Not for the Unwary:
Claims Trading Strategies, Risks

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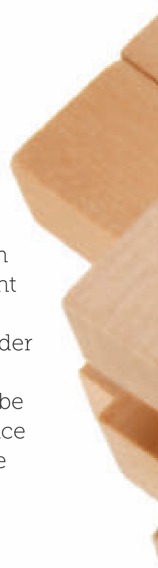

Investing in distressed debt is not a new phenomenon, and, in fact, it dates to colonial times, when speculators would purchase apparent high-risk debt with the intent of selling it at a higher redemption price. Distressed debt investing has continued through U.S. history but has skyrocketed over the last decade, creating one of the largest unregulated financial markets in the United States.

There are still financial speculators who buy distressed debt at a discount solely with the hope of getting paid a much higher rate of return. As years have passed, however, other reasons have developed to buy distressed debt, including to create leverage over an issuer to influence an asset sale or plan of reorganization. Investing in distressed debt often takes the form of claims trading, which carries certain risks that are not for the unwary. This article highlights some of the strategies used by claims traders as well as the potential risks to which they are exposed by their investments.

Threshold Issues for Basic Strategies

First, a potential claim buyer should understand the motivations of claim sellers. Sellers (small trade creditors and large institutions alike) are usually seeking quick liquidity, mitigation of further costs, and/or the avoidance of the risks attendant in bankruptcy cases (*i.e.*, potential disallowance, subordination, or a grossly delayed and de minimis, if any, distribution on a claim in the worst of bankruptcy cases, or a moderately delayed and quite uncertain potential recovery in the best of cases).

Interestingly, the universe of sellers has expanded over the years. While impatient trade vendors are often viewed as the typical sellers, as those least able to bear the uncertainties and burdens associated with delayed recoveries, increasingly, many traditional financial institutions and institutional investors, such as banks and insurance companies, have been quick to sell their claims as they, too, are forced to avoid speculation and look to the bottom line without delay.

Second, any potential investor should understand not only the universe of other potential claim purchasers but also their motivations and goals. There are two general types of investors: passive and active.

Passive investors often seek to obtain the difference between what they paid for the claim and what they think they may recover in the bankruptcy case.

Active investors come in several flavors, but all share in the strategy of using their investment to exert leverage over a debtor to create a higher rate of return. For example, some investors, often acting like lenders, may seek to obtain a blocking position in bankruptcy plan negotiations based on the total amount of acquired claims to leverage a more favorable treatment of their claims under a plan that will need their consent for success. Another active investor may be a competitor that is seeking to influence the debtor to sell assets (perhaps to the investor) or to liquidate to eliminate the competition. Hedge funds often are active investors that may want to see value generated from an asset sale, liquidation, debt-for-equity play, or some other strategic alternative.

One thing all active investors have in common is the desire to assert leverage in the bankruptcy process based on the face value of the claim(s) acquired, despite the discounted purchase price. In the end, the ultimate goal of these active investors is to buy a chair at the negotiation table to influence the case and to achieve optimal investment returns.

Distressed debt investors have numerous options and opportunities beyond the basic ones mentioned. For example, a distressed debt investor may seek to capture profits from (a) selling a whole claim, or a participation therein, to another creditor or third party at a premium (*i.e.,* flipping the claim during the bankruptcy case[1]), (b) participating in the reorganized entity, and/or (c) realizing a net gain across multiple levels (*e.g.,* a hedge fund that

buys claims at a steep discount while also "shorting" the debtor's stock[2]).

One issue for any distressed debt investor to consider is that a court may increase its scrutiny of a party that is a latecomer to the bankruptcy process. Anticipating this risk, an investor that has been focused on a distressed debtor may be able to purchase debt before the debtor files for bankruptcy protection. The market for distressed debt (including bank, bond, and trade debt) does not commence with the filing of the bankruptcy proceeding, but instead when the company is perceived to be insolvent or substantially stressed, which may occur months or more before a bankruptcy filing. A couple of hypotheticals help to illustrate.

Potential Risks, Other Considerations

HYPOTHETICAL 1 A buyer is considering purchasing a general unsecured claim of a vendor against the Acme Widget Company in the face amount of $500,000 shortly after the Chapter 11 case is filed.

Due Diligence. Before purchasing the claim, the buyer should ensure during its negotiations with the seller, to the extent possible, that the company will not dispute the subject claim (either in amount or entitlement) by obtaining from the seller all relevant documentation and support, as well as by conducting its own due diligence (including a review of bankruptcy documents, U.S. Securities and Exchange Commission filings, etc.). The buyer might consider structuring the transaction so that payment on any disputed portion is deferred until that portion of the claim is resolved favorably.

