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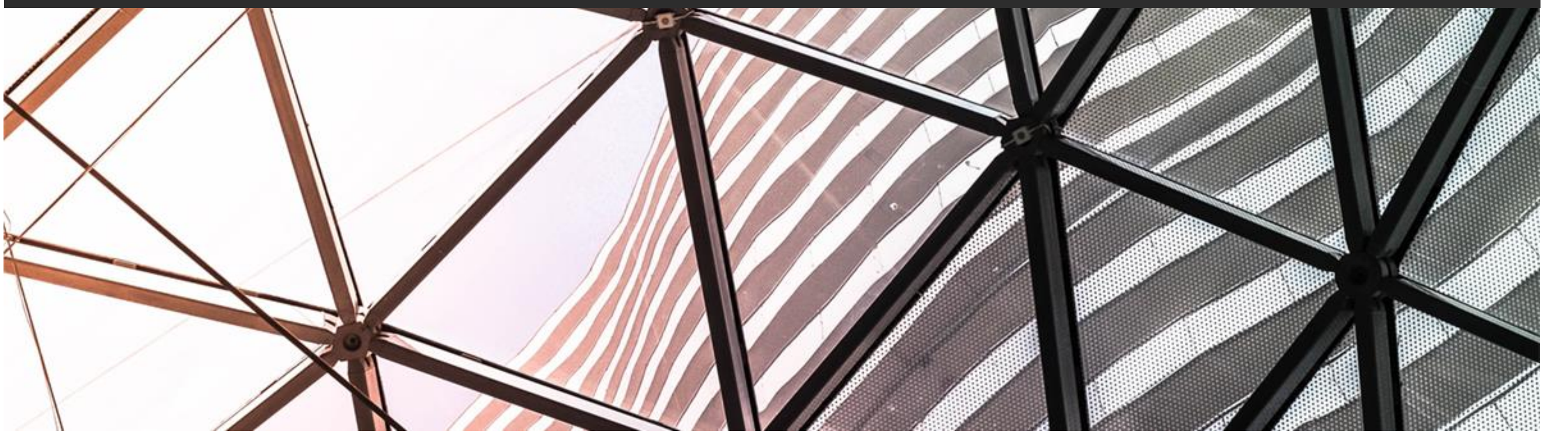

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Investors Beware: Exercising Care When Purchasing Bankruptcy Claims

Claims trading has become increasingly commonplace in today's bankruptcy cases, typically with little need for policing by the courts. Investors often purchase claims as a means by which to execute recovery or acquisition strategies, with the understanding that they generally acquire those claims subject to any infirmities.[1] Beyond that, courts have provided little guidance regarding other problems that might affect the use of claims purchased for strategic reasons.

Recently, this dynamic has begun to change. In recent decisions, three courts reviewed claims trading activity and emphasized the need for buyers to exercise care when purchasing claims. Based on these decisions, which are discussed below, it is important for claims purchasers to (a) conduct due diligence regarding the types of claim they are purchasing, (b) consider the procedural posture of the bankruptcy case in which they purchase claims, and (c) consider the purpose for which the claims are purchased. These lessons may be especially important for private equity and other funds seeking to acquire claims to increase their leverage in chapter 11 cases.

[1] *See In re KB Toys, Inc.*, 736 F.3d 247 (3rd Cir. 2013); *Enron Corp. v. Springfield Assocs. LLC (In re Enron)*, 379 B.R. 425 (S.D.N.Y. 2007) (if a claim is acquired by assignment, not by sale, then the buyer takes subject to the claims infirmities).

In re Woodbridge Group: Read the Fine Print!

In a recent decision[2] by Judge Kevin J. Carey of the U.S. Bankruptcy Court for the District of Delaware, a purchaser bought promissory notes containing clauses that prohibited their assignment to third parties. The note purchaser filed a proof of claim on the notes, and the debtors objected to the claim.

Defending the objection, the note purchaser first argued that the anti-assignment provisions were impermissible restrictions under Delaware law, taking the position that Delaware contract law permits the assignment of the notes. Disposing of this argument, the court held that both the promissory notes and the accompanying loan agreement prohibited the assignment of the notes and any rights thereunder.

