conform to formal requirements. UCC Article 3's formal requirements are designed to provide notice of the

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[228] Gilmore, *supra* note 12, at 1107.

negotiable status of the debt. No such notice is needed, however, in a market occupied solely by sophisticated players, like bankruptcy claims trading. If there is a bright-line rule, the parties will be aware of it. Thus, even reification, the merger of the debt and the instrument, which has traditionally been the crucial step for negotiability,[230] is not needed. Indeed, as Ronald Mann has noted, "In this modern age of multiple and rapid transactions in a national and perhaps global market, negotiability's emphasis on the physical document is a hindrance, rather than a benefit."[231]

In the end, negotiability is not about reification, so much as it is about what defenses travel with a claim. This has gotten lost in the formalist emphasis of UCC Article 3, the chief body of negotiability law, which made reification the essential precondition for negotiability. Nearly thirty years ago, Grant Gilmore observed that "Article 3 is a museum of antiquities—a treasure house crammed full of ancient artifacts whose use and function have long since been forgotten. Another function of codification . . . is to preserve the past, like a fly in amber."[232] Unfortunately, the formalisms of negotiability make it easy to miss the forest for the trees. The concerns that animated so much of past property transfer law—theft and forgery of instruments and indorsements—are sideshows today. Indeed, with electronic transactions, reification simply is not possible.

Although the hallmark of negotiable instrument law has long been its formal requirements, that need not be the case. Indeed, Gilmore, himself a skilled draftsman, observed that it would be possible to draft a negotiable instrument law without reference to formal requisites.[233] If codification is the handmaiden of ossification, then it is to the living common law that we should look for keeping commercial law in line with commercial practice.

Article 3 of the UCC provides a notable contrast to Article 2. UCC Article 2 was drafted primarily by Karl Llewellyn. Llewellyn had "reverence, above all other judges, for Lord Mansfield,"

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[229] UCC § 1-201(20) (2001).
[230] Gilmore, *supra* note 12, at 1077.
[231] *See* Mann, *supra* note 207, at 961.
[232] Grant Gilmore, *Formalism and the Law*, 13 CREIGHTON L. REV. 441, 461 (1979).

the great 18th century English jurist.[234] Lord Mansfield was particularly noted for using special juries of merchants to determine prevailing commercial practices.[235] As Edwin Rubin has noted, "In the view of Llewellyn and his fellow realists, the law should be grounded on real business practices, not formal concepts–precisely the approach that Mansfield championed."[236] This is best illustrated in UCC 1-201(20)'s definition of "good faith" as "honesty in fact and *the observance of reasonable commercial standards of fair dealing*."[237] Article 3, however, does not contain such an attachment of living commercial practice. As Rubin has observed, "The rules that both Original Article 3 and its revision promulgate are Lord Mansfield's, by and large, but his method of deriving such rules from the commercial realities *of the day* has been forgotten."[238]

Enron should cause us to rethink whether property transfer law needs to be revised in some areas to keep up with commercial reality. In particular, we should ask whether the formalities of Article 3 negotiability, including reification, make sense today. If their chief purpose is to give notice that a particular legal rule applies, we should ask whether the market is already on notice of that rule, especially in light of the high transaction costs to Article 3's formal requirements. The formal requirements of Article 3 make negotiability an opt-in system that is impractical for many types of commercial transactions. The formalities required for Article 3 negotiability limit parties' contracting choices; loosening the formal requirements of negotiability when it would not come at the expense of obligors or assignees would allow for contracts to better reflect parties actual, more nuanced preferences, rather than force an outdated binary choice upon them. While relatively few commercial transaction are negotiable today, this does not mean that parties do not want the liquidity benefits of negotiability, only that the costs of the statutory formalities are too high.

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[233] Gilmore, *supra* note 12, at 1072.
[234] Gilmore, *supra* note 232, at 460-461.
[235] Edwin L. Rubin, *Learning from Lord Mansfield: Toward a Transferability Law for Modern Commercial Practice,* 31 IDAHO L. REV. 775, 780 (1995).
[236] *Id.* at 787.
[237] UCC § 1-201(20) (2001) (emphasis added).

The law has long evinced a preference for negotiability in commercial cases, particularly when involving sophisticated parties because the liquidity benefits of negotiability outweigh its costs to obligors in these cases since the obligors are capable of protecting themselves through pricing and litigation. As commercial markets develop, it is important that the proper property transfer paradigm—negotiability or *nemo dat*—be applied, and that this application revolve around the realities of the market, not outdated formalities.

Bankruptcy claims are a case where the social value of market liquidity greatly outweighs the social interest in protecting obligors. This is because liquidity in the claims market affects the cost of borrowing in all markets. Moreover, the obligor—the bankruptcy estate—is not really a party in interest—only other creditors are, but, at least in theory, they all enjoy the possibility of higher resale prices. The direct benefits of negotiability for bankruptcy claims will not accrue to all creditors equally. Creditors with small claims—usually individuals with wage or benefit claims or tort judgment claims—are unlikely to be able to sell their claims because the transaction costs are too high for the additional control benefit. It will be large finance and trade creditors that reap the benefits of negotiability in terms of increased resale price, while distressed debt investors—usually sophisticated banks or hedge funds—will receive the benefit of claims with limited defenses. But there is a larger social benefit that accrues to all creditors—the decreased bankruptcy risk of borrowers because increased liquidity in the claims market will exert downward pressure on the cost of capital outside of bankruptcy. A federal rule of negotiability for bankruptcy claims would ensure a fair, efficient, and liquid market in bankruptcy claims that makes it easier for distressed companies to raise funds and lower borrowers' bankruptcy risks.

VI. CONCLUSION: EQUITY IS A ROGUISH THING

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[238] Rubin, *supra* note 235, at 795 (emphasis original).

Enron is cause to consider what risks one takes with an assignment, and whether those risks should include equitable subordination for behavior by parties up the chain of assignment unrelated to the assignment. Is it realistic to hold assignees responsible for investigating not just asset being purchased or even the chain of assignment, but also the *actions* of previous holders unrelated to the assignment? Such a requirement crimps liquidity and transparency in the bankruptcy claims market. It is also unnecessary because creditors never rely on priority resulting from equitable subordination in their decisions to extend value and can bring direct actions against the malfeasor if they or the bankruptcy estate has been harmed.

Over four hundred years ago, John Selden observed that "Equity is a roguish thing."[239] But equity is only roguish when it becomes detached from its guiding principles. *Enron* erred as a doctrinal matter by failing to recognize that the law's choice of property transfer system— *nemo dat* or negotiability—is based on protection of justified reliance. As a policy matter, too, *Enron* erred, by failing to recognize that hobbling of liquidity in the bankruptcy claims market has serious spillover effects into other markets and raises the cost of credit for borrowers, which exacerbates bankruptcy risk for creditors.

Enron is a reminder of the continuing value of negotiability in commercial contexts and the need to keep the law of property transfers in sync with evolving commercial reality. Bankruptcy law is still adjusting to the development of a large-scale claims trading market over the past two decades. The problems of claims trading deserve serious consideration, but any attempt to regulate claims trading needs to recognize the importance of the bankruptcy claims market for the economy as a whole. A federal law of negotiability for bankruptcy claims would do so by protecting the liquidity of a vital market and should be strongly considered by courts and Congress in the wake of *Enron*.

[239] SELDEN, *supra* note 97, at 43.