Some red flag factors that the buyer should watch for include:

- The claim is inconsistent with Acme's books and records (set forth, for example, in the filed schedules). The buyer should push the seller to fully explain the discrepancies. In some cases, it may be desirable/feasible for the buyer to push the seller to enter into a stipulation with Acme, which could also include the company's waiver of any potential avoidance actions.

- The buyer learns that the seller might have committed some questionable conduct, even conduct unrelated to the subject claim, that may lead to equitable subordination or other reduction or disallowance of the claim in the bankruptcy case. Some authorities suggest that assigned

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claims, in the assignee's hands, may be equitably subordinated under Bankruptcy Code § 510(c) based on the assignor's conduct.[3]

- The seller received a potentially avoidable prepetition transfer from the company. This is of concern because under 11 U.S.C. § 502(d), "the court shall disallow any claim of any entity from which property is recoverable under [among other sections] section … 550 … or that is a transferee of a transfer avoidable under section [among others] 544, … 547 [and] 548 [the avoidance action statutes]…, unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable under section … 550 …." Some courts have held that a claim in the hands of a claim buyer remains subject to § 502(d) disallowance because the original claimant had received a voidable transfer before transferring the claim and had not yet returned such money to the estate.[4]

While ideally avoiding claims marked by such red flags, the buyer could also negotiate for protective provisions in its agreement with the seller, including:

- A put option or similar unwinding provisions under which it could sell back the claim or a portion of it, including interest or other charges for the assignment period if certain defaults or other triggers occur, such as the seller's breach of representations, filing of a claim objection, disallowance/subordination of the claim, etc.
- Defense cost provisions under which the seller must pay to defend the claim and, relatedly, broad indemnification provisions in favor of the buyer
- Access provisions to enable the buyer to review the seller's records in connection with a claim objection.

Purchase Price. To determine the price to pay for a claim (typically a percentage of the claim's face amount), a buyer should analyze:

- The percentages of the claim that may be paid based on liquidation value and likely estimated distributions under a plan.
- The likely duration of the bankruptcy case until the claim is paid and the present value of the anticipated recovery.
- The buyer's desired profit margin, the cost of funds, and investment risk.

Again speaking hypothetically, assuming the recovery to the general unsecured creditors is estimated to be 40 percent and based on this analysis, an investor might be willing to pay 25 percent of the face value to purchase the claim today. From its perspective, the seller eliminates the uncertainty of payment and gains immediate liquidity. On the other hand, the buyer is betting that it will make 60 percent[5] on its investment. Of course, the actual rate of return depends on the accuracy of the factors analyzed, and therein lie the risks, since bankruptcy proceedings rarely are 100 percent predicable.

Conceivably, numerous problems could develop, including:

- A meltdown of the case, resulting in conversion to Chapter 7 and recoveries that are substantially less than expected.
- Delays in the sale/plan processes based on objections by interested parties that push back plan confirmation by a significant period of time, resulting in unexpected lost investment opportunity.
- Significant downward purchase price adjustments by a purchaser under an asset purchase agreement, resulting in many millions of dollars of the purchase price not being available to pay creditors.
- Preliminary claims estimates that were materially understated, greatly reducing the payout for the claim.
- The company taking an aggressive posture against the claim, jeopardizing and delaying for many months payment on account of the claim.

While anyone serious about purchasing claims in a bankruptcy case should analyze the possibility of such scenarios before deciding to buy a claim and determining its purchase price, no one has a crystal ball, so putting in place the protections described earlier is critical to minimizing a loss on investment.

HYPOTHETICAL 2 A buyer is considering purchasing a claim against a company that, under a plan, is hoping to convert substantially all of its valid debt into equity in a reorganized entity. Based on the company's business model, the buyer believes an equity stake in the reorganized company will be worth well over 80 percent of the claim's face amount in 18 months, and

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thus, for this and other reasons, the buyer pays 40 cents on the dollar for a $500,000 claim.

In addition to performing the due diligence discussed earlier, any investor must analyze the company's plan and its business projections and anticipated claim recoveries to be comfortable that sufficient value will be recovered from a reorganized entity. Nonetheless, this situation is typically fraught with risks, including:

- The possibility that the ultimate plan does not have a debt-to-equity conversion (*e.g.,* debtor may decide to reinstate the applicable debt or give a *pro rata* share of a cash reserve).

- The reorganized company's optimistic forecast is not realized.

- No active/liquid market exists for the stock or the stock price is otherwise in the cellar based on poor post-confirmation performance.

