

Selling a Claim in Bankruptcy Can Provide Liquidity, But “Let the Seller Beware”

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I. Motivation for Selling a Claim in Bankruptcy

1. **Seller’s Perspective** – A seller of a claim has probably already expended considerable effort and cost leading up to a bankruptcy claim. These efforts may have included significant screening efforts prior to issuing the initial credit, collection efforts, submitting documentation to verify the validity of the claim, and the cost of internal or external legal advisors. Ultimately, the company ended up in bankruptcy and collection in full or partially appears doubtful. Seller’s may have different motivations in considering a sale of a claim which may include:
 - a. **Cost Avoidance** – The seller may be interested in eliminating further costs and risks involved with the bankruptcy proceedings by selling their claim.
 - b. **Liquidity** – Getting cash now as opposed to waiting for months or in some cases years,² may serve the seller’s immediate cash flow needs. The bankruptcy may have even created a liquidity crunch for the seller, an out of formula situation with its senior lender, etc. In addition, in many bankruptcies cash is never ultimately paid out toward claims. Instead equity or additional debt may be issued from debtors emerging from Chapter 11 proceedings. The risk of not getting cashed out is often in conflict with the creditor’s needs, particularly if they have no interest in taking an equity or debt position that are difficult to convert to cash.²
 - c. **Price** – The buyer of a claim will adequately discount the price paid for a claim when compared with the amount and timing of an expected claim distribution. The buyer usually understands the value of the debtor, the rights and claims of the various classes of creditors, and the value of the claim purchased.² The selling party, however, may not have the legal and financial resources to evaluate the value of the claim. Accordingly, the buyer’s price may appear attractive to the selling party.
 - d. **Regulation** – Many institutional investors such as pension funds, mutual funds, etc. are not able to hold below investment grade bonds regardless of the future viability of the entity that could ultimately emerge from

¹ The opinions in this outline and during the presentation do not necessarily represent the views of O’Keefe & Associates Consulting, LLC.

bankruptcy. Their charters or regulation prevent them from doing so.³ Furthermore, Federal Reserve member banks have liquidity requirements including cash reserves and capital ratios to maintain. Banking regulatory requirements are especially relevant to today's economy with real estate, personal and corporate loan defaults on the rise.

- e. **Internal Policy** – Many bank credit administration policy makers pursue options to sell troubled loans (or “non-earning” assets from the bank’s perspective) to free up cash to underwrite new loans and investments (or “earning” assets).³

Also very important to the potential seller are new rights including a higher priority of distribution that have emerged from BAPCPA including 503(b)(9) administrative claims. While there still may be significant motivations and advantages to selling claims, as further explained below, there is a need to exercise caution when proceeding.

II. Strategies to Consider when Selling a Claim

1. **Ensure Claims are Undisputed** – A claims buyer usually makes first contact and presents a written or verbal expression of interest to purchase a creditor’s claim. Offers are expressed as a percentage of the claim amount. When selling a claim, it is important to establish whether the claim is disputed or not. Documentation and support as to whether the claim is “genuine” can be a key determination of improved pricing.² As an alternative, a trade creditor can also sell a part of its bankruptcy claim such as the undisputed portion of a claim.⁴
2. **Pricing** – The buyer will determine (i) the proportion of the claim to be paid based on a “bare bone” liquidation value and estimated distribution to the company’s creditors², (ii) the likely duration of the bankruptcy process before the claim is paid, (iii) the buyer’s likely profit margin, risk associated with the investment, and cost of funds, and (iv) the present value or “discounted” future cash proceeds expected. This calculation in many cases results in a significant discount to the face amount of the claim. If an agreement can be reached between the seller of a claim and the buyer of a claim, it will likely be at an amount that is equal to or less than the discounted value.² As a practical matter, it always a good idea as a seller of a claim to get 3 quotes and get references before proceeding.

The selling creditor should also recognize a greater percentage value when selling a claim with a higher priority of distribution such as lien rights, reclamation claims, and 503(b)(9) claims. As an alternative, when selling a claim with a higher priority, a sharing arrangement should be considered once the claims realized are above a pre-defined threshold. If an increased percentage cannot be negotiated for higher priority claims, the creditor should consider excluding these claims from the sale if they believe they will realize a greater dividend by holding the claim until distribution.⁴

3. **Confirmation Document** – Frequently, buyers may send sellers a Confirmation Document outlining the key terms including the claim amounts to be purchased, the purchase price, and all other terms and conditions.² This is not usually the document that transfers title. In fact, the Confirmation Document is much like a letter of intent and usually states that the sale of the claim is subject to a mutually acceptable Claim Assignment Agreement, the agreement that usually conveys title.

