BANKRUPTCY CLAIMS TRADING - OPPORTUNITIES AND HAZARDS

By: Robert Scheinbaum[1]

Bankruptcy claims trading, i.e., the sale of bankruptcy claims by the original creditors/claim-holders to investors, is on the rise. In several of the recent large bankruptcy cases, e.g., The Great Atlantic & Pacific Tea Co. (the "A&P" supermarket chains), Borders Group, Winn-Dixie Stores, claims trading has been an active and influential factor in the case.

For claims purchasers, bankruptcy claims represent investment opportunities in a specialized but growing market. In the A&P bankruptcy case, for example, there are currently dozens of claims-purchasing entities soliciting creditors and their attorneys. The fact that there is little variation in the prices offered for such claims or the terms of the contracts of sale proposed by the claims purchasers suggests an informed and research/analysis-based market.

For creditors, the sale of claims may be a way to obtain needed cash (sometime desperately needed) to fund operations, replacing the funds that would have otherwise been provided by the debtor (but, as practical matter, due to the bankruptcy, would likely not be paid for at least around 18 months). Such creditors are often trade vendors who rely on such cash (usually supplied by the debtor) to pay employees, order more raw materials or stock, and otherwise fund operations. Some of the benefits and potential hazards for creditors in connection with sales of bankruptcy claims are discussed herein.

<u>Opportunities</u>: As stated above, the primary benefit to the claim-holder of selling its claim is receiving cash now instead of later. Often, a large retail debtor such as K-Mart or A&P is a vendor's largest or primary customer, and the stoppage of payment for pre-petition services provided or goods delivered (which is afforded to the debtor by the "breathing room" that a bankruptcy filing provides) can have devastating effects on the debtor's vendors. Even if a debtor has been paying late, vendors generally adjust so that various operations and expenses can be funded or paid once a payment comes in; with a bankruptcy filing, any payments for prepetition goods or services are immediately halted and will be paid (i) in a reduced amount based on the pro rata percentage distribution to all unsecured creditors and (ii) at a much later date (i.e., as a practical matter, likely no earlier than 18 to 24 months from the date of filing).

Accordingly, claims are purchased by investors at a discount which reflects both (i) an estimate of what the percentage distribution to unsecured creditors will ultimately be (which estimate reflects the likelihood of success of a Chapter 11 reorganization and many other factors) and (ii) the time value of the money to the seller (on which a premium is likely imposed because the claims-holders that are interested in selling their claim generally need the money). Even so-called "priority" claims for goods or services supplied to the debtor within 20-days prior to the bankruptcy case and granted priority (i.e., the right to be paid in full before junior claims are paid by virtue of a recently enacted Bankruptcy Code provision) are generally not paid until confirmation of a plan of reorganization, which is highly unlikely to occur within the first year in any large-scale bankruptcy case. In the case of A&P, claims purchasers have recently been

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[1] Robert Scheinbaum is a partner at Podvey Meanor, P.C. and practices in commercial litigation, bankruptcy, creditors' rights and foreclosure.

offering around 80-85% of the face value for such administrative priority claims, which suggests that the market believes such claims will likely be paid in full, and around 20-25% of the face value for general unsecured (non-priority) claims, which primarily reflects the bankruptcy "haircut" that general unsecured creditors are expected to receive on their claims.

Hazards: Claims-holders should think carefully and prepare for contingencies in connection with contemplated sales of bankruptcy claims. Often the debtor's accounting of the amounts due to the creditor does not square with the creditor's records, particularly vendors that invoice the debtor per product delivered. In the A&P case, the debtors filed jointly-administered cases (with all non-claims filings in the main A&P case) but released their schedules of creditors separately for each debtor (e.g., store chains such as Pathmark, Food Emporium, etc.) and are requiring creditors who do business with one or more chains (and who had in the past been paid only by A&P) to files claims in each separate case. This will inevitably result in confusion and duplicate claims and objections to claims based on same. Under the default provisions of sale contracts offered by claims purchasers, the purchaser buys only the "good portion" of the claim, i.e. the portion of the claim that is not objected to by the debtor. Once a claim is objected to in whole or in part, the seller (formerly the claims-holder) is obligated to buy back with interest the objectionable portion of the claim. The default contracts are generally unclear as to which party - the claims purchaser or the seller - has the obligation (and at whose expense) to make appropriate filings in the bankruptcy court or to otherwise resolve with the debtor the correct amount of the claim. Unless a claim seller can negotiate adequate terms addressing this and similar situations, the seller may be under a contractual obligation to repay money in the future that it has likely already spent to fund operations. Further, there is conflicting case law as to whether a debtor may object to or assert a set-off as to a vendor's claim based on the vendor receiving what the Bankruptcy Code refers to as "preferential" payments, i.e., made on account of an antecedent debt to the creditor within 90 days prior to the bankruptcy filing. In jurisdictions where it is determined that a debtor may object to or assert a set-off as to an otherwise valid claim based on the creditor's receipt of preference period payments (even where the creditor may have statutorily-provided "new value" or "ordinary course of business" defenses to the claim of preference), the creditors may be obligated to buy back the claim from the claims purchaser with interest unless such contingency is addressed in the sale contract.

Whether to sell a bankruptcy claim is an important consideration to be faced by any vendor in a large-scale bankruptcy. Although the sale of the claim may be a practical way to obtain needed cash in the face of the financial challenges that the bankruptcy of a large customer entails, the creditor should prepare for and address contingencies including potential objections to the claim.