To minimize the risk that the company does not propose a debt-to-equity plan, the purchaser may want to buy numerous and larger claims to obtain a blocking position, leading to greater bargaining power. However, there is a potential risk that the claim buyer may be unable to vote the purchased claim(s). The holder of a claim is generally entitled to cast a vote under Bankruptcy Code § 1126(a), but a Bankruptcy Court can disqualify the vote if it finds the buyer purchased the claims in bad faith. Unless there are some unusual circumstances, while a Bankruptcy Court may be wary of a claims buyer with no prior stake, this risk should be relatively small in most cases; buying claims to increase voting power and block a plan by itself is generally not considered bad faith.

As an example, in *In re Marin Town Center,*[6] the court determined that a creditor who had purchased a number of claims post-petition and who basically wanted to acquire the debtor's real property did not act in bad faith in respect to voting its unsecured claims: "A vote cannot be said to have been cast in bad faith simply because it was voted for the purpose of blocking confirmation of a reorganization plan.... Section 1126(e) does not require a creditor to have an interest in seeing the debtor reorganize."

Cases like this should be compared with cases like *In re Allegheny*.[7] There, the claim buyer—which had bought certain secured and unsecured claims post-petition and proposed its own plan—held a blocking position against the debtor's plan and was purportedly seeking control of the reorganized debtor. The court found that the creditor acted in bad faith because it was doing more than "merely furthering their own economic interests" as a creditor. As an "outsider," a buyer cannot disenfranchise other creditors and have a veto in the reorganization process, the court ruled. It should be noted that the creditor in *Allegheny* apparently engaged in a pattern of trying to manipulate the debtor, obtained inside information, etc.—factors that should not be present in most claim buying situations.

Caveat Emptor

Distressed debt investors should appreciate that while some bankruptcy cases may appear to be straightforward, there are always risks that may prevent the investment from providing the expected returns. The more active an investor is, the greater the risks and, presumably, the greater the rewards. No matter whether the investor is passive or active, however, it is critical for a distressed debt investor not only to conduct thorough diligence but also to negotiate away as many risks as possible in the purchase agreement. J

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[1] To flip a claim, a party tries to buy low and sell high, taking advantage of market fluctuations prior to plan confirmation. Because the claim flipper is usually involved for a shorter time period, its negotiation and other expenses are less and it can profit from a relatively moderate increase in the price.

[2] See, *e.g.*, Fisher & Buck, Hedge Funds and the Changing Face of Corporate Bankruptcy Practice, 25-10 *ABIJ* 24 (Dec. 2006 / Jan. 2007). In this article, the authors explain:

> [B]ecause of its "short" position, Alpha Partners [hypothetical hedge fund] is not motivated to pursue the overall maximization of value for all constituencies of DebtorCo's bankruptcy estate. Rather, Alpha Partners is interested only in the fate of its particular holdings and is adverse to the interests of equityholders. Indeed, Alpha Partners hits a grand slam on its investment if DebtorCo recovers enough value to pay off its bank, unsecured and trade debt, but does not recover enough money to provide a return to equityholders. Thus, unlike a more traditional creditor who might be indifferent to the fate of equityholders, Alpha Partners actually profits from poor returns for equityholders.

[3] See, *e.g.*, *Enron Corp. v. Springfield Assocs., LLC (In re Enron Corp.),* 379 B.R. 425 (S.D.N.Y. 2007). In *Enron*, the court reasoned that claims that have been assigned (as opposed to sold) may potentially be equitably subordinated based on the transferor's conduct under Code § 510(c) because, in the court's view, equitable subordination is an attribute of the original claimant that does not inhere in the claim itself, and under a pure assignment of a claim, the assignee steps in the shoes of the assignor.

[4] See, *e.g., In re KB Toys Inc.,* 736 F.3d 247 (3d Cir. 2013); In re Metiom, Inc., 301 B.R. 634, 642-43 (Bankr. S.D.N.Y. 2003).

[5] The buyer pays $250 on a $1,000 claim, or 25 percent, expecting a gross return of $400, or 40 percent, on the original $250 investment, for a gross return on investment of 60 percent, excluding the time value of money.

[6] *In re Marin Town Center,* 142 B.R. 374 (N.D. Cal. 1992). See also, *e.g., In re Figter, Ltd.,* 118 F.3d 635 (9th Cir. 1997).

[7] *In re Allegheny,* 118 B.R. 282 (Bankr. W.D. Pa. 1990). See also, *e.g., DISH Network Corp. v. DBSD N. Am., Inc. (In re DBSD N. Am., Inc.)*, 634 F.3d 79 (2d Cir. 2010).