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Column
Last in Line

*24 HOW TO ANALYZE A CLAIM-TRANSFER AGREEMENT

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In most bankruptcy cases, the destiny of unsecured creditors is to file a claim and then wait--sometimes years--for a distribution at a fraction of the face amount of the claim. Not surprisingly, unsecured creditors get *excited* whenever a claims trader offers to buy the claim at a decent rate, because that offer ends the waiting game and pays the unsecured creditor cash *now*. While the unsecured creditor is motivated to get cash in the short term, the claims trader hopes to acquire the claim for less than the debtor's ultimate distribution thereon, thereby realizing a profit on the deal. As a byproduct, the claims buyer will also acquire the vote on the claim it purchases and, consequently, may help chart the course of the reorganization itself. Indeed, if the debtor ultimately distributes stock instead of cash on unsecured claims, a claims buyer could conceivably wind up with a significant portion of the debtor's stock, and possibly a voice in the destiny in the reorganized debtor.

Bankruptcy Rule 3001(e) governs transfers of claims. The Rule was amended in 1991 and, according to the Advisory Committee Note, the purpose of the amendment was to limit the role of the bankruptcy court in the adjudication of disputes regarding the transfer of claims. If the claim is transferred (other than for security) *before* the proof of claim is filed, only the buyer or an indenture trustee can file the proof of claim. If a claim (other than a claim based on a publicly traded note, bond or debenture) is transferred other than for security *after* the proof of claim has been filed, the buyer must file evidence of the transfer with the bankruptcy court. The clerk of the court will then notify the seller of the transfer, and the seller has 20 days within which to object to the transfer of the claim. This mechanism is designed to prevent the fraudulent transfer of claims. Although Bankruptcy Rule 3001(e) does not give the debtor the right to object to the actual transfer of the claim (*see, e.g.,* *In re Lynn*, 285 B.R. 858 (Bankr. S.D.N.Y. 2002)), bankruptcy courts will scrutinize a timely plausible argument of collusion or arguments that a proof of claim was fraudulently assigned. [1]

Steps in the Process

Generally, there are two steps to the transaction: the initial "trade confirmation" or "agreement to assign or sell claim" (initial agreement) and the final assignment or sale agreement (final agreement). The initial agreement looks like a term sheet or outline of the transaction: It identifies the buyer and seller, the proof-of-claim amount, the purchase rate and additional purchase rate if part of the claim is allowed as a priority claim (*e.g.*, for reclamation, etc.), the timing of the payment of the purchase price, and other pertinent terms. The initial agreement is generally subject to several conditions, including the execution of the final agreement. Although the initial agreement looks like a term sheet, it often recites that the parties intend to be bound, and it is generally signed by the seller and buyer. Sometimes, selling creditors tend to sign the initial agreement without benefit of counsel, reasoning that it is just a term sheet and can easily be recanted if a higher or better offer comes along. This is generally misguided, and the careful creditor should seek advice of counsel before signing even the initial agreement because its terms

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often provide the backbone of the transaction. Although many provisions of the initial agreement constitute business terms of the deal, seller's counsel will want to make sure that the initial agreement is workable and subject to the terms of the final agreement.

The Fine Print

The details of the transaction are more fully set forth in the final agreement. These form contracts are legendarily buyer-centric. In analyzing the final agreement and determining which provisions need to be negotiated, the selling creditor and its counsel might want to focus on the following issues:

Definition of "Impairment": Because the buyer's ultimate goal is to realize a profit on the deal, the final agreement tries to ensure that the claim will be allowed and paid. Any impairment of the claim is the antithesis of the buyer's goal. Consequently, many final agreements tend to use a "hairtrigger" definition of "impairment" and are drafted so that "impairment" is defined as the mere *filing* of an objection to the claim, or of a motion or action (such as a preference action) that *could* disallow, reduce or subordinate all or any portion of the claim, or delay or lessen distributions on the claim. The definition of "impairment" is important to the seller as well as the buyer because final agreements generally require the seller to repurchase or repay the buyer for the impaired claim or the impaired portion of the claim. Thus, final agreements that use a "hair-trigger" definition of "impairment" are designed to unwind the transaction and require the seller to repurchase the claim (often for the purchase price paid for the impaired claim or portion thereof, *plus* interest) as soon as a claim objection or preference action is *filed.* Seller's counsel may want to try to negotiate a less buyer-oriented definition of "impairment." For example, the seller might seek a definition of "impairment" pursuant to which an impairment does not even occur unless the claim objection is sustained, or unless the preference action is not resolved within a reasonable period of time, etc. Alternatively, the seller might try to negotiate a period of time within which the seller can defend the claim or cure the impairment before the buyer can require the seller to repurchase the claim or the impaired portion thereof. The seller may also want to try to negotiate the retention of the right to defend the claim, at least for a period of time, to avoid the buyer "taking a dive" as soon as a claim objection is filed and simply triggering the seller's repurchase obligation.