In order to prevent getting hand-cuffed into a transaction that may never be consummated, a trade creditor should consider (i) forgoing the execution of the Confirmation Document, or (ii) requesting rights that grant the seller the same “walk away” rights as the buyer is afforded if the sale is not consummated by the agreeable deadline.⁴

4. **Claim Assignment Agreement** – The Claim Assignment Agreement is the key document that provides the rights to transfer the claim. The creditor should make sure this agreement provides for payment at the same time the claim is assigned and that special care is taken with regard to any disputed portion of an assigned claim so the timing and enforceability of the payment is well defined. The selling creditor usually must settle for a deferred payment on the disputed portion of a claim until it is allowed by a court order. Usually this does not occur until the conclusion of the bankruptcy case and very well may be long after the disputed claim was originally assigned. The selling creditor should review the agreement carefully to make sure there is an enforceable obligation to receive consideration for the disputed portion of a claim once it is approved and thereby avoid allowing a windfall to the buyer.⁴ In addition, if the claim is increased, the buyer should have the obligation to buy any “excess claim” at the agreed upon percentage of claim amount.

Some key terms and conditions that may be a part of such an agreement include but are not limited to:

- a. **Percentage of Purchase Price for Claim May Be Variable** – Some Claim Assignment Agreements remove the risk from the transaction for each party by including a provision for the rise or fall of the amount of the claim over time as more information about the creditor’s likely recovery becomes available.²
- b. **Put Options** – Provisions in Claim Assignment Agreements may include a “put” or ability to sell all, or the disputed part, of the claim back to the seller including steep interest charges for the entire assignment period. In some cases this right is available due to breach of standard representations or the mere filing an objection even if the objection is ultimately defeated. If the price paid for the claim turns out to be high, the buyer may exercise its rights in this regard to get its money back² which serves an “escape clause”. This is an area to exercise caution when selling a claim since

very typical actions in bankruptcy proceedings such as proof of claims and preference avoidance actions may be classified as triggers for these put options. Also, it is advisable to insist on a reasonable interest rate of interest on any repayments, for example, prime rate.

- c. **Defense Costs** – Some Claim Assignment Agreements include provisions that the seller must pay to defend a claim and to pay back disallowed claims.² Without financial risk, the buyer may have very little incentive to defend the claim. The selling creditor should consider requesting a provision that requires the buyer to notify the creditor of any objection to the claim, the option to defend the claim, and sufficient time to resolve the claim.⁴ At the very minimum, the selling creditor should insist that the buyer cannot settle and reduce the amount of the claim without prior written consent of the seller.
 - d. **Set-offs** - Some Claim Assignment Agreements include provisions that limit the set-off rights and the ability of the seller to recoup amounts due from the bankrupt entity.² These limitations could include 503(b)(9) and other administrative claims that were not part of the sale if not crafted carefully by the seller.
5. **Other Considerations** – Some other factors to consider before a claim can be sold including the following:
- a. **Creditor Committee** – If the seller serves on the Creditor Committee, there may be inside knowledge of potential distribution factors or other information that could impact the value of the claim. Accordingly, there may be restrictions on a seller’s ability to sell the claim, and/or the selling party may have to resign from the Creditor Committee.²
 - b. **Court-Ordered Restrictions** – Some creditors, especially large creditors, may be restricted from selling their claims to preserve net operating loss tax benefits that could be lost.²
6. **Evidence of Transfer of Claim** – This additional document is usually required. While it does not mention the price paid, it should be filed with the bankruptcy court as a means to notice other parties of the claim transfer. The other parties of interest in the bankruptcy have a maximum 20 days to file an objection to the claim transfer.²

While bankruptcy claims are usually sold at a deep discount, there is a market for those creditors who can’t wait for the reorganization to be completed. However, the sale or transfer is can be risky. The process requires careful evaluation and planning from a legal and financial perspective.

² Bob Eisenbach, “*Selling A Bankruptcy Claim: Opportunity and Risk*,” Business Bankruptcy Blog, August 11, 2006.

³ Dion Friedland, Chairman, Magnum Funds, *2007 Magnum Global Investments Ltd .website*.

⁴ Bruce S. Nathan, Esq., Lowenstein Sandler PC, “*Sales of Trade Claims: The Rewards and the Risks*,” Business Credit, May 2006.