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Bankruptcy Claims Sellers Should Consider All Risk Elements

By Doug Mintz, Neil Begley, and Robert Brown2023-08-11T04:00:15000-04:00

Over the past year, digital asset investors have become acutely aware of asset custody and counterparty credit risks due to the high-profile bankruptcies of Voyager, Celsius, BlockFi, and FTX. These investors have found that, at times, their assets may be stuck in a bankruptcy proceeding for years. However, these investors—now bankruptcy claim holders—have options for more immediate liquidity.

Claim holders considering the path to quicker liquidity must understand that not all claims or trades are the same. Claims buyers generally want to purchase the recovery risk on a given class of claims while preserving the ability to look back to the seller if there is a specific impairment to the claim. Claims sellers want to sell their claim(s) and never hear about it again. These competing interests exist in a claims trade from start to finish.

Claims Trading Risks

In structuring a transaction, there are three general categories of risk that parties must consider:

Recovery Risk represents the dollar value that a certain class of creditors will receive from the bankruptcy estate as a percentage of the notional amount of a claim. For example, general unsecured creditors in any case face the risk that, as a class, they will receive a distribution at a percentage from 0% to 100%. However, the form, timing, and number of distributions may not be known for several years.

Notional Amount Risk or seller-specific risk, is the risk that the claim being sold may be disallowed or otherwise reduced or subordinated by the bankruptcy court, resulting in an impairment to the claim's validity or priority of payment.

There's a risk that if party A sells a claim to party B for $10 million, the bankruptcy court will not recognize, or "allow," the claim in the amount of $10 million. The debtors (and others) can object to claims, resulting in delay or ultimately disallowance in whole or in part. Resolution of these issues could take years.

Seller's Counterparty Credit Risk accounts for the risk that a seller can't honor representations or guarantees about the notional amount of the claim.

Claim Impairment

A claim is deemed allowed pursuant to the Bankruptcy Code in the amount in which it's scheduled or filed unless the claim is disallowed, reduced, or subordinated by a bankruptcy court order. This and other attacks on a claim that could result in an individual claim receiving less, or receiving a delayed payment compared with claims of similarly classified creditors, is known as claim "impairment" in the bankruptcy claims trading market.

An individual claim may become impaired or subject to an attack that could result in impairment for a wide variety of reasons. A court may reduce or subordinate a claim if a creditor—particularly a creditor who is an insider-creditor—has committed "bad acts" that have benefited one creditor at the expense of others, such as purchasing claims to destroy a competitor, using one's insider status in a manner that causes harm to other creditors, or abusing the bankruptcy process.

A court may subordinate a claim to those of other claimants on the basis of fraud and other illegal acts, non-arm's length transactions with the debtor, an insider's breach of fiduciary duty, or a creditor's use of the debtor as an alter ego.

If a claim holder fails to comply with the requirements for asserting a claim established by the bankruptcy court or cannot produce evidence to support the claim's validity, the bankruptcy court or creditors committee may challenge the claim.

Risk Allocation in a Claims Trade

The market has generally settled upon four methods for allocating impairment: risk–recourse, non-recourse, as-is, or hold-back.

Recourse. A recourse agreement generally provides the buyer with the strongest level of counterparty protection—assuming such counterparty has strong credit. A claim sold on this basis may provide the buyer the ability to force the seller to repurchase all or part of the claim, through the exercise of a contractual put right, if the claim becomes impaired.

In exercising the put right, the buyer may sell back the defective portion of the claim to the seller and receive a negotiated amount of interest accruing from the date of the initial sale.

Non-Recourse. Non-recourse trade documentation contains representations and warranties intended to protect the buyer in the event of an impairment—without the contractual put right. Subject to the representations, warranties, and indemnities in the documentation, the buyer bears the risk of impairment. A buyer may be entitled to sue or seek indemnification from the seller depending on the wording in the transfer documents.

Both recourse and non-recourse structures may protect a seller from notional amount risk. Whether the seller retains impairment risk depends on the precise wording of the trade documentation. As so, the label “non-recourse” may not accurately reflect the parties’ relative positioning.

As-Is. Essentially, an “as-is” trade is a non-recourse trade, but the seller’s representations and warranties are knowledge-qualified and not forward-looking past the effective date of the claims sale.

The market may discount claims sold on an as-is basis, but market factors such as the competitiveness of bids, seller credit risk, and the maturity of the market—including whether the notional amount value of the claim has been fully and finally settled with the debtors—can make this a viably competitive structure.

Hold-Back. A buyer may either escrow or withhold a portion of the purchase price until all or part of the purchased claim is allowed by final and non-appealable order of a bankruptcy court.

Participants in the claims trading market are free to negotiate transfer documents to their advantage. Claim sellers should discuss trade structures with experienced counsel prior to agreeing to any trade or process to trade, including any preliminary trade confirms, emails, or instant messages to protect against the various potential risks.

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