

# Selling claims in Chapter 11: A remedy with risks

David Conaway considers claims trading as a way of recovering payments in Chapter 11 cases



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## Global impact

In 2018, the Chapter 11 claims trading market generated \$45 billion of claims sales. Three Chapter 11 cases generated the highest volume of claims trading: Lehman Brothers, Westinghouse Electric and Toys R Us. Because of their global tentacles including physical locations, global financing and insurance, supply chain and affiliates, creditors around the globe held claims against these and many other Chapter 11 debtors. While non-U.S. creditors may have utilised traditional remedies and strategies to recover payment in Chapter 11, such creditors should also consider the highly-developed U.S. claims trading market as a potential solution.

## Risks and remedies

When a contract counter-party files Chapter 11, the creditor's investment is at risk. High loan to collateral value ratios for the customer's secured debt have become the norm, such that value available to unsecured creditors is often minimal. Fortunately, unsecured creditors have a number of available strategies and "remedies" to be paid.

One such "remedy" is selling the pre-petition Chapter 11 claim to a claims purchaser, which can allow the creditor to monetise all or a portion of its claim, and avoid the vicissitudes of the Chapter 11 proceeding. The selling creditor may also have a tax deduction available and be able to remove the receivable from its balance sheet.

A recent New York case, *TRC Master Fund, LLC v. AP Gas & Electric (TX) LLC*, highlighted



*Electric (TX) LLC*, highlighted pitfalls of selling Chapter 11 arising from the claims sale contract.

## Claims trading market

The claims trading market is an industry unto itself. In 2018, there were nearly 8,000 claims traded, with a dollar value approaching \$45 billion. The buyers and sellers include investment banks, hedge funds, independent broker-dealers, corporations, pension funds and insurance companies. The bulk of the claims trades have values of \$250,000 or less.

Buyers' motivations to purchase claims range from a buy low, sell high strategy (buy below par from a motivated seller and receive a higher Chapter 11 distribution) to a strategic investment in the Chapter 11 debtor's capital structure, to acquire an equity stake in the reorganised debtor or otherwise impact the Chapter 11 proceeding. The Chapter 11 Plan "distribution" to unsecured creditors is often equity in the reorganised debtor. In fact, a

number of significant merger and acquisition transactions have occurred in Chapter 11. In 2003, Wilber Ross acquired Burlington Industries, Inc. and Eddie Lampert's ESL Investments acquired Kmart after purchasing a significant number of unsecured claims and bank debt before and during the Chapter 11 proceedings. Such purchased debt allowed Ross and Lampert to acquire controlling equity positions. In *Pacific Western Bank, et al. v. Fagerdala USA-Lompoc, Inc.*, 891 F.3d 848 (9th Cir. 2018), the 9th Circuit U.S. Court of Appeals allowed a creditor to use purchased claims to block the vote in order to confirm a Chapter 11 plan.

## The court ruling

In *TRC Master Fund, LLC v. AP Gas & Electric (TX) LLC*, a New York state appellate court ruled that the seller's claim was impaired and pursuant to the sales contract, the buyer could sue the seller for the return of the purchase price plus interest at 10%. The buyer seeks repayment



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of almost \$250,000 plus interest and attorneys' fees.

In AP Gas, and as is customary in most claim sales, the buyer and seller were parties to the buyer's standard assignment of claim agreement. Typical of such agreements, the AP Gas contract had a repurchase provision:

- Assignee does not ... assume the risk that all or any part of the claim ... is ... objected to ... or impaired in any way ... (an "Impairment").
- Assignor agrees to immediately repay, upon demand of Assignee ... an amount equal to the ... amount subject to Impairment ..., plus interest thereon at 10% per annum.

The Chapter 7 trustee objected to the claim, and the buyer demanded repayment as the claim was impaired. The creditor refused and the buyer filed suit. The creditor filed a motion to dismiss because the claim objection was withdrawn 37 days after it was filed. The New York Appellate Court denied the creditor's motion to dismiss, and the suit against the creditor will proceed.

Likely, after the claim was purchased, the debtor converted to a Chapter 7 liquidation, rendering the claim worthless, which motivated the buyer to undo the purchase.

The AP Gas contract also provided that the seller was obligated to pay the buyer's attorneys' fees in enforcing its rights under the contract. In addition, the contract provided that New York law applied and any disputes would be resolved in New York courts. AP Gas is based in Texas, and the Chapter 7 case was in Texas. Because of the assignment contract, however, the seller/creditor was sued in New York.

### Additional considerations

#### *Seller's due diligence*

Prior to any sale, the seller of a

claim should undertake internal due diligence to verify the validity of its claim and that the underlying documentation supporting the claim is in order. Sellers should also understand the dynamics of the Chapter 11 proceedings as well as the identity and motivations of the buyer.

In AP Gas, with the one-sided claim assignment agreement, there was little downside to the buyer in purchasing the claim. It effectively had a "put" option for the claim if it was impaired.

#### *Seller's cooperation obligations*

Another provision in a typical claim assignment contract is the "cooperation" provision that obligates the seller to assist the buyer in realising on the claim. For example, the AP Gas agreement provided:

- Assignor agrees to execute, acknowledge and deliver ... all such further instruments and other documents, and to take all such further action as may be necessary or appropriate to affect assignment of the Claim and all interests therein to Assignee, to fully assist Assignee in enforcing the Claim and to otherwise effectuate the intent of this Assignment.

#### *Negotiate the terms*

If the sale occurs to a "buy low, sell high" buyer, a motivated seller may have limited leverage to negotiate the key terms of the buyer's form contract. When buyers are purchasing blocks of claims for strategic reasons as indicated above, buyers are more willing to negotiate key terms.

Sellers should negotiate the terms of the assignment contract, including to limit the impairment provision, the seller's "cooperation" obligations, and the interest and attorneys' fees. A different venue may also be more favourable to the seller.

#### *Scheduled claims*

Generally, buyers will only agree to purchase a claim for the amount listed in the debtor's schedules of assets and liabilities,

and provided the claim is not listed as "contingent, unliquidated or disputed", even if the seller has filed a proof of claim.

We have also seen cases where credit insurers have applied the same standard before paying on an insurance claim, even though such standard is not consistent with the terms of the insurance policy.

#### *The price*

The purchase price for claims offered by buyers can vary materially. We maintain working relationships with the major claims purchasers and in essence submit RFPs to a number of potential buyers to insure the highest possible purchase price. The "market" price often fluctuates during the course of the Chapter 11 proceeding.

If a seller has options, a motivated buyer may also be more willing to negotiate the terms of the agreement.

#### *Claim priority*

Claims buyers generally offer different amounts for general unsecured claims and administrative claims (which have a higher priority in payment under the Bankruptcy Code). Administrative priority claims can arise from post-petition sales, or under Section 503(b)(9), which grants an administrative priority claim for goods delivered to and received by the debtor within 20 days prior to its Chapter 11 filing.

### Takeaways

Creditors holding claims against Chapter 11 debtors should consider the claims trading market as an opportunity to monetise their claims. In doing so, creditors should acknowledge the dynamics of the market and the potential pitfalls arising from the Chapter 11 case involved, the buyer and the claims assignment contract. ■



## CREDITORS SHOULD ACKNOWLEDGE THE DYNAMICS OF THE MARKET AND THE POTENTIAL PITFALLS ARISING FROM THE CHAPTER 11 CASE INVOLVED

