



Bankruptcy Claims Trading: Basic Concepts

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This Note provides an overview of the bankruptcy claims trading market, including a discussion of the relevant statutory provisions governing claims trading, the risks involved, claims trading agreements and practice tips for buyers and sellers of bankruptcy claims.

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Bankruptcy claims trading generally involves the buying and selling of claims against companies seeking relief under the Bankruptcy Code. In 2012, investors traded bankruptcy claims totaling more than \$41 billion, despite a decrease in large corporate Chapter 11 filings that year. This Note discusses:

- The claims trading market.
- The laws governing claims trading.
- The risks involved with claims trading.
- A typical claims trading timeline.
- Claims trading agreements.

It also includes practice tips for buyers and sellers of bankruptcy claims.

THE CLAIMS TRADING MARKET

Under the Bankruptcy Code, a "claim" is broadly defined as a "right to payment," whether liquidated or unliquidated, fixed or contingent, matured or unmatured, disputed or undisputed, legal or equitable or secured or unsecured (§ 101(5), *Bankruptcy Code*). In theory, then, any "right to payment" against a debtor could be sold (meaning, subject to a claims trade).

In practice, however, the vast majority of the multi-billion dollar claims trading market centers on those claims which are, at least to some degree, liquidated and undisputed. By centering on these sorts of claims (for example, bond claims or liquidated trade vendor claims), both parties to a claims trade can avoid unnecessary entanglements with the bankruptcy claims objection process, allowing the parties to trade claims based solely on the perceived value of the distributions made on account of those claims in connection with the debtor's case.

Types of Bankruptcy Claims

Buyers and sellers trade the following types of bankruptcy claims:

- **Secured claims.** Secured claims are obligations of the debtor subject to a perfected lien on collateral. They are paid based

on the value of the collateral because the Bankruptcy Code only treats a claim as secured up to the value of the collateral securing it, while treating any residual amount as unsecured (§ 506(a), *Bankruptcy Code*). Secured claims are not often traded because a collateral valuation may require an appraisal or other expert analysis, and because secured claims do not represent the same opportunity for arbitrage and control as do unsecured claims.

- **Trade claims.** Trade claims are unsecured obligations of the debtor. Traditional trade claims are held by the debtor's vendors, suppliers and service providers. However, trade claims may also include claims held by other parties, such as landlords, lawyers, unions and employees, as well as claims for damages resulting from the debtor's rejection of executory contracts. Trade claims are either:
 - general unsecured claims, which are the last to be paid (see *Practice Note, Order of Distribution in Bankruptcy: General Unsecured Claims* (<http://us.practicallaw.com/7-383-1336>));
 - priority claims, which must be paid in full as a condition to confirmation of a plan of reorganization, subject only to waiver by the affected creditor (for example, administrative expenses of the bankruptcy proceeding, employee wage claims and various prepetition tax claims) (see *Practice Note, Order of Distribution in Bankruptcy: Priority Claims* (<http://us.practicallaw.com/7-383-1336>)); or
 - unsecured claims with de facto priority (for example, reclamation claims, section 503(b)(9) administrative claims and lease assumption cure claims) (see *Practice Note, Order of Distribution in Bankruptcy: De Facto Priorities* (<http://us.practicallaw.com/7-383-1336>)).
- **Counterparty claims.** Counterparty claims are claims that result from financial transactions in which the non-debtor party was "in the money" at the time of the debtor's bankruptcy (for example, swap termination claims, prime brokerage claims, repurchase agreement counterparty claims and commodity hedging counterparty claims).

Market Participants

The claims trading market is not limited to traditional buy and hold investors. Instead, particularly in large Chapter 11 cases, claims are often traded and re-traded many times by large scale market players and would-be arbitrageurs, either as part of a buy low, sell high strategy, or as part of a larger strategic effort to exercise control in a debtor's case.

These parties typically participate as both buyers and sellers of bankruptcy claims:

- Trading divisions of investment banks.
- Hedge funds.
- Independent broker-dealers.

In addition, these parties typically participate only as sellers of bankruptcy claims:

- Corporations.
- Pension funds.
- Insurance companies.
- Re-insurers.
- Loan portfolio divisions of investment banks.

Buyer's Perspective

From the buyer's perspective, claims trading offers the opportunity to reap the benefit of any distributions in the debtor's case above the price paid to the seller, along with the right to vote on the debtor's plan of reorganization and participate more generally in the debtor's case. Buying bankruptcy claims may also provide opportunities to:

- Acquire equity in the reorganized debtor.
- Strategically invest in the debtor's capital structure.
- Acquire undervalued claims sold by motivated sellers who are not able to or interested in holding post-reorganization equity (for example, smaller companies that cannot wait until the end of the case to receive their distributions for cash flow reasons, or who are unwilling to tolerate the risk that the distribution may be smaller than expected).
- Obtain and assert leverage in a bankruptcy case.

