Claims Traders Beware: More Risk Than You Bargained For!

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Introduction[1]

Bankruptcy claims trading was once largely dominated by trade creditors hoping to receive some value for their claims against a company in bankruptcy. For example, the plumber who was not paid for fixing the sink in an office building might sell his $300 claim against a debtor-building owner to an investment firm in exchange for an immediate pay-out of a fraction of the total claim amount. Over the past several years, however, the size, scope, and nature of the claims trading market has changed dramatically, as has the sophistication of market participants and the complexity of the underlying claims being traded. In many large bankruptcy cases, the small trade creditors have been joined by hedge funds and investment banks as unsecured creditors seeking to unlock liquidity with respect to swap, hedge, or structured financial product claims against large debtors such as Lehman Brothers and Enron. SecondMarket, a claims trading marketplace, has estimated that the potential market for bankruptcy claims is $500 billion, with an estimated $8 billion in claims traded in 2009[2] and $40 billion in estimated claims traded in 2010[3] demonstrating tremendous year over year and potential for growth in this asset class. Whether an investment fund looking for exposure to claims or a non-debtor counterparty looking for short term liquidity, parties must understand the potential risks of participation in this market.

Risks Associated with the Purchase and Sale of Bankruptcy Claims

Claims trading is largely unregulated, and the bankruptcy courts provide only limited oversight. Accordingly, it is incumbent upon purchasers and their counsel to be wary of the special risks attendant to investments in bankruptcy claims. In particular, purchasers of bankruptcy claims should be aware of three major categories of risk: (1) recovery risk; (2) notional amount risk; and (3) counterparty credit risk. Recovery risk is related to the distribution provided to a creditor pursuant to a debtor's plan of reorganization or liquidation and is beyond the scope of this article. Counterparty credit risk, as discussed below, is the risk that a seller may later become insolvent, creating potential difficulty in seeking damages for any breach of the claim sale documents. In many instances, the most significant risk to the value of a claim is the notional amount risk, i.e., the risk that the claim may be disallowed in whole or in part or that the face amount of the claim may otherwise be reduced or subordinated by the bankruptcy court, resulting in an impairment to the claims' validity or priority of payment in the bankruptcy case. Put simply, there is a risk that if Party A sells a claim to Party B for $100.00, then the bankruptcy court will not recognize or "allow" the claim in the amount of $100.00. If a claim is not recognized or allowed in its full face amount, it is

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said to be "impaired" (not to be confused with the term "impairment," as defined in 11 U.S.C. § 1124).[4]

Reasons for Impairment

Under the Bankruptcy Code, a claim is deemed allowed in the amount in which it is scheduled or filed, unless it is either disallowed or reduced or subordinated by a bankruptcy court order.[5] This is known in the claims trading market as claim impairment and can result from a successful attack by the debtor, creditors' committee, or other party-in-interest for a variety of reasons.

a) Bad Acts

A creditor's claim in a chapter 11 case may be reduced or subordinated if the creditor (particularly an insider-creditor) has committed "bad acts" that have benefited one creditor (usually the offending 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. The practical effect of this subordination is that the bad actor's priority in right of payment may be subordinated to that of all other creditors, potentially diminishing the recovery percentage on the bad actor's claim. Instead of being first in line, a first priority secured claim holder could find his or her claim subordinated to all other secured and unsecured creditors and senior only to equity interests in the debtor.

b) Fraud/Insider Trading

A court also may subordinate a claim on the basis of: (1) fraud and other illegal acts; (2) non-arm's length transactions with the debtor; (3) an insider's breach of fiduciary duty; and (4) a creditor's use of the debtor as an alter-ego. Harm to the debtor's other creditors is an essential element of such an equitable subordination cause of action.

c) Non-Compliance with Procedural or Substantive Requirements

A claim may be challenged and reduced or disallowed on procedural or substantive grounds if, for example, the claim holder has failed to comply with requirements for asserting a claim as established by the bankruptcy court or cannot produce evidence to support the claim's validity. For instance, in most chapter 11 cases, the bankruptcy court sets a deadline (a "bar date") for filing proofs of claim against the debtor. Notice of the deadline must be given to all creditors and parties in interest in the case. Claims filed by a creditor after the bar date are subject to disallowance. Similarly, a claim may become subject to attack and ultimate reduction or disallowance for substantive deficiencies, such as those relating to adequacy of supporting documents and/or compliance with underlying documentation requirements relating to claim calculation.[6] For example, a debtor might challenge the calculation method utilized by a claim holder or might demand evidence demonstrating that the claim holder received the requisite number of market quotations in support of its calculation, pursuant to the underlying documents.

d) Preferential Transfer

A creditor's claim may also be challenged or disallowed if the creditor received a preferential payment[7] from the debtor within 90 days of the bankruptcy filing, even if it was unrelated to the bankruptcy claim being asserted.

Allocating Notional Amount Risk in Transfer Documents

If a claim becomes subject to one or more of the impairments described above, the purchaser's remedies against the seller will depend on the transfer documents used in the sale process. The market has generally settled upon four methods for allocating impairment risk, with language known as: (1) recourse; (2) non-recourse; (3) as-is; or (4) hold-back.

a) Recourse

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A recourse agreement provides the purchaser with the strongest level of protection and generally enables a purchaser to focus on counterparty credit and recovery risks. If a claim is sold on a recourse basis, the purchaser will have the ability to force the seller to repurchase the claim, through the exercise of a contractual put right, if the claim becomes impaired.[8] Depending on the language used in the transfer documents, the seller may have a right to cure the impairment by a certain date rather than immediately repurchasing the claim. When a purchaser is allowed to exercise the contractual put right, the purchaser may be permitted to sell back the defective portion of the claim to the seller and also receive a negotiated amount of interest accruing from the date of the initial sale.

