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What Are the Pros and Cons of Selling a Bankruptcy Claim?

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As 2024 gets into full swing, much uncertainty plagues financial markets around the world as we continue to deal with elevated interest rates, political unrest around the world and an upcoming presidential election in the U.S.

To combat these uncertainties, companies are focused on preserving cash flow partly through focusing on collection efforts. Toward this end, a company with a claim against a bankrupt vendor or supplier might consider selling its bankruptcy claim in order to promptly collect on account of such a claim.

While the business of buying bankruptcy claims has been around for a long time and there are many advantages to selling one, it is important to understand the risks of selling a bankruptcy claim so that such risks can be considered and mitigated.

There are several advantages to selling a bankruptcy claim.

The first, and most obvious advantage, is that by selling a bankruptcy claim, the creditor will receive immediate payment on account of the amount owed to it. While the deadline to file claims often occurs early in a bankruptcy case, it can take a long time before a creditor receives a distribution in the case.

This is especially true where recoveries for creditors are contingent on the outcome of litigation. Some creditors would rather take a smaller payment today, and invest those funds back into their business, rather than wait for a larger return down the road.

Second, although in most cases creditors will receive cash on account of their claim, in some cases creditors may receive a different form of distribution, such as stock in the reorganized entity or a promissory note. By selling the claim, the creditor can ensure they receive a guaranteed cash payment.

Third, selling a claim eliminates uncertainty regarding the amount that will be recovered on account of the claim, provided that no issues later arise with the validity of the claim as discussed below.

Fourth, by selling the claim for less than the full face value of the claim, a creditor may be able to take an immediate tax deduction for the loss. An experienced accountant should be consulted regarding any tax

consequences related to selling a claim.

Finally, selling a bankruptcy claim allows the creditor to get back to its business, and eliminates the time and expense of monitoring the bankruptcy case.

While there are advantages to selling a claim, there are also risks that must be considered.

First, it is not always true that the early bird gets the worm. Simply put, by selling the claim, a creditor may get less than it would have had the creditor waited to receive a distribution in the bankruptcy case, as claims purchasers purchase bankruptcy claims at a discount.

Second, to the extent that the claim is objected to and ultimately reduced or disallowed in the case, many claim purchase agreements provide that the purchaser is entitled to a refund, and sometimes even penalties and interest.

Third, to the extent that the debtor has claims against the creditor, the creditor will lose its setoff and recoupment rights as a result of selling the claim since it will no longer be the holder of such a claim.

Finally, for some creditors — especially those wanting to ensure a go-forward business partner — serving on the official committee of creditors is important as it gives them a front-row seat to the bankruptcy case. However, a creditor that sits on an official committee will be required to resign if it decides to sell its claim since it is no longer a creditor in the case.

As with any transaction diligence, before deciding to sell a bankruptcy claim there are a number of steps a creditor should undertake in connection with such a sale.

First, the creditor should engage with several different claims purchasers in order to ensure the best price for the claim. However, it is important that a creditor has realistic expectations about recovery on account of their bankruptcy claim.

In many Chapter 11 cases, creditors receive a fraction of what they are owed. The offer to buy a bankruptcy claim reflects both a discount based on the likelihood of recovery on the claim and the time value of money — i.e., how long it will be before payment on account of the claim will be made.

Second, the creditor should spend time reviewing key pleadings in the bankruptcy case to understand what is expected to happen in the case and the projected potential recoveries for creditors.

This includes the first-day declaration, which provides an overview of the assets and liabilities of the company; any sale motion, which sets forth the purchase price and may highlight the funds that might be available to pay creditors; and any disclosure statement, which discusses projected recoveries to creditors.

Third, the creditor should check to see if the debtor has scheduled its bankruptcy claim and that the scheduled claim is not listed as contingent, disputed or unliquidated, or CUD. If the claim is marked as CUD, extra caution is required since this means that the debtor does not agree with the claim or there is some other issue with the claim

that could affect the ultimate treatment of the claim in the bankruptcy case.

Fourth, the creditor should understand the type of claim held in the bankruptcy case. Certain types of claims, such as Section 503(b)(9) claims, related to goods received by the debtors in the 20 days prior to the bankruptcy being filed, are entitled to higher priority than general unsecured claims in the bankruptcy case.

Moreover, administrative expense claims and priority claims must be paid in full in order for a plan to be confirmed. Because these claims have a higher chance of payment — and often receive payment in full — it is often the case that these claims should receive a higher sale price.

Before deciding to sell your claim, it is important to conduct a careful analysis of the risks and benefits in connection with the potential sale.

By doing so, a creditor can monetize its claim with confidence and minimize any risk that any amounts received in connection with such a sale will be subject to potential disgorgement.

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