Seller's Perspective

From a seller's standpoint, claims trading offers a minimum level of return in the bankruptcy case. By selling bankruptcy claims, sellers can also:

- Avoid the risk of a delayed recovery, as bankruptcy cases often take years to be resolved.
- Obtain a tax deduction, if the claim is sold for a loss.
- Avoid volatility, as the value of claims often fluctuates significantly over the course of a case.
- Remove a receivable from their balance sheets.
- Reduce:
 - the legal expenses involved with evaluating, filing and

potentially litigating a claim; and

- the general costs of participating in the time-consuming bankruptcy process.

When Bankruptcy Claims are Traded

Bankruptcy claims are traded at all stages of a debtor's Chapter 11 case (see *Practice Note, Bankruptcy: Overview of the Chapter 11 Process: Stages of a Typical Freefall Chapter 11 Case* (<http://us.practicallaw.com/4-380-9186>)). Depending on the particular facts of the case and the likelihood of a recovery for creditors, claims trading may begin as soon as the bankruptcy petition is filed and may continue until final distributions are made, well after plan confirmation.

Prices for claims against a debtor can vary wildly depending on events transpiring within the case itself. These events may include:

- A successful sale of assets (see *Practice Note, Buying Assets in a Section 363 Bankruptcy Sale: Overview* (<http://us.practicallaw.com/1-385-0115>)).
- Resolution of contested litigation.
- The filing of a plan of reorganization or liquidation (see *Practice Note, Chapter 11 Plan Process: Overview* (<http://us.practicallaw.com/0-502-7396>)).

Changes in the debtor's industry more broadly can also affect the price of claims. These changes may include:

- Commodity prices.
- Foreign competition.
- Regulatory issues.
- Broader economic factors.

How Bankruptcy Claims are Traded

Bankruptcy claims are typically traded under a claims purchase agreement, assignment of claim agreement, or purchase and sale agreement (see *Claims Trading Agreements*). There is no single industry standard form of agreement, but most agreements contain standard provisions, which are more or less negotiable depending on:

- The size and nature of the claim.
- The relationship between the buyer and the seller.
- The price being paid for the claim.

LAWS GOVERNING CLAIMS TRADING

Generally Applicable Statutory Provisions

Several sections of the Bankruptcy Code and several of the Federal Rules of Bankruptcy Procedure (Bankruptcy Rules) are relevant to all buyers and sellers of bankruptcy claims. These concern:

- Filing transfer notices and proofs of claim (see *Bankruptcy Rule 3001(e)(1)*, *Bankruptcy Rule 3001(e)(2)*, *Bankruptcy Rule 3001(e)(3)* and *Bankruptcy Rule 3001(e)(4)*).

- Disallowance of claims (see *Section 502(d) of the Bankruptcy Code*).
- Equitable subordination of claims (see *Section 510(c) of the Bankruptcy Code*).

Bankruptcy Rule 3001(e)(1)

Bankruptcy Rule 3001(e)(1) provides that if a proof of claim has not been filed before the time of the transfer, then the buyer may file a proof of claim if the claim has been transferred other than for security (*Fed. R. Bankr. P. 3001(e)(1)*). A claim is "transferred other than for security" if it is not transferred for the purpose of providing collateral.

The buyer should file a proof of claim as soon as possible. Proofs of claim in Chapter 11 cases must be filed before a court-established bar date to be allowed. The buyer will want to make certain that the bar date has not passed before it purchases a claim.

For more information on filing a proof of claim, see *Practice Note, Filing a Proof of Claim in a Chapter 11 Bankruptcy Case* (<http://us.practicallaw.com/8-385-1512>).

Bankruptcy Rule 3001(e)(2)

Bankruptcy Rule 3001(e)(2) provides that if a claim, other than one based on a publicly traded note, bond or debenture, has been transferred other than for security **after** a proof of claim has been filed, the buyer must file evidence of the transfer (*Fed. R. Bankr. P. 3001(e)(2)*). Once the evidence has been filed, the court clerk will notify the seller by mail of the filing and the seller then has 21 days after the mailing of the notice to object. The court will hold a hearing if the seller files a timely objection. If the court finds that the claim has been transferred other than for security, it will enter an order substituting the buyer for the seller as the new owner of the claim on the books and records of the bankruptcy court. If the seller does not file an objection, the buyer is automatically substituted for the seller.

This Bankruptcy Rule is rarely applicable to the seller unless there is some issue involving the legitimacy of the transfer of the claim by the seller to the buyer. The seller typically waives the 21-day notice period and the right to object in the claims purchase agreement, so objections to claim transfers are uncommon.

Bankruptcy Rule 3001(e)(3)

Bankruptcy Rule 3001(e)(3) applies when the claim is based on a publicly traded note, bond or debenture that is transferred for security **before** a proof of claim has been filed (*Fed. R. Bankr. P. 3001(e)(3)*). A claim is "transferred for security" if it is transferred for the purpose of providing collateral.

