A Primer on Selling Bankruptcy Trade Claims

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If 2020 taught us anything, it is to prepare for the unexpected. The unprecedented events experienced in 2020, including the COVID-19 pandemic and the resulting severe economic stresses felt both domestically and globally, strongly suggest continued market challenges and an increase in bankruptcy filings in 2021 and possibly 2022.

The energy and retail sectors have been hit particularly hard, with the number of Chapter 11 filings of billion-dollar companies at levels unimaginable just a year ago. Businesses across the country are navigating state and federal safety restrictions and shutdowns, the travel and leisure industry is nearly nonexistent, and unemployment continues to run at historically high levels. As a result, many more businesses throughout the broader economy are expected to seek to reorganize, or sell their assets, through Chapter 11 over the next several years.

A credit professional, faced with a customer's bankruptcy filing, might consider selling their company's trade claim to a claims buyer. While the bankruptcy claims trading market has grown steadily over the past decade, there has been a recent explosion of sale of claims that offers trade creditors holding claims against bankrupt customers more options and opportunities to quickly convert those claims to cash. Selling a trade claim to a claims buyer provides a creditor with an upfront, though discounted, cash payment for the claim, in lieu of having to monitor its customer's bankruptcy case for months or years, uncertain what, if any, distribution will be made by the debtor through the end of the case.

This article provides an overview of the motivations of the participants in the bankruptcy claims trading market, the mechanics underlying claim transfers, troublesome and the most frequently negotiated provisions in claim assignment agreements, and tips for how to maximize the purchase price for the sale of a claim.

Reasons to Sell a Bankruptcy Claim

A trade creditor's most obvious and primary motivation for selling its claim is to quickly monetize the claim through an immediate cash payment. The claims reconciliation and distribution process is notoriously slow in bankruptcy cases, particularly for very large debtors. Even for middle market debtors, there is frequently a several-year delay between when a customer files for bankruptcy and when creditors receive distributions, if any, on their claims. Moreover, there is no guaranty that the ultimate distribution will be made in cash. It is not unheard of for a debtor to distribute illiquid stock in the reorganized company in satisfaction of creditor claims.

The sale of a trade claim eliminates the delay and risk associated with holding and monitoring a claim throughout the lengthy bankruptcy process. While a trade creditor selling a claim may receive a purchase price that is materially less than what the creditor would have received from the debtor, the sale eliminates the risk that the creditor will receive a nominal or no recovery through the end of the bankruptcy. Selling a trade claim also provides certainty from an accounting perspective because the claim will not have to be

carried on the creditor's records. The claim seller may also receive certain tax benefits from writing down the receivable and locking in the claim price.

Claims Buyer's Motivation

While trade creditors selling their claims are usually looking for a quick exit, claims buyers are frequently involved in the bankruptcy case for the long haul. Purchasers spend countless hours and resources reviewing and analyzing a debtor's assets and the amount and priority of claims. Based upon this information, buyers make assumptions about how much a debtor will ultimately pay on account of each class of claims through the end of the bankruptcy case.

Some claims buyers are very patient and wait until the end of the bankruptcy case to receive all distributions on their acquired claims. Other purchasers acquire and hold claims as an investment opportunity, expecting that distributions will be made in the reorganized debtor's equity. And still other claim buyers acquire trade claims and then resell them in bulk to other claim purchasers.

A trade creditor solicited by a claims buyer should also contact other potential buyers to purchase the claim and attempt to get potential buyers to compete against each other to bid up the purchase price offered.

Regardless of the model claims buyers adopt, their goal is to make a profit on the transaction by paying a materially lower price than the amount the debtor ultimately distributes on account of the claim. Once a claims buyer invests the substantial resources necessary to conduct a financial analysis of a particular debtor, the buyer will be motivated to solicit a large number of trade creditors holding claims against the debtor and purchase those claims at the lowest possible price.

Very large Chapter 11 cases that generate the interest of numerous claims buyers drive competition for the purchase of trade claims. Faced with increased competition, buyers are often forced to increase the purchase price—and reduce their profit—in order to close a sale.

A trade creditor solicited by a claims buyer should also contact other potential buyers to purchase the claim and attempt to get potential buyers to compete against each other to bid up the purchase price offered. If a buyer does not think it has any competition, it has no incentive to offer anything but the lowest possible price for the claim. For larger claims, trade creditors should contact other credit professionals, industry trade groups, accountants and lawyers to seek referrals for potential claims purchasers. The more interested buyers there are, the more likely a selling creditor will be able to maximize the purchase price.

Agreements Underlying Sales of Claims

Once a trade creditor and a buyer have agreed on a purchase price for a claim, the next step is documenting the sale through a claim assignment agreement. To understand the structure of a claim assignment, it is necessary to understand exactly what is being sold and what promises the buyers and sellers are making to each other.

