BANKRUPTCY CLAIMS

NEW INVESTORS ENTER THE MARKET

The effects of Lehman Brothers' 2008 bankruptcy filing continue to reverberate, particularly in the private market for bankruptcy claims. One might argue that the bankruptcy, which covered almost $700 billion in assets, has forever altered the dimensions of the claims market, bringing new, sophisticated players into an asset class they had hitherto ignored.

"The bankruptcy claims market is absolutely dominated by Lehman," says Andrew Gottesman, SecondMarket's head of bankruptcy claims. "It's by far the biggest animal in the jungle."

To illustrate, Gottesman notes that of the 687 bankruptcy claims trades made privately in December 2010, 277 (or 40 percent) were Lehman related and were worth about $1.74 billion. This compares dramatically to the market's runner-up Motors Liquidation Company (formerly General Motors Corporation), whose 17 trades in that period represented 2.5 percent of December's total trades and were worth only $40.1 million.

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The Lehman trades involve credit default swap and derivative contract termination claims, along with more traditional trade claims, such as unpaid contractor claims left in limbo by the bankruptcy.

Seeking to boost performance

"Over the past two years, you've had hedge funds that were traditionally either in equities, high yield or other healthier markets come into distressed, and this is one of the places they're looking for exposure," says David Karp, who leads the Distressed Debt and Claims Trading Group at the law firm Schulte Roth & Zabel LLP.

Several investors (e.g., private equity firm Apollo Management L.P., hedge fund Appaloosa Management and distressed investor Lone Star Funds) have been using the claims market to boost their positions in struggling companies to either take control or amass blocking positions in tough negotiations, turning claims trading into an important tool for distressed investors.

Karp adds that many new market entrants are already looking ahead to opportunities in the U.S., European and emerging markets. Those could involve over-levered companies that were bought during the leveraged buyout boom of 2005 and 2007, and European banks caught in that continent's sovereign debt and housing crises.

But it's important to note, he adds, that the claims market is still relatively small when viewed in light of its potential. (SecondMarket estimates the potential market for bankruptcy claims of $450 billion, with some $8 billion in claims traded in 2009 and approximately $40 billion in 2010.)

As a result, trading protocol is

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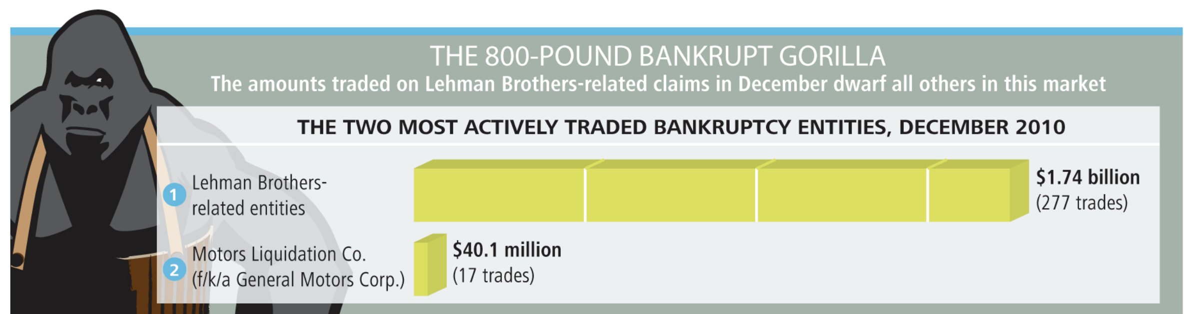

Source: SecondMarket Holdings, Inc.

Bankruptcy Claims

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still not as standardized as more mature markets, and participants need to be aware of some issues. In particular, there are significant uncertainties in terms of the notional values of claims. Lehman's estate, for example, could object to the value of a claim and reduce its value after it has changed hands.

"The allocation of that risk is one of the biggest tensions between buyers and sellers in the market today," Karp says, noting that in most cases buyers have been insisting on put rights in case the claim shrinks in value, or including language in the contract representations, warranties and indemnification clauses to protect against that instance.

"Many longtime participants in this space would love to have the market believe that markets are standard and that there are no unique issues to be negotiated on a claim-by-claim basis," he says, adding, "But that's not the best way to view it. ■

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