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Bankruptcy Platform Extinct

Do Online Claims Trading Marketplaces Have a Future?

by Randall Reese

In March, SecondMarket shuttered its platform for trading in claims against bankrupt companies. While the company is better known for its private company equity trading platform, it had also offered trading in bankruptcy claims for several years. SecondMarket, which was then known as Restricted Stock Partners, acquired Trade Receivable Exchange, Inc. (also known as T-REX) in June 2008. At the time of the acquisition, T-REX claimed to be "the largest online auction platform serving the bankruptcy claims market."

SecondMarket has widely been viewed as having faltered in the wake of lackluster post-IPO performances by Facebook, Groupon, and Zynga, and recently acknowledged going through a round of layoffs. In a statement announcing the company's exit from the claims trading business, SecondMarket cited a lack of strategic fit with its other business lines for the decision.

SecondMarket is neither the first company to attempt to build an online platform for trading bankruptcy claims, nor the first to ultimately exit the business. However, the decision of a high-profile, venture-backed company to wind down this business line after years of investment does highlight the difficulty of building a sustainable online claims trading exchange. While few in the claims trading industry were willing to discuss SecondMarket specifically, several did offer insights into the systemic issues that make the business so challenging.

Adam Stein-Sapir, Co-Managing Partner of Pioneer Funding Group LLC, an investment fund focused on acquiring trade claims, believes that there are two major issues that limit the attractiveness of trading bankruptcy claims through an online exchange. First, he notes that while the exchange model works well for commodities, trade claims against bankrupt companies are never commodities. In addition, Stein-Sapir believes that there is an imbalance between the cost of customer acquisition for claims trading platforms and the revenue that the platform, acting as an intermediary, is able to generate from each customer. In this model, the customer is the creditor holding a claim against a bankrupt company. While some customers may hold claims against multiple debtors, Stein-Sapir notes that this is relatively uncommon. Therefore, many creditors will end up being one-time customers of the platform. This is problematic because the intermediary captures a comparatively small portion of the value being transferred.

By comparison, the average cost of acquiring a customer is likely quite significant. The biggest driver of the cost of customer acquisition is that only a small percentage of creditors are likely to be interested in selling their claims, according to Stein-Sapir. Because it is difficult to identify the particular creditors who will be interested sellers, the intermediary must market to a large number of creditors at significant cost. A low response rate means that each actual customer becomes very expensive to reach. Others in the industry agree, suggesting that market size estimates that are based on simply aggregating the total amount of liabilities in Chapter 11 cases can be misleading. According to one participant, "the 'actual' market [i.e., the number and magnitude of claims that are likely to be traded by their claim holder] is much smaller."

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A second, more subtle, cost of customer acquisition is caused by the nurturing required to transform a creditor into a motivated seller. Stein-Sapir's experience is that many creditors require a large amount of education before they decide whether to sell a claim. "A lot of creditors are not familiar with claims trading, so there is a lot of explaining to do to walk through the process." He believes that placing an intermediary between the seller and purchaser of the claim makes this process more complex by "adding yet another layer of discussion and explanation." An individual with experience with claims trading platforms agreed, noting that the "education and sales process to convert a claim holder into a knowledgeable and rational claim seller is very challenging." As a result, "consistently sourcing claims that are priced appropriately is also very challenging," he said. He suggests that most creditors need pricing guidance from an exchange, but "that guidance is hard to provide since there is not a database of market pricing available for purchase."

David Karp, who leads the Distressed Debt and Claims Trading Group of Schulte Roth & Zabel LLP, notes that many purchasers of distressed debt do expect to transact through a middleman and that several brokers have set up claims trading desks or added claims to their distressed debt desks within the last two years. However, that is an "extremely competitive" business, according to Karp. He adds that it is "hard to sustain a broker on small claims" and, further, that "sourcing large claims is the name of the game because of transaction costs and settlement risk." Karp says that there are some who are looking to take advantage of untapped opportunities by structuring products through the aggregation of smaller claims. Overall, Karp believes that brokers that are able to put their own balance sheets to work will be better positioned to succeed.

Most expect the market for claims against bankrupt companies to continue to be robust and demonstrate long-term growth. While the imminent resolution of the Lehman Brothers and MF Global cases will reduce trading volumes in the near term, Karp notes that new buyers are moving into the market constantly. The types of claims being traded have expanded and trading in claims against insolvent companies in Europe and Latin America is growing. Overall, he believes that it is an interesting time in the claims trading market because investment funds are continuing to show more interest in claims trading and the secondary market is continuing to evolve. At the same time, creditors have become savvier and there is more information available to creditors in the post-Lehman world. Nevertheless, it is "still a market dictated by the large and sophisticated buyers," Karp says.

There appears to be less consensus regarding the ability of an online bankruptcy claims trading platform to capture significant market share. Stein-Sapir notes that there is no obvious solution to either the unique aspect of each claim or the cost of customer acquisition, and that neither issue will be easily remedied by technological improvements. Others believe that we will eventually see a transparent market where claims are traded electronically, but remain unsure how long such a market will take to develop. ¤