Bankruptcy Rule 3001(e)(3) is similar to Bankruptcy Rule 3001(e)(1), except that either the seller or the buyer, or both, can file the proof of claim for the full amount (see *Fed. R. Bankr. P. 3001(e)(1)*). The proof of claim must be supported by a statement setting out the terms of the transfer.

This Bankruptcy Rule is usually inapplicable because most claims

are bought and sold outright and it is relatively rare to see claims transferred as collateral.

Bankruptcy Rule 3001(e)(4)

Bankruptcy Rule 3001(e)(4) governs claims based on a publicly traded note, bond or debenture that is transferred for security **after** a proof of claim has been filed (*Fed. R. Bankr. P. 3001(e)(4)*).

Bankruptcy Rule 3001(e)(4) is similar to Bankruptcy Rule 3001(e)(2) (see *Bankruptcy Rule 3001(e)(2)*).

This Bankruptcy Rule is usually inapplicable because most claims are bought and sold outright and it is relatively rare to see claims transferred as collateral.

Bankruptcy Rule 3001(e) Practice Tips

Concerning Bankruptcy Rule 3001(e):

- The buyer should:
 - obtain an express representation from the seller on whether a proof of claim has been filed (see *Sellers' Negotiated Representations*);
 - get copies of all filed documents relating to the claim; and
 - check the claims docket to verify the accuracy of the representation.
- If no proof of claim has been filed before the claim transfer, the buyer should file a proof of claim as soon as possible to avoid any issue of a missed bar date.
- If a proof of claim has been filed before the claim transfer, the buyer should file evidence of the transfer as soon as possible to allow the objection period to run. Filing evidence of the transfer will also ensure that notices concerning the claim, such as an objection to the allowance of the claim, and payments on the claim go directly to the buyer.
- Effective May 1, 2013, bankruptcy courts collect a \$25 fee for the filing evidence of the transfer of a claim. If multiple claims transfers are filed at one time by one entity, the \$25 fee is charged for each individual transaction. This fee applies to any transfer of a claim that is filed, whether it is a partial transfer of the claim or a transfer of the entire amount of the claim.

Section 502(d) of the Bankruptcy Code

Section 502(d) of the Bankruptcy Code provides for the disallowance of a claim to the extent the holder of the claim retains property recoverable under the avoidance provisions of the Bankruptcy Code, even if the claim is entirely unrelated to the avoidance action (§ 502(d), *Bankruptcy Code*). This section becomes relevant if the buyer or seller has been the recipient of a preference, fraudulent conveyance or some other avoidance action. In short, no distribution will be made on the claim if the debtor or trustee has a cause of action for an avoidance claim. The existence of that cause of action will usually result in a demand from the buyer to the seller that the seller refund the purchase price paid for the claim with interest from the date of purchase (see *Disallowance and Impairment of Claims*).

For more information on avoidance actions, see *Practice Notes, Preferential Transfers: Overview and Strategies for Lenders* (<http://us.practicallaw.com/6-381-6416>) and *Other Creditors and Fraudulent Conveyances in Bankruptcy: Overview* (<http://us.practicallaw.com/4-382-1268>).

Section 502(d) Practice Tips

A seller should be wary of selling its claims if it knows that it has exposure for an avoidance action, such as a preference, because that exposure is likely to trigger a future indemnification claim by the buyer and may defeat the purpose of selling the claim (see *Indemnity*).

A buyer should:

- Conduct thorough due diligence on the claims it wishes to purchase, to:
 - confirm whether there is any pending litigation between the debtor and the claims seller; and
 - to see whether the seller is readily identifiable as a target of avoidance litigation (by, for instance, reviewing the debtor's statement of financial affairs, which identifies all entities that received payments from the debtor during the 90 days before the bankruptcy filing).
- Obtain:
 - a preference risk representation from the seller that it did not receive payments from the debtor within 90 days before the filing of the bankruptcy petition (see *Sellers' Negotiated Representations and Practice Tips*); and
 - indemnification from the seller for breach of this representation (see *Indemnity*).
- Factor the risk of disallowance into the price of the purchased claims.
- Consider characterizing the claims trade as a "purchase and sale" rather than as an "assignment" if the purchase agreement is governed under New York law (see *In re Enron Corp.*, 379 B.R. 425, 442 (S.D.N.Y. 2007) (stating "[w]here a claimant has purchased its claim, as opposed to receiving it by assignment, operation of law, or subrogation, assignment law principles have no application with respect to personal disabilities of claimants. Thus, purchasers are protected from being subject to the personal disabilities of their sellers")). However, if the purchase agreement is governed under Delaware law and is for the sale of a trade claim, this distinction may not make a difference (see *In re KB Toys, Inc.*, 470 B.R. 331, 342-43 (Bankr. D. Del. 2012) and also see *Legal Update, In re KB Toys: Disabilities Accompany a Transferred Trade Claim* (<http://us.practicallaw.com/8-519-5833>)).