Next, the note purchaser argued that the debtors' prior breach of the notes rendered the anti-assignment provisions unenforceable. Rejecting this argument, Judge Carey ruled that neither the original noteholder nor any assignee could emerge with more rights than they had before a debtor's breach of any note instruments.

Finally, the note purchaser argued that section 9-408 of Delaware's Uniform Commercial Code, which deals with a pledge of a security interest in a promissory note, nullifies the anti-assignment provisions of the notes. The court dispensed with this argument by noting that the claims purchaser did not claim a security interest in the notes and therefore could not rely on this UCC provision.

The bankruptcy court indicated that claims trading is not prohibited in bankruptcy, and pointed out the provisions of the Federal Rules of Bankruptcy Procedure which contemplate the transfer of claims. Judge Carey noted, however, that these provisions do not preclude a bankruptcy court's ability to look at the underlying debt instruments to determine if they are assignable under applicable non-bankruptcy law. In reaching this decision, Judge Carey harmonized the ruling with his prior decision in the *KB Toys* case, where he ruled that a claim "purchaser holds that claim subject to the same rights and disabilities under Bankruptcy Code § 502(d) as does the original … claimant."[3]

The important take-away from this decision is that claim purchasers and their professionals must do their due diligence and cannot ignore anti-assignment provisions in debt instruments or other loan documents. As this decision arises from one of the most prominent venues for chapter 11 cases in the United States, it is likely to have a lasting impact.

In re Fagerdala USA – Lompoc, Inc.: Creditor Can Block Confirmation of a Chapter 11 Plan Through the Purchase of Claims

The Ninth Circuit Court of Appeals[4] recently held that a secured lender's purchase of unsecured claims to block confirmation of a chapter 11 plan was permissible. In reversing a bankruptcy court's designation of the claims under section 1126(e) of the Bankruptcy Code, the Ninth Circuit held that a creditor's purchase of claims to block confirmation in pursuit of its own self-interest was not a basis to establish bad faith, absent an effort to seek an untoward advantage. In reaching its decision, the Ninth Circuit disregarded arguments that the lender's failure to make an offer to all unsecured creditors was evidence of bad faith.

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[2] *See In re Woodbridge Group of Companies, LLC, et al.*, No. 17-12560 (KJC) (Bankr. D. Del. June 20, 2018).
[3] *See In re KB Toys, Inc.*, 470 B.R. 331, 343 (Bankr. D. Del. 2012), aff'd sub nom., 736 F.3d 247 (3d Cir. 2013).
[4] *See Pacific Western Bank, et al. v. Fagerdala USA – Lompoc, Inc. (In re Fagerdala USA – Lompoc, Inc.)*, 2018 WL 2472874 (9th Cir. June 4, 2018).

In re Technicool Systems, Inc.: Claims Purchase Cannot Retroactively Create Standing

In an opinion[5] by Circuit Judge Don R. Willett, the Fifth Circuit Court of Appeals recently considered whether a party could, after losing an issue in bankruptcy court due to its lack of standing, then purchase a claim to obtain standing in an appeal. The party was a defendant in litigation brought by a bankruptcy trustee, and objected to the trustee's retention of counsel. The Fifth Circuit held that the party could not create standing through the purchase of a claim after the bankruptcy court overruled the party's retention objection.

The Fifth Circuit covers the states of Texas, Louisiana, and Mississippi, and has been a particularly active jurisdiction for chapter 11 filings in recent years. It is apparent from this decision that the Fifth Circuit, and potentially other circuits, will not permit investors to create standing retroactively in order to pursue an appeal.

These decisions demonstrate that claims trading is on the courts' radar, and that due care must be exercised when buying claims for strategic purposes. If done with care at an appropriate stage of the proceedings, claims trading can continue to be employed as a strategy to obtain a favorable result in chapter 11 cases. Added to the existing case law on point, these recent decisions offer additional guidance as to how best to execute that strategy.

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[5] *See Furlough v. Cage (In re Technicool Systems, Inc.)*, No. 17-20603 (9th Cir. June 20, 2018)