



# Bankruptcy Claims Trading: What is it? How do I maximize my returns?

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Up is down and down is up in the current economic climate. Many large companies have or will file bankruptcies and attempt to restructure their finances. Any creditor that has filed a "claim" against a bankruptcy estate may receive offers from "claims traders" seeking to purchase those claims. So if an investment firm that you have never heard of contacts you seeking to buy your claim for 35 cents on the dollar, what do you do? How do you know if this buyer is legitimate? Is this a fair price? What's the difference between a sale on recourse versus non-recourse? Should you just discard the offers and wait for the debtor to pay distributions? Do you have to agree to the legal documents prepared by the trader? What's the up and downside? Recent high profile cases where purchasing bankruptcy claims has been fairly active include Lehman Brothers, General Motors Holding, Washington Mutual, and General Growth. Bankruptcy claims can be secured or unsecured and include debts owed to vendors, institutions, landlords, any business or individuals. The market for bankruptcy claims has historically been hindered by a low profile based on the lack of a public pricing index, standardized contracts, or a centralized exchange for buyers and sellers. When a creditor becomes aware that a debtor has filed for bankruptcy, many panic and sell their claim to the first willing buyer. These sellers fail to research the potential recovery value of the debt they are selling. On the other hand, with some effort, creditors can receive a fair price for selling their claims. While it's rare for creditors to sell their claims for 100% of face value, they can at least take steps to ensure that they are negotiating an arms-length transaction with the sophisticated hedge funds and investment banks that invest in bankrupt or credit impaired companies. **Who are These Buyers?**

Many bankruptcy claims traders are brokers that act as middlemen in the transaction although some are the actual claims investors. Generally, these middlemen have a network of potential investors, and search bankruptcy claims dockets for potential sellers. Their usual commission is a small fraction of the total value of the transaction. Claims traders must make quick decisions based on imperfect and/or speculative information; sometimes they win, sometimes they lose. Successful claims buyers are able to diversify much of the risk by investing in a wide variety of bankruptcies and a myriad of claims. They typically buy claims

only in the largest Chapter 11 bankruptcy cases from which a leaner, meaner reorganized business will likely emerge. Traders can solicit bids by cold-calling and mailing offers to creditors listed on the debtor's bankruptcy schedules or the claims dockets. Claims trading can continue long after the debtor has filed a disclosure statement and plan of reorganization. It is important to determine before selling a claim whether there are any court orders in the case restricting the ability of creditors holding certain claims—such as those above a certain amount—from selling their claims. Such restrictions generally are imposed in order to preserve net operating losses or "NOLs" for the debtor's tax purposes. If a creditor expresses an interest in selling, that creditor will typically be sent a short confirmation letter, which outlines the basic terms of the sale. From there, the claim holder will be asked to supply supporting documentation and execute a purchase agreement, commonly referred to as the "assignment of claim agreement." Many sellers sign these agreements without negotiating any terms.

As a potential seller of bankruptcy claims, always beware. Don't rely on the bankruptcy courts to protect your company. The claims trading market is unregulated by the Bankruptcy Code, although there are some general provisions that apply to claims trading. For example, Bankruptcy Rule 3001(e) governs the mechanics of claims trading. If those procedures are followed, the rights held by the original claim-holder are transferred to the investor who purchases the claim. These rights transfer as if the investor had paid the full face value for the claim, even if the actual purchase price was substantially discounted from the face value. Because the transferred claim is subject to any defenses/set-offs available to the debtor against the transferor, claims trading must be undertaken with detailed knowledge of the debtor's potential rights and defenses against the selling creditor. Also the claims purchaser normally will insist on provisions that protect it in the event that the claim is disputed and disallowed or reduced by the court.

### **Advantages of Selling Your Claims – Cash Now!**

First, immediate cash is the primary advantage. Creditors can choose to sell their claims for immediate cash at a discount instead of waiting – possibly for years – to see a return. Many creditors would prefer to recover 50 cents on the dollar today (for example), rather than risk holding out for a better return in the future. That cash can be immediately reinvested in a creditor's business, taking advantage of the time value of money. Selling claims also reduces uncertainty.

Second, by cashing out, creditors eliminate the risk of receiving an illiquid equity distribution (such as notes or bonds) as opposed to cash. Many large Chapter 11 bankruptcies provide distributions to unsecured creditors in the form of equity, not cash or a combination of equity and cash. Even if creditors are entitled to all cash distributions, there is still a risk that creditors will receive small distribution checks over a long period of time. The creditor should consult a tax professional regarding the tax consequences of a claim sale.

Finally, the creditor does not have to deal with further involvement in the bankruptcy itself – although the sale agreement may require the seller to assist in the event of an objection to the claim following sale. Monitoring a bankruptcy case can be difficult especially if the bankruptcy is outside the creditors' principal place of business (such as New York or Delaware). Often, the creditor will need to retain legal counsel to monitor its claim through a bankruptcy especially if the claim is highly valued or subject to dispute. This can amount to a creditor paying "good money" to chase "bad money."

### **Best Practices if You are Selling Your Claim.**

1. Keep realistic expectations. Companies file for bankruptcy because they don't have enough money to pay their creditors. In many Chapter 11 cases, creditors ultimately recover pennies on the dollar or sometimes nothing. Unsecured creditors are rarely paid out in full. The claims offers reflect discounts for the likelihood of recovery and the time value of money (i.e., the projected time period from the purchase of the claim to the ultimate distribution in the case).
2. Use the internet and your networks (other creditors and attorneys) to do research. Research your bankruptcy case before you sell – the more you know about the status of the case, the debtor, and your claim, the better you can judge what your claim is worth. A disclosure statement which projects what the potential distributions on allowed claims will be is especially helpful. At this time, there is no publicly quoted pricing index for bankruptcy claims and public documents do not include pricing information.
3. Go shopping. You may not want to jump at the first offer you receive. There are numerous distressed debt firms that are interested in purchasing bankruptcy claims. The challenge is how to find these buyers. Be proactive. Have the traders compete against one another.
4. Don't gamble against the house. Attempting to predict the ultimate recovery value for claims holders is the same as speculating on any other market. Even distressed debt analysts who are so called "experts" often cannot accurately value bankruptcy claims.
5. Demand higher prices for higher priority. Secured claims, administrative claims, and reclamation claims (i. e. 503(b)(9)) all have a higher priority than general unsecured claims under bankruptcy law. As such, higher claims will generate higher offers. If you hold any of these types of claims, especially if they are allowed, you should expect to receive a significantly higher price than your fellow unsecured creditors.
6. Get professional assistance. No court or government agency is required to approve the pricing or contract terms of your claim sale. Buried within the sale documents is legalese that could be prejudicial. This can include non-recourse sale terms, indemnity rights, interest rates, and reasonable representations and warranties. Creditors are commonly obligated to buy back the claim, possibly with interest, in the event of an objection, disallowance, or reduction of the gross amount of the claim. As such, it is critical to seek legal counsel or consult with an expert in bankruptcy claims trading when in doubt.

*Allan H. Ickowitz is Co-Chair of Nossaman's Financial Services and Bankruptcy Practice Group and specializes in the bankruptcy, creditors' rights and workout areas including commercial, real estate and related litigation. He has over 30 years of experience in insolvency matters involving financing transactions, real estate, energy, utility, transportation, communications, healthcare, environmental manufacturing, environmental, and other transactions. He can be reached at [aickowitz@nossaman.com](mailto:aickowitz@nossaman.com) or 213.612.7849.*