

SELLING BANKRUPTCY CLAIMS: GETTING IN ON CASHING OUT

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Many businesses view claims against customers in bankruptcy more as liabilities than as assets: entitlements of uncertain value to be paid, if at all, in an indefinite number of installments over an unknown period of time.

However, many investment firms do treat bankruptcy claims as assets, for which they are willing to pay cash. "Vulture funds" purchase millions – even billions – of dollars in bankruptcy claims from creditors at a portion of their face value, in anticipation of influencing the outcome of the bankruptcy case or of a higher distribution – in cash or in equity of the reorganized debtor – at the end of the case. While such funds seek to leave as much risk as possible with the creditor-seller, they are often willing to negotiate on several issues. Here are some important points to consider and watch for:

Don't Be Afraid to Shop Around: If one purchaser wants to buy your claim, chances are that several others are also in the market. You may receive multiple cold calls and at any time (even late in a case, after a debtor has begun making distributions on your claim); your industry colleagues, your financial advisors, and your lawyer may also know of opportunities for the sale of a bankruptcy claim.

Exactly What Is the Buyer Offering to Buy?: Claim purchasers typically limit their risk by offering to purchase, up front, only those claims that are least likely to be challenged by the debtor. While creditors are often owed more than the debtor acknowledges in the schedules of liabilities filed with the court, claim buyers will usually pay immediately only for a claim that is listed as undisputed in those schedules or that has been allowed (*i.e.*, recognized as valid) by court order. Purchase agreements often provide that, if a purchased claim of one amount is later

allowed in a higher amount, the buyer may, at its option, purchase that excess amount at the same percentage rate it paid for the initial amount.

When Does the Buyer Pay?: Oddly, most purchase agreements omit one important provision: a date certain by which the buyer must pay for the claim being sold. It is usually possible to negotiate a requirement that payment be made within some specified time period, *e.g.*, three business days from the execution of the purchase agreement.

Does the Seller Get to Keep All of the Buyer's Payment?: Claim buyers also manage risk by requiring claim sellers to refund – with interest – a portion of the purchase price paid by the buyer, if the claim the buyer bought is reduced or attacked in any way. The refund is proportionate to the amount of the claim reduced – *e.g.*, if the claim is cut in half, the seller must refund half the purchase price.

Typically, claim purchase agreements provide that a refund will be due, not only if the purchased claim is reduced, but also if it is objected to or otherwise challenged, even though the objection may later be resolved in the claim seller's favor. This means that the seller might have to refund money to the buyer, with interest, when an objection is filed, only to resolve the objection and receive some of that money back again (but without the interest). To address this problem, the seller may (a) ask that no refund be due until the court issues a final order reducing the claim or (b) ask for a "defense period," during which time the seller will attempt to resolve the objection and the buyer will not seek a refund.

How Broad Are the Representations the Seller Must Make Regarding the Claim?: The buyer typically asks the claimant-seller to promise that numerous assertions about the nature of the claim and the claimant's relations with the debtor are true. Because the seller's monetary

obligations to the buyer are triggered by breach of these representations, creditor-sellers should consider each proposed representation carefully to be sure it is accurate.

Buyers will almost always insist on a statement that the claim is (in typical language) a "valid, liquidated, and undisputed obligation of the debtor not subject to offset, reduction, or objection". However, be careful of representations like these:

– *No liens on the claims to be sold:* If the seller has a lender with a lien on accounts receivable, the bankruptcy claims may be subject to that lien; the buyer will want a lien release from the lender.

– *Seller does not owe the debtor money or have possession of any of the debtor's property:* If the debtor holds a claim that might be offset against what the debtor owes the claim seller (*e.g.*, a claim for a refund from the seller), or if the seller has custody of the debtor's property (*e.g.*, special tooling used in making product for the debtor), this representation must be conformed to reflect those facts.

– *Seller received no payments from the debtor during the 90 days before the commencement of the debtor's bankruptcy case:* The Bankruptcy Code's preference statute (11 U.S.C. §547) allows a debtor to recover certain amounts paid to creditors during the 90 days before the bankruptcy case was filed. A creditor's claim may be disallowed until the creditor repays such amounts.

Buyers of claims want to know if this is a risk.

How Broad Is the Seller's Obligation to Indemnify the Buyer for Its Losses, including Attorneys' Fees?: In addition to requiring refunds, purchase agreements also require the claim seller to indemnify the buyer for losses resulting from breach of the seller's representations.

Usually quite broad, these provisions can be read to require a seller to pay the buyer for *any* damages, however unforeseeable, that the buyer might sustain to its own business as a result of the disallowance of the purchased claim, as well as for any actions the buyer's attorneys might choose to take in the bankruptcy case, including basic tasks like reviewing objections and monitoring the proceedings.

Because the refund obligation places on the seller the financial risk of a claim's reduction, the seller, not the buyer, should determine whether to incur the costs of defending an objection to the claim. It may be possible to negotiate documents that give the seller the right to defend a claim free of any obligation to indemnify the buyer for duplicating that effort and that otherwise reasonably limit the seller's indemnification obligations, including by excluding damages that arise only indirectly from the reduction of the claim.

While it can be a quick way of cashing out of a bankruptcy case, selling claims is not without risks, some of which are not obvious. An insolvency professional with experience in claims trading can help you navigate the pitfalls in these transactions.