b) Non-Recourse

An assignment of claim agreement that does not contain a contractual put right but contains representations and warranties intended to protect the purchaser in the event of an impairment is generally labeled by the market as "non-recourse." In a non-recourse trade, subject to the representations, warranties, and indemnities in the assignment of claim agreement, the purchaser bears the risk of impairment because the purchased claim cannot be forcibly sold back to the seller, even if the claim subsequently becomes impaired. Depending on the wording in the transfer documents, however, a non-recourse purchaser may still be entitled to sue or seek indemnification from the seller, particularly if the impairment is related to a breach of the seller's covenants, representations, and warranties regarding the claim. For example, if a purchased claim is later disallowed but the transfer documents contained a representation that the claim was valid and an indemnity for any breach of the representation, the purchaser of the claim may still pursue contractual remedies against the seller despite the non-recourse nature of the claim.

The precise wording of the representations and warranties will determine whether impairment risk will be retained by the seller; as such, the term "non-recourse" may not accurately reflect the parties' relative risk positions. Although a non-recourse agreement contains no automatic purchaser right to recovery, carefully crafted representations, warranties, and indemnification provisions can shift impairment risk to such a degree that the trade may more accurately be categorized as recourse rather than non-recourse. In such an instance, a seller may need to consider whether the seller has retained any impairment risk and whether or not cash received from the purchaser is truly unencumbered and not subject to claw-back risk.

It is common for purchasers to try to force the seller to retain the notional amount risk. In some cases, when a purchaser negotiates a hold-back (discussed below) and offers to take the remainder of the claim on a non-recourse basis, the purchaser actually may expect to be covered for notional amount risk on the non-recourse portion of the claim by virtue of representations and warranties and attendant indemnification in the transfer documents. True non-recourse or "as-is" transactions are more rare.

c) As-Is

An "as-is" trade is exactly as it sounds - a trade with very limited representations and warranties, usually covering such things as due authorization and valid organization. An as-is trade thus transfers both the recovery risk and the notional amount risk to the purchaser. It follows logically that purchasers generally attach a significant discount to the value of the claim if they are willing to take it as-is and assume these risks.

d) Hold-Back

A hold-back occurs when the claims purchaser either escrows or withholds 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. In these situations, the

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parties generally negotiate the precise terms of any escrow arrangement and specifically delineate how the hold-back is to be released from escrow or otherwise funded by the seller.

Counterparty Credit Risk

If the seller of a claim itself becomes a chapter 11 debtor or otherwise becomes insolvent, the purchaser's ability to exercise a recourse trade put right may be rendered worthless. Similarly, in the context of a non-recourse sale, the purchaser likely will not be able to obtain indemnification or sue to recover for breach of representations and warranties from an insolvent seller. When buying a bankruptcy claim, therefore, the purchaser is assuming certain risks with respect to the creditworthiness of the seller.

In addition to conducting diligence on the company in bankruptcy, a purchaser should carefully diligence its trade counterparty to ensure that the seller is solvent and can meet its obligations and potential liabilities listed in the claim trading documents. If a seller is insolvent or in financial distress, the value of any representations, warranties, or indemnities contained in the transfer documents may be severely compromised. If there is a question as to the seller's creditworthiness, the purchaser should consider requiring a guaranty of the seller's obligations by a well-capitalized affiliate or insist upon a hold-back in an amount equal to a significant percentage of the purchase price until the claim is allowed by final order of a bankruptcy court.

Conclusion

At this time, claims trading is not subject to federal oversight either through bankruptcy courts or federal securities laws. Market participants are free to negotiate transfer documents to their advantage. Purchasers and their counsel must ensure that such documents contain appropriate protections against the various potential risks as to the ultimate value of the purchased claim. In the claims trading market, increasingly sophisticated investors, traders, and counsel must work in tandem to guard against documentation pitfalls and maximize returns.

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[1] For trade-specific advice, please consult with legal counsel. This article is for general informational purposes only and does not constitute, and should not be relied upon as, formal legal advice or a formal legal opinion.

[2] BCD News and Comment, "8 billion in unsecured claims traded in 2009," Vol. 52, No. 21 (March 16, 2010).

[3] SecondMarket, Claims Trading Monthly, December 2010.

[4] For the purposes of this article, the discussion of the concept of "impairment" in the context of trade claims should not be confused with the term "impairment," as defined in 11 U.S.C. § 1124 (which provides that "a class of claims or interests is impaired under a plan unless, with respect to each claim or interest of such class, the plan . . . leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest." *See* 11 U.S.C. § 1124(1)).

[5] 11 U.S.C. § 502(a).

[6] For example, a debtor might challenge the calculation method used by a claim holder or might demand evidence showing that the claim holder obtained the requisite number of market quotations in

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support of its calculation, in accordance with the underlying documentation.

[7] The Bankruptcy Code defines a preferential payment as: (1) the transfer of an interest of the debtor in property; (2) to or for the benefit of a creditor; (3) for or on account of an antecedent debt owed by the debtor before such transfer was made; (4) made while the debtor was insolvent (the debtor being presumed to be insolvent within the 90 day period preceding the filing of a petition); and (5) made within 90 days before the filing of the bankruptcy petition (or within one year if the creditor was an insider); (6) that enables the creditor to receive more than such creditor would have received if the case were a chapter 7 liquidation proceeding. 11 U.S.C § 547. Such payments must be returned by creditors and are considered part of the bankruptcy estate - the rationale being that it is unfair for one creditor to be favored (or preferred) over another creditor on the eve of a debtor's bankruptcy filing.

[8] In many instances, the purchaser will be permitted to exercise its put right at the first sign that the claim may become subject to an impairment.

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