



Distressed Players Look to Trade Claims An increasingly popular but quite complicated option

Investment Dealer's Digest

Kate Laughlin

12 December 2005

Distressed investing is taking a new twist as funds increasingly look to a different type of asset: trade claims. Trade claims encompass debts owed by a bankrupt company, particularly to vendors and suppliers. In Chapter 11 proceedings, trade claim creditors often join distressed bondholders in the pool of unsecured lenders vying to get repaid.

Of late, discounted trade claims have been a popular option for investors who traditionally buy distressed bonds. Indeed, Matthew Hamilton, head of private debt trading at APS Financial Corp. (APSF) in Austin, Texas, said that he currently sees more value in trade claims than in distressed bonds. "That's because of the discount, and because there seems to be a lot of money on the sidelines, and a lot of pent-up demand for some of these situations," he explained.

The current demand for trade claims is a result of many converging factors, including the size and nature of recent bankruptcies, the growth of hedge funds and the trend toward longer hedge-fund lockup periods. Unlike many other asset classes that go in and out of vogue according to the shifting dynamics of the economy, the demand for attractively discounted trade claims generally always outweighs its limited supply. However, supply has been increasing, particularly in the automotive sector as more companies head toward bankruptcy.

"The reason trade claims are so attractive to investors is because there is a dearth of ideas out there, and also because they can buy these 'fulcrum' debt instruments at such a significant discount to the bonds," said APSF's Hamilton.

Depending on a company's capital structure, trade claims may rank *pari passu* to unsecured bonds, or, in some cases, they may hold a senior position. In the case of auto parts supplier Delphi, for example, since its bonds were issued at the parent holding company level, the bonds are structurally subordinate to Delphi's trade claims, which are held at the operating company level. "With Delphi, the trade claims are structurally senior. And they're discounted further than the bonds, often by 10-15%," said Hamilton.

Furthermore, if a creditor is interested in taking a controlling position in a reorganized company, buying its trade claims is one vehicle to advance this goal. That's because bankruptcy trustees often grant trade claim creditors equal footing with bondholders, even if the bond volume is much greater than the aggregate amount of trade claims (this may change under the new bankruptcy laws, sources said). In short, an investor may get a larger stake than the total dollar value of the investment might otherwise warrant.

"If you can control the trade claim class, then you have a lot of leverage in terms of voting, even when the claims are only 10-25% of the pool," said APSF's Hamilton.

Not simple

This may sound like a canny investment for distressed specialists, but in practice, it's not so simple. For one thing, the complex and nonstandardized administrative and legal processes involved in buying trade claims make buying unsecured bonds look like child's play.

"Trade claims are much less liquid than unsecured bonds," said Jamie Zimmerman, managing partner of Litespeed Partners, a hedge fund that invests in distressed companies. "One spends more administrative time and money making sure the claim is properly transferred and characterized correctly than when one buys an unsecured bond where an indenture trustee represents the bond issue in court," she said.

Because of these complications, and the often sparse size and availability of trade claims, the cost-reward ratio isn't always worthwhile, added Craig Dean, principal at restructuring firm AEG Partners. "The challenges really relate to the size of the deals that are available relative to the amount of work that they take," he said.

Distressed debt buyer and restructuring guru Wilbur Ross of WL Ross & Co. agreed, pointing out that "trade claims are generally very small in denomination, often with under \$100,000 trading in an individual piece." In such a case, the absolute dollars an investor can make just aren't that significant, especially when the investor is running a larger fund.

And when a distressed player does latch on to an attractively-sized and -priced trade claim, the investor still has to endure the laborious process of buying the claim. "The clearing and settlement is really difficult. It's almost like bank debt 10 years ago," said Hamilton. Trade claim sales are executed through privately negotiated documents, as bank loan trades still are, but the bank loan world now utilizes standardized documents, proceedings and protocols, thanks to the Loan Syndications and Trading Association. No comparable entity exists to unify trade creditors.

The problem with standardizing the trade claim industry is that it is composed of so many disparate parties, including thousands of types of original creditors. "How can you standardize that type of arrangement? Depending on how many bankruptcies there are per year, you might have hundreds of thousands of individual claimants with different attorneys, agendas and interests," noted APSF's Hamilton, who said that he didn't foresee the asset class becoming any more standardized in the near future.

He added that despite the attractiveness of trade claims, they will likely never become a large market, due to the level of sophistication necessary to evaluate and administer each particular claim.

Another issue, said Litespeed's Zimmerman, is that each trade claim is unique, since it trades under a contract with negotiated representations and warranties given by the particular seller. If the claim purchased is not free and clear, the buyer must seek recourse against that seller, and to that extent, the buyer takes on the credit risk of the seller, she explained.

Demand persists

Despite the arduous process associated with investing in trade claims, sources say that investors are especially interested in the assets these days because of their need to diversify.

"Demand is probably growing with the natural growth of hedge funds, and their need to find new and additional asset classes," said Dean of AEG Partners. Also, longer hedge-fund lockup

periods-which some funds are imposing to avoid registration with regulators-are giving hedge fund managers more flexibility and time to invest in such illiquid, distressed paper, which they couldn't do if they needed constant liquidity. "If you're trading oriented, you can't just move in and out of this stuff," pointed out Hamilton.

Although trade claims are not expected to achieve the same level of popularity as other distressed asset classes, market participants expect market growth. "A larger percentage of distressed funds that, prior, were just looking at publicly issued securities will now look to this alternative asset class," said Hamilton.