Section 510(c) of the Bankruptcy Code

Section 510(c) of the Bankruptcy Code provides for the equitable subordination of a claim to the claims of other claimants if the claimant was found to have engaged in inequitable conduct (§ 510(c), *Bankruptcy Code*). Therefore, if the seller engaged in inequitable conduct, the claim may be equitably subordinated,

even in the hands of the buyer.

For more information on equitable subordination, see *Practice Note, Lenders Beware: The Risk of Equitable Subordination in Bankruptcy* (<http://us.practicallaw.com/4-386-2555>).

Section 510(c) Practice Tips

A seller should be wary of selling its claim if it knows that it has exposure for an equitable subordination claim, since that exposure is likely to trigger a future indemnification claim by the buyer and may defeat the purpose of selling the claim (see *Indemnity*).

A buyer should:

- Conduct thorough due diligence on the claims it wishes to purchase.
- Obtain:
 - representations from the seller that it has not engaged in the kind of conduct that would lead to the disallowance or subordination of the claim (see *Sellers' Representations*); and
 - indemnification from the seller for breach of this representation (see *Indemnity*).
- Factor the risk of equitable subordination into the price of the purchased claims.
- Consider characterizing the claims trade as a "purchase and sale" rather than as an "assignment" if the purchase agreement is governed under New York law (see *In re Enron Corp.*, 379 B.R. at 442 and *Section 502(d) Practice Tips*).

Other Applicable Statutory Provisions

There may be additional Bankruptcy Rules and Bankruptcy Code sections that become relevant in certain cases where the buyer is either:

- Seeking to take control of the debtor.
- A sponsor or proponent of a Chapter 11 plan.
- A member of a group or committee.

These concern:

- Disclosure of certain information by groups, committees and entities that consist of or represent more than one creditor in a bankruptcy case (see *Bankruptcy Rule 2019*).
- Disqualification of votes on a plan of reorganization cast, solicited or procured in bad faith (see *Section 1126(e) of the Bankruptcy Code*).

Bankruptcy Rule 2019

Bankruptcy Rule 2019 requires certain entities that are members of groups or committees to disclose their identities and nature of their claims against the debtor. It does not require a claims purchaser in its capacity to make this disclosure (*Fed. R. Bankr. P. 2019*). However, if the claims purchaser joins an ad hoc committee, an official committee or a group or committee "acting in concert to advance their common interests," it may be subject to disclose certain information under Rule 2019.

For more information on Rule 2019, see *Practice Note, Disclosure Under Bankruptcy Rule 2019* (<http://us.practicallaw.com/8-502-1885>).

Section 1126(e) of the Bankruptcy Code

Section 1126(e) of the Bankruptcy Code provides that a claim, potentially including a claim acquired for the express purpose of blocking confirmation of a plan, can be designated or, in other words, excluded from the plan voting process when it is voted other than "in good faith" (§ 1126(e), *Bankruptcy Code* and see *Legal Updates, Second Circuit Delivers Opinion in DBSD North America, Inc.* (<http://us.practicallaw.com/9-504-7371>) and *SDNY Upholds Bankruptcy Court's Decision That Upset Dish Network's Loan-to-Own Strategy* (<http://us.practicallaw.com/9-501-9882>)).

For more information on vote designation, see *Practice Note, Disenfranchising Creditors: Designating Votes on Chapter 11 Plans* (<http://us.practicallaw.com/9-505-4074>).

Section 1126(e) Practice Tip

The seller should not indemnify the buyer against actions that the buyer may take in connection with the Chapter 11 plan process, including, specifically, whether the buyer's vote is allowed (see *Buyers' Risks* and *Indemnity*).

CLAIMS TRADING RISKS

There are many risks involved with claims trading. Distressed investors actively trading in bankruptcy claims should consider these legal risks inherent to participating in this market:

- The requirement to disclose sensitive information under Rule 2019 may be triggered, if the trader joins a group or committee (see *Bankruptcy Rule 2019*).
- Although the court's decision in *In re Washington Mutual, Inc.* was partially vacated, traders that acquire a blocking position regarding a plan of reorganization risk being deemed temporary insiders owing fiduciary duties to other members of their class and having their claims equitably disallowed (see *461 B.R. 200 (Bankr. D. Del. 2011)*, vacated in part by *No. 08-12229, 2012 WL 1563880 (Bankr. D. Del. Feb. 24, 2012)* and see also *Legal Update, WaMu Bankruptcy Court Holds Hedge Fund Creditors May be Insiders* (<http://us.practicallaw.com/3-508-3965>)).

There are also risks that must be allocated between buyers and sellers in the claims purchase agreement concerning the specific claim being traded (see *Buyers' Risks* and *Sellers' Risks*).

Buyers' Risks

It is typical market practice for buyers to retain:

- General economic risk.
- The risk of the ultimate recovery to creditors in the specific case. For example, this may include:
 - the treatment of the claim under the plan;

- the risk of a delayed recovery if a plan cannot be easily confirmed; or
- the risk that recovery to creditors may be diluted if the debtors' estates are substantively consolidated (see *Practice Note, Substantive Consolidation in Bankruptcy* (<http://us.practicallaw.com/7-521-6812>)).

