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Why Buy a Bankruptcy Claim When You Can Acquire A Distribution Right?

Andrew H. Sherman

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The trading of claims is a familiar practice in bankruptcy cases, both as a short-term investment vehicle and a long-term opportunity with the intention of obtaining a strategic position in the confirmation process.[1] In certain instances, an investor can purchase a claim at a discount prior to the confirmation of a plan based on the assumption that the plan will provide a distribution in excess of the purchase price of the claim, taking into consideration the time-value of money between the date of purchase and the date of distribution under the confirmed plan. Alternatively, an investor can acquire a significant portion of the debt to inject the investor into the fray of the chapter 11 process. In this manner, the investor can acquire a strategic position to participate in the plan negotiation process, acquire a blocking position within a particular class of claims or attempt to acquire control of the debtor.

When pursuing a short term investment strategy, the acquisition of a claim carries certain baggage, including the risk of being sued for actions which relate to the claim or other types of avoidance actions which can significantly delay the distribution on the claim. The baggage associated with a transferred claim has been articulated by Bankruptcy Judge Arthur Gonzalez in the *Enron* cases where he held that a transferee's claim against a bankrupt's estate can be subordinated or disallowed solely because of the transferor's misconduct or failure to return avoidable transfers even when there is no finding of wrongdoing. *Enron Corp. v. Avenue Special Situations Fund, II, LP (In re Enron Corp.)*, 340 B.R. 180 (Bankr. S.D.N.Y. 2006); *In re Enron Corp.*, 333 B.R. 205 (Bankr. S.D.N.Y. 2005). Under these rulings, a purchaser of a claim is subject to later attack and subordination of the claim, regardless of whether that transferee had any knowledge of the transferor's inequitable conduct or purchased the claim in good faith for value.

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However, an investor usually does not need the rights associated with the claim's baggage and simply wants to purchase the income stream generated by the claim. In such cases, an investor should consider acquiring a distribution right – the right to receive the distribution on the claim – nothing more and nothing less. This article discusses certain problems associated with the purchase of a claim in bankruptcy and suggests an alternative to the acquisition of an entire claim – the purchase of a distribution right.

What Is A Bankruptcy Claim And What Is A Distribution Right?

At its core, a bankruptcy claim is nothing more or less than an enforceable obligation entitling the party to a right to payment from the debtor.[2] A bankruptcy claim also vests its holder with certain rights. For example, the holder of a claim has the right to be heard in a bankruptcy case and, generally, has the right to vote in favor of or in opposition to a plan of reorganization. The holder of a bankruptcy claim may also hold a right of setoff and counterclaim against a debtor as a result of the claim. These rights, in and of themselves, have certain value for parties in a bankruptcy case.[3] As a result of these rights, a bankruptcy claim can be a powerful and strategic tool.

These powerful rights and benefits are not usually important to an investor who only wants the economic component of the claim. That economic component –

***Andrew H. Sherman** is a Member of Sills Cummis Epstein & Gross P.C.'s Creditors' Rights/Bankruptcy Reorganization Practice Group. The views and opinions expressed in this article are those of the author and do not necessarily reflect those of Sills Cummis Epstein & Gross P.C.*

Please email the author at asherman@sillscummis.com with questions about this article.

the distribution to be paid by the bankruptcy debtor to its creditors – is typically the specific right which a claims investor seeks to acquire. Because this discrete right can be separately identified, there may be a means for an investor to only purchase the right to receive the distribution (the distribution right) while leaving the balance of rights and associated baggage, with the holder of the original claim. Distribution rights have been sold in at least one bankruptcy case, but such transactions are not commonplace and have yet to face judicial scrutiny. In a distribution rights transaction, the investor enters into a contract with the holder of the claim whereby the investor will pay a fixed sum for the right to receive the distribution. The consideration for the purchase or a portion of the consideration can be paid at the time of the contract with the balance to be paid upon the occurrence of the distribution by the debtor. Obviously, these terms can vary on a transaction by transaction basis.

The Enron Problems

On September 24, 2003, Enron filed an adversary proceeding against various large institutional creditors alleging that they received certain preferences and fraudulent conveyances, and that they aided and abetted Enron's accounting fraud, thereby injuring Enron's creditors. The lawsuit implicated the rights of claims purchasers because Enron sought to subordinate or disallow the claims which were acquired by the transferees based on the conduct of the claims transferors.