Bankruptcy claims are not sold or traded like stocks on the New York Stock Exchange. Instead, claims are transferred through individually negotiated assignment agreements. Although there is no standardized claim assignment form, and every claim sale has unique characteristics, buyers generally use assignment agreements that contain both universally accepted terms, as well as other terms that are subject to negotiation.

In all bankruptcy claim sales, a seller transfers to the buyer the right to receive all distributions on account of the claim in exchange for receiving the purchase price. The buyer takes both the upside potential to earn a profit on the sale and the downside risk that the distribution on the claim might be less than the purchase price.

For example, if a trade creditor believes the claim it is selling will ultimately receive only a 5% recovery, but unforeseen developments in the debtor's bankruptcy case result in the buyer receiving an 85% distribution on account of the claim, the seller cannot recover anything more against the buyer, unless the seller negotiated for some upside potential. Alternately, if the seller sells the claim for a purchase price equal to 20% of the face amount of the claim, and the purchased claim, and all similar claims, receive no distribution through the conclusion of the bankruptcy case, the buyer has no rights against the seller, unless the seller breached any terms of the assignment agreement.

However, a claims buyer does not take the risk that the debtor ultimately disputes the purchased claim. It is critical that a trade creditor understand this fundamental issue because selling a claim is never risk-free.

All claim assignment agreements require that the seller represent to the buyer that the claim being sold is valid, in an amount no less than the amount stated in the assignment agreement, and is not—and will not become—subject to any objection by the debtor. Many assignments also require that the purchaser receive the same distribution on account of the claim at the same time that other similarly situated creditors receive distributions. In other words, the underlying assumption in all claim sales is that the debtor will not object to the claim and the purchaser will receive the same percentage distribution from the debtor at the same time as all other holders of claims of the same priority.

A typical assignment agreement provides that if the debtor objects to the claim, or the debtor asserts any claims against creditor (such as a dispute, setoff right or preference claim) following the sale, then the buyer has the right to compel the seller to repurchase the claim and pay back the purchase price to the buyer, with interest sometimes at an exorbitant rate, which can often be negotiated down.

Key Assignment Provisions

Depending on the size and complexity of a claim sale, an assignment agreement can range from a very simple two-page form, with the buyer unwilling to make any modifications, to a very heavily negotiated, lengthy agreement that provides for multiple contingencies in the event a debtor

objects to the assigned claim, or otherwise asserts claims against the seller.

Regardless of complexity, all assignment agreements should contain the same basic information: (i) the name of the seller and the buyer; (ii) the name of the debtor and information identifying the bankruptcy case; (iii) the amount of the claim; and (iv) the purchase price. The purchase price will generally be listed on an exhibit to the assignment agreement and will be written as the amount of the claim multiplied by a "purchase rate".

The assignment agreement should state that the sale of the claim is conditioned upon the seller's receipt of the purchase price, preferably contemporaneously with the execution of the assignment. Unscrupulous claim buyers may use forms that are silent on when the purchase price must be paid. This is a huge red flag that the assignment agreement is full of loopholes allowing the buyer to avoid paying the purchase price for a variety of reasons.

A typical assignment agreement may also identify: (i) the selling creditor's undisputed claim, listed in the debtor's schedules filed with the bankruptcy court; and (ii) the creditor's proof of claim, filed with the bankruptcy court, which might be a larger amount than the scheduled claim. The difference between the amount listed on the proof of claim and the scheduled amount of the claim is the "disputed" portion of the claim to be sold.

The treatment of a disputed claim under an assignment agreement will vary depending upon the terms of the assignment agreement that the buyer and the seller negotiate. For instance, an assignment agreement may provide that the buyer will pay the seller at the time of the claim transfer for both the undisputed and the disputed portion of the claim. This is generally done when the selling creditor has high confidence in the validity of its claim and does not believe that the debtor has grounds to contest the amount asserted in the proof of claim. In this circumstance, the selling creditor takes the risk that if the debtor objects to the disputed portion of the claim, the buyer has a right to demand return of the purchase price, with interest, and compel the seller to repurchase the claim.

Alternatively, an assignment agreement may state that the selling creditor receives only the purchase rate multiplied by the amount of the undisputed portion of the claim provided in the bankruptcy schedules when the claim is sold. The assignment should also provide that the buyer owes the selling creditor an additional purchase price equal to the purchase rate multiplied by the portion of the additional allowed amount of the claim, if some or all of the disputed portion of the claim is subsequently allowed. Claim buyers will often insist on this "delayed payment" structure where the buyer questions the seller's financial ability to repay the purchase price if the debtor successfully objects to the claim, possibly years after execution of the assignment agreement.