For various reasons, bankruptcy claims often only recover a fraction of their allowed value.

- The risk that the court may designate their votes on the plan based on their own conduct (see *Section 1126(e) of the Bankruptcy Code*).

Sellers' Risks

Sellers usually retain the risk that the claim will differ from how it was described in the claims purchase agreement. Specifically, sellers usually retain the risk that the claim will be:

- **Disallowed.** A claim may be disallowed, in whole or in part, if the debtor can successfully object to the claim (see *Practice Note, Filing a Proof of Claim in a Chapter 11 Bankruptcy Case: Objections to Claims* (<http://us.practicallaw.com/8-385-1512>)). This may be because the seller was the recipient of a preference, fraudulent conveyance or some other voidable transfer (see *Section 502(d) of the Bankruptcy Code*), or because the claim is simply not valid. The seller often agrees to refund the purchase price (or a pro rata portion of the purchase price commensurate with the portion of the claim that was disallowed) with interest if the claim is disallowed (see *Disallowance and Impairment of Claims*).
- **Impaired.** Whether or not a claim is impaired, in whole or in part, depends on how the claims purchase agreement defines impairment. For example, a claim may be impaired if it is reduced or objected to and the objection is not resolved within a specified period of time (see *Disallowance and Impairment of Claims*). This can affect the timing of when the seller's obligation to pay is triggered.
- **Equitably subordinated.** If the seller engaged in inequitable conduct, the claim may be equitably subordinated (see *Section 510(c) of the Bankruptcy Code*).

Practice Tip: Sellers' Risks

While sellers typically retain the risk that the claim is not as described, buyers should still perform due diligence on the claims they wish to purchase. However, less diligence is necessary if the claim is formally allowed before purchase, although it should still be performed because of the risk that the claim may be reconsidered. Claims are deemed allowed if a proof of claim has been filed, unless a party in interest objects. A claim that is listed on the debtor's schedules as undisputed, noncontingent and liquidated is also deemed allowed unless a party in interest objects.

Other Risks

The parties should also consider the following other types of risks and how to allocate them in the claims purchase agreement:

- **Counterparty credit risk.** The potential insolvency of:
 - the buyer creates a credit risk for the seller if a portion of the purchase price is deferred (see *Buyers' Covenants*); or
 - the seller creates a credit risk for the buyer if the indemnity is triggered (see *Indemnity*) or if the seller is required to refund the purchase price with interest if the claim is disallowed (see *Disallowance and Impairment of Claims*).
- **Treatment of NOLs in trading orders.** Net operating losses (NOLs) can be offset against taxable gains of a debtor once it emerges from bankruptcy. NOLs can represent significant assets of a debtor's estate. However, a change of control of a certain amount of a debtor's equity can result in the debtor losing the ability to carry forward net operating losses. A change of control may be triggered by a transfer of equity or claims that can be exchanged for equity under a plan of reorganization.

To help prevent this, a bankruptcy court can enter a trading order containing filing and notice requirements, which allows the debtor the opportunity to object to the proposed transfer of the claim (see *Claims Trading Orders*). Failure to comply with the requirements of a trading order can null and void the claim, and constitute a violation of the automatic stay (see *In re Mesa Air Group, Inc., No. 10-10018, 2011 WL 182450 (Bankr. S.D.N.Y. Jan. 20, 2011)* and *Legal Update, Mesa Air Group Case Reminds Lenders to Comply with Claims Transfer Notice Requirements in Bankruptcy Cases* (<http://us.practicallaw.com/8-504-7220>)).

CLAIMS TRADING TIMELINE

After the buyer identifies a trade and performs the necessary business and legal due diligence on the claim and the seller selects the buyer, these steps typically occur:

- **Oral trade.** The parties orally agree on a purchase price and the terms of the deal.
- **Trade confirmation.** The buyer sends the seller a trade confirmation which contains a written record of the material terms of the sale (see *Trade Confirmations*).
- **Claims purchase agreement.** The parties negotiate the terms of the purchase agreement (see *Claims Trading Agreements*).
- **Closing.** The parties execute the purchase agreement and the buyer transfers funds to the seller.
- **Rule 3001(e) notice of transfer.** If the claim was traded after a proof of claim was filed, the buyer pays a \$25 filing fee and files evidence of the transfer on:
 - Form B210A, if the claim was transferred other than for security (see *Bankruptcy Rule 3001(e)(2)*); or
 - Form B210B, if the claim was transferred for security (see

Bankruptcy Rule 3001(e)(4)). However, this is not typical (see *Bankruptcy Rule 3001(e)(3)*).