The claims purchasers moved to dismiss the complaints alleging, in part, that since the claims purchasers purchased the claims in good faith, without any knowledge of misconduct, the claims purchasers should not be held liable for the predecessors' actions. The Bankruptcy Court ruled against the claims purchasers and denied the motions to dismiss. The Bankruptcy Court found that equitable subordination is not limited to only those claims related to the inequitable conduct that caused the injury to the creditor class. Instead, equitable subordination can apply to claims unrelated to any inequitable conduct held by the claimant alleged to have engaged in that conduct, limited by the amount of damages stemming from the inequitable conduct that is not otherwise compensated to that class. Consequently, the Bankruptcy Court concluded that the transfer of a claim subject to equitable subordination does not free such claim from subordination in the hands of a transferee.

Subsequent to the decision on equitable subordination, the Bankruptcy Court issued another opinion to address whether a claim which was transferred can be disallowed pursuant to section 502(d) of the Bankruptcy Code, due to the possibility of avoidance actions against the party that filed the claim. Once again, the Bankruptcy Court denied a motion to dismiss the section 502(d) cause of action based on the principle that a transferred claim is subject to all defenses to which it was subject in the hands of the original holder of the obligation. The Bankruptcy Court further ruled that a claims transferee can rely on section 550(b) of the Bankruptcy Code if it does not have either (i) knowledge of the debtor's possible insolvency or unfavorable financial condition at the time of the transfer or (ii) notice that the transfer may be recovered by the trustee. Applying these criteria to the facts of the motion to dismiss, the Bankruptcy Court concluded that the defendants clearly were not "without knowledge of the voidability of the transfer" as required by section 550(b) of the Bankruptcy Code.

A Possible Solution

The result of the *Enron* decisions is greater uncertainty in the claims trading markets. The *Enron* decisions are currently under appeal and the District Court recently determined that it would consider an interlocutory appeal on these issues.[4]

To avoid the consequences of the *Enron* decisions, claims purchasers should consider purchasing or contracting to purchase only a distribution right – the right to receive the distribution from the debtor – the true economic component of the claim. By purchasing only a distribution right, the claims purchaser will buy the right to receive the dividend or payment from the bankrupt debtor, but the claim remains with the original holder. A distribution rights transaction could avoid the consequences under the *Enron* examples described above because the holder of the original claim must still defend the claim and face the consequences of any possible avoidance actions, and the acquirer of a distribution right never faces those issues. Once cash, stock or other consideration is ready to be distributed to the holder of the claim, the holder of the claim has contracted with the purchaser of the distribution right to transfer those assets for a fixed sum. A transfer of a distribution right reduces the claim to its most basic components and enables the transfer or sale of one component of the claim while the balance of the claim remains with the original claim holder. One distinct advantage of a distribution right is the ability to separate a claim such that the claim can be allowed in one amount for distribution purposes and allowed in another amount for all other purposes. This concept can protect a creditor and preserve full rights of setoff, while limiting the distribution to the amount recognized by the debtor.

A transfer of a distribution right is not a panacea for all claims trading issues. The sale of a distribution right is not provided for in the Bankruptcy Code and has not been tested by the courts. Consequently, it is a novel type of transaction which includes some risk. There may be risk due to the lack of notice for these transactions. Unlike a claims transfer which requires notice and an opportunity to object, there is no such scrutiny for a sale of a distribution right. Further, since there is not an open market for distribution rights, there may be some tension in how to value the transactions. In some instances there may be a premium paid over the price of a claim while in others there may be a discount to the price of a claim. Another possible concern is the lack of control over any litigation relating to the claim, but that issue can be addressed through drafting.

The sale of a distribution right is simply another type of transaction which should be considered or discussed as a means to transfer a right to payment in a bankruptcy case. Although the transaction is not a silver bullet, it does address and/or simplify the claims sale process.

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[1] In re Celotex Corp., *224 B.R. 853, 856 (Bankr. D. Fla. 1998)*

[2] Cohen v. De La Cruz, *523 U.S. 213, 218, 118 S. Ct. 1212, 140 L. Ed. 2d 341 (1998) (quoting Pennsylvania Dept. of Public Welfare v. Davenport, 495 U.S. 552, 559, 109 L. Ed. 2d 588, 110 S. Ct. 2126 (1990)).*

[3] *One example of the value of holding a bankruptcy claim is that a party seeking to contest the results of a bankruptcy sale may not have the ability to challenge a sale unless that party holds a claim in the bankruptcy case.*

[4] Enron Corp. v. Springfield Assocs., L.L.C. (In re Enron Corp.), *2006 U.S. Dist. LEXIS 63223 (S.D.N.Y. 2006)*