Representations and Warranties: Some final agreements contain an exhaustive list of seller's representations and warranties, all for the benefit of the buyer. Obviously, the buyer needs to know that the seller owns the claim and is authorized to transfer it to the buyer (either alone or with the consent of any secured creditor that may have a security interest in the claim or the receivable which the claim represents), and that the seller has not previously sold the claim. However, some buyer-oriented final agreements contain many more warranties than this short list. The seller *and* its counsel should review all of the representations and ***64** warranties and negotiate limitations to them where appropriate--especially with respect to issues upon which the seller has limited knowledge (such as whether the debtor plans to object to the claim.) Phrases such as "to seller's knowledge" and "seller has not received written notice of" are very useful in limiting the seller's warranties in the final agreement. Some final agreements require the seller to represent that it has never been an insider of the debtor (within 11 U.S.C. §101(31)) or a member of the creditors' committee in the debtor's bankruptcy case; this warranty recognizes that bankruptcy courts do not look kindly upon insiders of the debtor or other parties with sensitive information about the debtor, engaging in claims-trading based on that information. *See, e.g., In re Papercraft Corp.*, 211 B.R. 813 (W.D. Pa. 1997).

Indemnity: Many final agreements require the seller to *indemnify* the buyer for any loss or fee (including attorneys' fees) that the buyer incurs if there is an impairment of the claim or if any of the seller's representations or warranties turn out to be untrue. Seller's counsel might want to try to delete the indemnity clause altogether. Often, however, the buyer wants an indemnity provision so that it has a "club" to use if the claim is impaired and the seller attempts to shirk its repayment obligation. Between these two positions, seller's counsel should attempt a negotiated resolution. Perhaps the indemnity clause could be drafted so that it is triggered *only if* the seller fails to repurchase the impaired claim (or the impaired portion of a claim) within a certain period of time.

Description of the Claim: Obviously, the final agreement should accurately describe the proof of claim being sold by the dollar amount, debtor's case name and number, claim number (if available), etc. Generally, buyers purchase claims based on the

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scheduled amount thereof. Because the scheduled amount of the claim is often less than the proof-of-claim amount, it makes sense for the final agreement to address what will happen if the proof of claim is allowed for more than the scheduled amount. The seller will probably want the buyer to be obligated to purchase any additional allowed amount on the claim for the same purchase rate paid for the rest of the claim. Similarly, if the seller has a possible reclamation or other administrative priority claim, the final agreement should address that issue, and sellers often seek a higher purchase rate for the administrative priority portion of the claim because of its higher priority.

Seller's Remedies if the Transaction is Unwound: Because the form final agreement is drafted by the buyer and for the buyer's benefit, it is not surprising that it is generally silent on what happens *after* the claim is impaired and the seller is required to repurchase. Will the claim be reassigned to the seller? Will the buyer provide and file documentation to memorialize that reassignment? What will happen if the claim is reassigned to the seller, but the distribution on the claim is paid to the buyer; will the buyer be required to hold that distribution in trust for the sole benefit of the seller and turn it over to the seller promptly? The seller needs to take a moment to think about what the transaction will look like if an impairment occurs and the transaction is unwound.

Dream Come True, or Trap?

While unsecured creditors tend to view the offer to purchase the claim as a dream come true, claim-transfer agreements are very buyer-oriented and may constitute a trap for the unwary seller/creditor. Selling creditors are well advised to seek the advice of counsel in negotiating relief from these buyer-centric documents and help facilitate a smooth transaction that transforms the unsecured claim into a cash distribution--*at last*.

Footnotes

1 *See, e.g.*, *In re Altman*, 265 B.R. 652 (Bankr. D. Conn. 2001), in which the bankruptcy court stated: "To rule otherwise would suggest that unless one of the parties to such fraudulent conduct objects, a bankruptcy court would be powerless to fashion an appropriate remedy. This court should not provide a forum for shielding fraudulent conduct ...." 165 B.R. at 658-659.

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