- **Notice to seller.** If the claim was traded after a proof of claim was filed, the court clerk mails a notice of the transfer to the seller giving the seller 21 days to object to the sale, unless the seller waived this notice in the claims purchase agreement (see *Bankruptcy Rule 3001(e)(2)* and *Bankruptcy Rule 3001(e)(4)*).
- **Proof of claim.** Depending on the type of claim, the buyer or the seller can file a proof of claim, if one has not already been filed (see *Bankruptcy Rule 3001(e)(1)* and *Bankruptcy Rule 3001(e)(3)*).
- **Objections.** If the claim was traded after a proof of claim was filed, the seller has 21 days to object to the transfer, unless it waived this notice period (see *Bankruptcy Rule 3001(e)(2)* and *Bankruptcy Rule 3001(e)(4)*).
- **Administration of the claim.** This involves responding to objections to the claim and participating in any negotiations to settle the claim.

TRADE CONFIRMATIONS

The trade confirmation is typically prepared by the buyer. It contains a formal written record of the material terms of the sale agreed to by the parties, including:

- The debtor's name, case name and case number.
- A description of the claim and the amount and the claim number, if a proof of claim was filed.
- The percentage rate used to determine the purchase price. Typically the purchase price is stated as a percentage of the scheduled undisputed claim amount.
- Other specific terms of the trade.

The trade confirmation usually states that the sale is contingent on the execution of a claims purchase agreement that is acceptable to both parties (see *Claims Trading Agreements*). While active claim buyers often attach a draft of the claims purchase agreement to the trade confirmation, if the buyer does not submit it with the trade confirmation, sellers should request this document to review it for any non-negotiable objectionable terms that would prevent the transaction from closing.

Sellers should also be careful not to sign a trade confirmation that prevents them from marketing the claim to other potential buyers, if there is a risk that the transaction may not close.

CLAIMS TRADING AGREEMENTS

There is no single industry standard form of agreement used to document a claims trade. Documenting of the purchase and sale of claims usually takes the form of a claims purchase agreement, but can also take the form of an assignment of claim agreement or a purchase and sale agreement. However, buyers may be able to escape certain liabilities associated with the claim if the trade is characterized as a sale rather than as an assignment (see *Section 502(d) Practice Tips*).



The claims purchase agreement reflects a compromise between the parties concerning the allocation of risk of claim impairment and reduction (see *Claims Trading Risks*) and the allocation of control to settle the claim with the debtor (see *Defense of the Claim*).

Certain provisions within these agreements have become standard in the market (see *Standard Terms*), but others are heavily negotiated (see *Negotiable Terms*).

Standard Terms

Virtually all claims purchase or assignment agreements contain several standard terms.

Description of Claim and Transaction

Claims purchase or assignment agreements typically include:

- A description of the claim and its legal priority over other claims, if any (for example, a reclamation claim, a section 503(b)(9) administrative claim or a general unsecured claim).
- Seller's assignment or sale of the claim and related documents (for example, invoices) conditioned on payment of the purchase price.

Sellers' Standard Representations

Most of the seller's representations are usually heavily negotiated (see *Sellers' Negotiated Representations*), but sellers routinely represent that:

- The claim is valid and allowed in the full amount stated, and is not subject to any valid legal or equitable defenses.
- They are duly organized, validly existing and in good standing under the laws of the jurisdiction of their formation.
- They have the full power and authority to enter, deliver and perform their obligations under the purchase agreement.
- They have obtained all corporate and all other approvals required to enter, deliver and perform their obligations under the purchase agreement.
- No consents or approvals of any third party or governmental entity are required to enter, deliver or perform their obligations under the purchase agreement.
- The execution, delivery and performance of their obligations will not violate, conflict with, require consent under or result in any breach or default under their organizational documents, any applicable law or any of the provisions of any contract or agreement to which they are a party or to which any of their material assets are bound.
- The purchase agreement is legal, valid, binding and enforceable in accordance with its terms.

Sellers' Covenants

Sellers typically agree to:

- Cooperate by signing any additional documents that may be necessary to effectuate the transfer.

- Forward any notices, including any objections, they may receive concerning the assigned or sold claim.
- Hold in trust any distributions received regarding the claim pending delivery to the buyer in the same form received, typically within two to five business days.
- Defend the merits of the claim at their expense, but at the buyer's direction. Sellers may assign to buyers the right, but not the obligation, to defend or settle the claim (see *Defense of the Claim*).

Buyers' Representations

Buyers typically make the same standard representations made by sellers (see *Sellers' Standard Representations*).

Practice Tips: Buyers' Representations

In many buyer-friendly claims purchase agreements, buyers make no representations. However:

- Sellers should request at least these enforceability representations to ensure that:
 - the buyer has the contractual capacity and authority to enter into the agreement; and
 - the agreement is legally enforceable and complies with applicable law.
- If a portion of the purchase price is deferred, particularly if the delayed amount is large or secured, additional buyer representations may be appropriate (see *Buyers' Covenant to Pay the Purchase Price*).