A claims seller should always question any provision in an assignment agreement that grants the buyer the option, rather than imposing an obligation, to pay an additional amount for the allowed portion of a previously disputed claim. This provision relieves a buyer of any further requirement to make payments beyond the initial purchase price for the claim. This can amount to a windfall to the buyer where there was no basis for the dispute; the disputed portion of the claim is ultimately allowed, and the buyer ends up receiving a distribution on a part of the claim for which no payment was made.

> Prior to selling a claim, a trade creditor should also consider whether it has preference risk.

For sizable claims, selling creditors should insist on a provision in the assignment agreement that requires the buyer to notify the selling creditor of any objection to the claim and afford the creditor a specified period of time to defend against any objection. Otherwise, the buyer could choose not to respond to a claim objection, and the creditor would lose the opportunity to recover any additional purchase price otherwise payable under the assignment as a result of the allowance of a disputed claim. A claims buyer's unwillingness to negotiate any changes to an assignment agreement is another red flag that the buyer is using a very "pro-buyer" form and is relying on an inexperienced seller to simply sign it without questioning its provisions.

Assignment agreements also typically require the seller to make additional representations and warranties, the violation of which allow the buyer to compel the trade creditor to repurchase the claim, repay the purchase price and pay the interest charges specified in the agreement. A buyer insists upon these provisions to ensure it is obtaining the benefit of its bargain—an allowed claim on which the buyer will receive the same treatment as other creditors holding claims of the same priority. Selling creditors should reject vague and broad representations and covenants that a seller would have difficulty proving in the event of a dispute with the buyer.

For instance, an assignment agreement frequently contains a representation that the selling creditor's claim is valid, undisputed and enforceable. The creditor would be in breach of this representation, and risks being compelled to repurchase the claim, if any portion of the claim is subject to dispute. The creditor could avoid this risk by representing that only the creditor's scheduled claim is valid, undisputed and enforceable.

An assignment agreement might also contain a covenant that the buyer will not receive any less favorable treatment on the claim than the holders of other unsecured claims. This provision would be breached if all unsecured trade creditors receive distributions on their claims, while the distribution on the buyer's claim is deferred for any reason, such as a pending dispute concerning the claim, including potential preference liability.

Prior to selling a claim, a trade creditor should also consider whether it has preference risk. Most assignments contain a representation that the creditor is not subject to preference risk. This provision protects the buyer from an objection to the claim based on a preference claim against the creditor and the resulting risk of disallowance of the claim at worst, or a prolonged delay

in distribution on the claim at best, both of which could result in the buyer compelling the seller to repurchase the claim and repay the selling price, plus interest.

Claims sellers should recognize that a buyer will likely invoke a breach of the seller's representations as an "escape hatch" to bail out of a bad investment (e.g., where the recovery on the claim is less than the purchase price paid) and compel the seller's repurchase of the claim and repayment of the purchase price with interest. Trade creditors can minimize this risk by negotiating an adequate period of time to defend against and resolve any claim disputes, including preference claims. If the buyer refuses to agree to such a provision, the trade creditor should consider seeking out another buyer, or foregoing the sale of the claim until resolution of the preference claim or other dispute.

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Finally, a selling creditor should exclude from the sale, or request a higher purchase rate for, that portion of its claim premised upon lien rights, priority status under section 503(b)(9) of the Bankruptcy Code, or reclamation rights. A creditor might be entitled to a larger recovery, or payment in full, on account of such claims and may want to retain this claim and receive payment directly from the debtor. The creditor also might consider negotiating a sharing arrangement on any additional recoveries on these claims, or the creditor might seek the right to compel the buyer to purchase, at the original purchase price, any portion of the claim that was excluded from the sale and was later re-characterized as a general unsecured claim.

Assignment agreements are never filed with the bankruptcy court, and the purchase price paid for the assigned claim is typically subject to confidentiality restrictions. If a creditor sells its claim prior to filing a proof of claim, the buyer can file a proof of claim with respect to the transferred claim without notice to the bankruptcy court. If the claim is sold after the creditor filed a proof of claim, Federal Bankruptcy Rule 3001(e) requires that the buyer file a form with the bankruptcy court providing notice of the transfer of the claim, but no disclosure is required concerning the purchase price or other details of the assignment.

Conclusion

A trade creditor should consider the sale of its claim against a customer in bankruptcy as part of the creditor's collection toolkit, particularly for large debtors where there is a robust claims trading market. However, the prospect of quickly monetizing a claim must be weighed against the risk that the purchase price must be returned to the buyer if the claim is of questionable validity, or there is material preference risk.

A trade creditor that decides to move forward with a sale of its claim should exercise great care to understand, and adequately negotiate, the terms of the assignment agreement to get the benefit of its bargain and avoid the risk of granting the buyer an option to compel the seller's repurchase of the claim in order to avoid a bad investment. The prospect of a credit executive having to explain to management an unanticipated repurchase of the claim and repayment to the buyer is a risk that should be avoided at all costs.

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