



LENDING AND RESTRUCTURING ALERT

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Don't Lose Your Consolation Claim

The Bankruptcy Code softens the blow, to some extent, to a creditor from whom a debtor or trustee has recovered a payment or property pursuant to certain avoiding powers granted by the Code. For example, a creditor forced to return a payment avoided as a preferential or fraudulent transfer generally receives a pre-petition claim once it has returned the funds to the estate. But one lender that was required to return over \$2.1 million to a debtor's estate earned the hard way that a sale of bankruptcy claims can cause a creditor to lose the right to assert a "consolation" claim.

In this case, after an involuntary bankruptcy petition was filed against it, the debtor made payments to the lender which were not authorized by the bankruptcy court or any provision of the Bankruptcy Code. The lender subsequently sold essentially all of its claims to a third party, pursuant to an agreement that provided that the lender transferred "all claims . . . suits, causes of action . . . whether known or unknown, against the . . . Borrower."

The debtor then brought an action against the lender seeking to avoid the unauthorized post-petition payments and, in fact, the bankruptcy court ruled that the lender was required to return those payments. The lender and the creditors committee agreed that, after it returned the funds, the lender would be granted a pre-petition "consolation" claim equal to the amount returned. The lender contended that this claim should be a secured claim, since its original claim was secured. Naturally, the committee argued that the lender should receive only an unsecured claim.

The bankruptcy judge ruled that both parties were wrong. The Court noted that the lender had already absolutely and unconditionally assigned all claims and proceeds thereof, whether known or unknown. Thus, when it sold its claims, the lender had failed to retain any consolation claim that might arise in its favor if it later were required to return to the debtor any avoidable payment.

What's a lender to do?

When selling a bankruptcy claim, a lender should bear in mind the need to document the transfer carefully so as to protect itself in case it is later found to have received an avoidable transfer.

For more information on these or other legal issues, please contact Paul Rubin at 212-592-1448 or prubin@herrick.com, Andrew Gold at 212-592-1459 or agold@herrick.com, or Scott Tross at 973-274-2030 at stross@herrick.com.

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