Buyers' Standard Covenants

The primary covenant for buyers is their obligation to pay the purchase price, which is the primary consideration they are providing in connection with the deal (see *Buyers' Covenant to Pay the Purchase Price*).

Negotiable Terms

What can be negotiated is most often:

- A function of the purchase price.
- The relationship between the parties.
- The particular circumstances relating to the claim.

Sellers' Negotiated Representations

While sellers make routine enforceability representations (see *Sellers' Standard Representations*), many are heavily negotiated because they reflect the risks the seller assumes regarding the claim. This is particularly true for trade claims. The seller must indemnify the buyer for any misrepresentations the seller makes under the agreement (see *Indemnity*). In some cases, the seller may have no better information than the buyer concerning the representation, but as a matter of risk allocation, it typically assumes the risk that the representation proves to be false. For example, sellers may be asked to represent that:

- The amount of the claim is no less than as stated in the purchase agreement.

- There are no defenses or offsets to the allowance or payment of the claim (see *Practice Note, Filing a Proof of Claim in a Chapter 11 Bankruptcy Case: Objections to Claims* (<http://us.practicallaw.com/8-385-1512>)).
- They have not engaged in any conduct which would result in the claim not being paid or being paid proportionately less than other similarly situated creditors (see *Section 510(c) of the Bankruptcy Code*).
- The claim is valid, liquidated, not contingent or subordinated, and has not been previously assigned or hypothecated.
- No objection to the claim has been filed or threatened (see *Practice Note, Filing a Proof of Claim in a Chapter 11 Bankruptcy Case: Objections to Claims* (<http://us.practicallaw.com/8-385-1512>)).
- No payment has been made on the claim.
- A proof of claim has been timely filed (if this is the case) (see *Rule 3001(e) Practice Tips*).
- The claim is free and clear of any liens, claims or encumbrances.
- They did not receive any payments from the debtor within 90 days before the filing of the bankruptcy petition.

Practice Tips: Sellers' Negotiated Representations

Concerning the sellers' negotiated representations:

- Because of the risk that a claim may be impaired, buyers should insist on strong representations from the seller. This includes the preference risk representation in the last bullet, which is meant to protect the buyer from the effects of section 502(d) of the Bankruptcy Code (see *Section 502(d) of the Bankruptcy Code*). Sellers should seek to avoid making this representation for the same reason, or at least try to limit it to payments received only in connection with the claim they are selling.
- Sellers should seek to add a knowledge qualifier to their representations to minimize their indemnification obligations for unintentional misrepresentations (see *Indemnity*).
- Because sellers may be required to repurchase the claim if it is impaired or disallowed (see *Disallowance and Impairment of Claims*), sellers should seek to tie in the impairment provision with their representations concerning the claim so that they are consistent. Otherwise a narrow impairment provision can be circumvented by broad representations, as both provisions address the same risk.
- If a seller represents that the claim is free and clear of any encumbrances, it should ensure that if it has a lender with a lien on accounts receivables, including bankruptcy claims, that the lender releases this lien.
- Sellers, particularly broker-dealers, that flip claims should seek to limit their representations to the extent received from the previous seller.

Buyers' Covenant to Pay the Purchase Price

While it is standard for buyers to agree to pay the purchase

price (see *Buyers' Standard Covenants*), this covenant can be structured in various ways depending on whether the claim is listed as disputed or undisputed in the debtor's schedule of liabilities filed with the bankruptcy court. Some possibilities include requiring payment of:

- The full purchase price immediately after the parties execute the claims purchase agreement or within a specified number of business days after execution. Typically buyers agree to this only if the claim is listed as undisputed or if the claim has been allowed by the court.
- A percentage of the scheduled undisputed portion of the claim, deferring payment (or holding back) a portion of the purchase price until that portion of the claim is allowed by the court. The price for the newly allowed portion of the claim is usually based on the same percentage used to calculate the initial purchase price. Sellers typically seek to obligate the buyer to purchase this excess amount, while buyers tend to resist and prefer this to be optional. A similar situation may arise if the claim is increased.

Sometimes sellers seek compensation for delayed settlement, calculated either from the trade date or the settlement date. Such a clause would, in effect, require a claim buyer to pay a penalty if the closing of the sale (and payment of the purchase price) was unduly delayed for some reason beyond the seller's control. For instance, claims market makers will often attempt to line up flip trades that can be closed in rapid succession. As a result, they may be unwilling to close a trade with an upstream seller before their downstream buyer is ready to close. However, this is not standard practice. It must be negotiated at the time of the trade and documented in the trade confirmation (see *Trade Confirmations*).

Indemnity

A typical indemnity provision in a claims purchase agreement provides for the indemnification of the buyer for:

- Breaches of the seller's representations, warranties or covenants (see *Sellers' Standard Representations, Sellers' Negotiated Representations* and *Sellers' Covenants*).
- Attempts to disallow, reduce or subordinate the claim or claim amount.
- Disgorgement by the buyer of any amounts received regarding the claim.

While virtually all claims buyers insist on an indemnity, the existence and scope of the indemnity can sometimes be negotiated as a function of the purchase price paid for the claim.

Practice Tips: Indemnity

When negotiating an indemnity:

- If the seller retains the right to defend a claim, the indemnity should be drafted to exclude any defense costs incurred by the buyer that result from duplication of the seller's defense efforts (see *Defense of the Claim*).



- If buyer representations are included in the claims purchase agreement, the seller should seek indemnification from the buyer for any breach of these representations (see *Buyers' Representations*).

Disallowance and Impairment of Claims

Claims purchase agreements usually provide that, if the claim is disallowed for any reason, the seller must refund the purchase price and repurchase the disallowed claim, together with any interest on the amount of the purchase price from the purchase date through the repurchase date. If the claim is disallowed in part as opposed to being wholly objectionable or disallowed, the refund price may or may not be limited to the amount allocable to the portion that was disallowed.

These remedies may be available before the claim is actually disallowed if it is considered "impaired" under the claims purchase agreement. The scope of impairment is subject to negotiation. For example, buyers should seek to define impairment as broadly as possible to at least include:

- A pleading that reserves the debtor's right to object to the claim.
- The filing of any objection until it is resolved or that is not resolved within a specified period of time.
-
- The filing of a preference action or other avoidance action, against the buyer that seeks to disallow its claims (see *Section 502(d) of the Bankruptcy Code*).
- A final order reducing or disallowing the claim.
- A judgment on an alleged preference, or other avoidance action against the buyer to the extent it results in a disallowance of the claim.

Conversely, sellers should seek to define impairment as narrowly as possible so that, for example, a claim is not impaired until:

- The court enters a final order disallowing or reducing the claim.
- An alleged preference, or other avoidance action against the buyer, is reduced to judgment (see *Section 502(d) of the Bankruptcy Code*).

Practice Tips: Disallowance and Impairment of Claims

- Buyers should ensure that any triggers for the seller's recourse obligations are explicit, to avoid the time and expense of potential litigation against sellers who challenge these provisions (see *Longacre Master Fund, Ltd. v. ATS Automation Tooling Sys. Inc.*, No. 11-3413-cv, 2012 WL 4040176 (2d. Cir. Sept. 14, 2012) and *Legal Update, Longacre v. ATS: Reservation of Right to Object Sufficient for Claim Impairment* (<http://us.practicallaw.com/3-521-6423>)).
- Because the obligation to repurchase the claim, if any, may take several years to arise, sellers should seek a low interest rate, if not seek to eliminate it entirely.

Defense of the Claim

Because sellers typically bear the risk that the claim may be

disallowed, they have an interest in retaining the right to settle or defend the claim (see *Sellers' Risks*). Therefore, a seller may seek:

- The right to settle or defend the claim directly with the debtor.
- To limit the buyer's right to settle the claim without its prior written consent. Most claims purchase agreements provide for the seller to assign to the buyer the right, but not the obligation, to defend or settle any dispute regarding the claim.
- A period to resolve any objections to the claim, during which time the buyer agrees not to pursue any remedies.

Sellers either bear defense costs directly or indemnify buyers for these costs under the indemnification provisions in the claims purchase agreement (see *Indemnity*).

Practice Tip: Defense of the Claim

Sellers should ensure that they receive:

- Notice of any dispute concerning the claim.
- The opportunity to defend any objection or participate in any settlement regarding a dispute, as the outcome will affect the amount, if any, that the seller may be required to refund.

CLAIMS TRADING ORDERS

In many large chapter 11 cases, it has become customary to ask the court to enter, as part of the slate of first day motions, a trading order designed to preserve the debtor's ability to retain certain tax advantages, including NOL carryforwards that might otherwise be lost in the event of excessive amounts of claim trading. Such orders typically require the purchasers of multi-million dollar claim positions (the precise threshold will vary, but is typically substantial) to give notice of their intention to buy substantial positions before the claim trade becomes effective to allow the debtor and other parties in interest to object if they believe that the claim trade would have deleterious tax or other consequences. In cases where these orders have been entered, it is extremely important for claims buyers to be aware of their existence because a failure to comply with their provisions will generally result in the court's refusal to recognize the trade (see *Other Risks*).

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For more information, search for the following resources on our website.

Topics

- Bankruptcy
(<http://us.practicallaw.com/topic4-380-7408>)

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- Disclosure Under Bankruptcy Rule 2019
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- Disenfranchising Creditors: Designating Votes on Chapter 11 Plans
(<http://us.practicallaw.com/9-505-407>)
- Filing a Proof of Claim in a Chapter 11 Bankruptcy Case
(<http://us.practicallaw.com/8-385-1512>)
- Lenders Beware: The Risk of Equitable Subordination in Bankruptcy
(<http://us.practicallaw.com/4-386-2555>)

For the links to the documents referenced in this note, please visit our online version at <http://us.practicallaw.com/5-526-6247>

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