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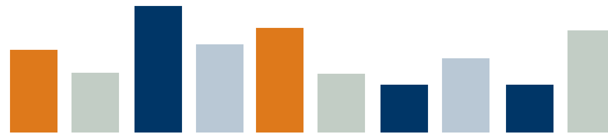

Investment Management Hot Topics

Current Issues in Trading Fixed Income Securities

October 4, 2011

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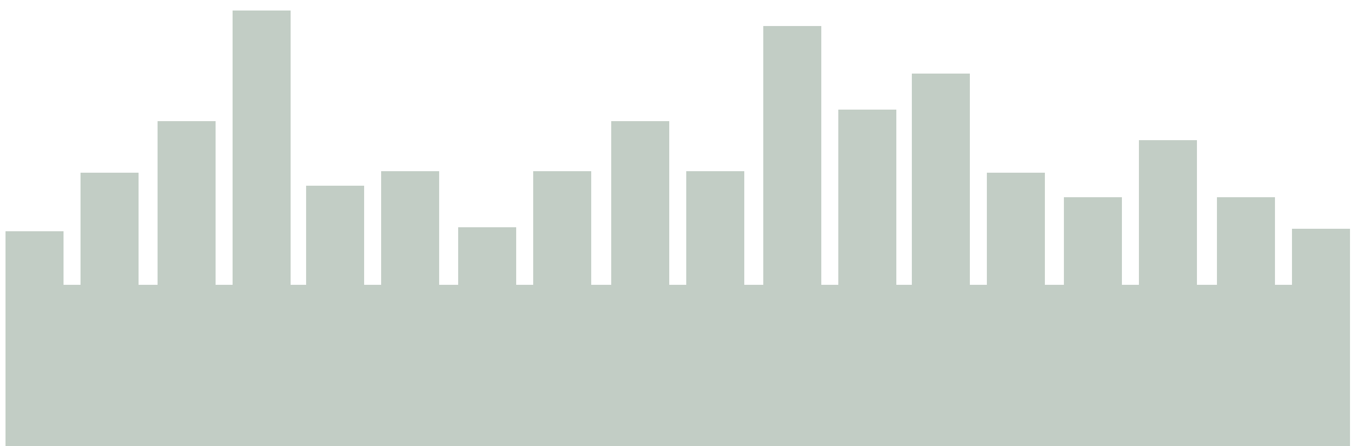
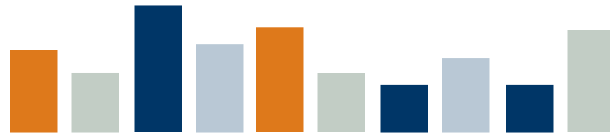
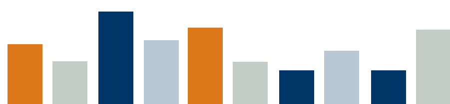


Schulte Roth & Zabel 

Investment Management Hot Topics

1. About the Speakers



Harry S. Davis
919 Third Avenue
New York, NY 10022
+1 212.756.2222 | harry.davis@srz.com

Harry S. Davis is a partner in Schulte Roth & Zabel's Litigation and Regulatory & Compliance Groups, where his practice focuses on complex commercial litigation and regulatory matters for financial services industry clients, including hedge funds, funds of funds and private equity funds, prime and clearing brokers, and auditors and administrators. Harry has substantial experience in both securities regulatory matters and private litigation, including investigations by the Securities and Exchange Commission, U.S. Attorneys' Offices, the Department of Justice, the Commodities Futures Trading Commission, the Federal Trade Commission, state attorneys general, state securities regulators and self-regulatory organizations.

Harry has litigated numerous cases in federal and state courts throughout the United States, including his recent successful representation of a prime broker in a hotly contested and high-profile fraudulent transfer trial brought by the bankruptcy trustee of a failed hedge fund. Over the course of his career, Harry has represented clients in investigations and litigations involving allegations of insider trading, market manipulation, market timing and late trading, alleged securities law violations concerning PIPEs, short-swing profits, securities and common law fraud, advertising, breach of fiduciary duty and breach of contract, among other claims. To prevent minor issues from growing into bigger problems, he provides litigation and compliance counseling to many of the firm's clients, and conducts internal investigations.

A sought-after speaker and author, Harry recently served as the editor of the *Insider Trading Law and Compliance Answer Book*, to be published this year by the Practising Law Institute, and authored two chapters: "Introduction to the Law of Insider Trading" and "Materiality." He recently participated in "Hot Button Regulatory Enforcement and Compliance Issues for the Hedge Fund Industry" at GAIM Ops Cayman, "Hedge Funds: Tracking the Progress of Reform" at *The Financial Times* Global Financial Forum and "An In-Depth Look at Recent Trading Revisions and Compliance" at the FRA Hedge Fund Compliance Summit. Harry graduated with a J.D., *magna cum laude*, from Cornell Law School, where he was editor of the *Cornell Law Review*, and was awarded his B.A., with departmental honors, from Johns Hopkins University.

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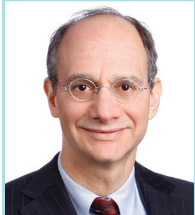

Steven J. Fredman
919 Third Avenue
New York, NY 10022
+1 212.756.2567 | steven.fredman@srz.com

Steven J. Fredman, a partner in the New York office of Schulte Roth & Zabel and co-head of the firm's Investment Management Group, concentrates his practice in the areas of investment funds (domestic and offshore), investment advisers and broker-dealers, the acquisition and related financing of investment management firms, and securities regulation.

Steve has structured and organized private investment partnerships and offshore funds, including general equity, arbitrage, global investment, private equity, distressed company, small cap and fund of funds, and has counseled on issues relating to partnership law, new product development, and other matters. He has structured and organized investment advisers and broker-dealers, handled the registration of commodity pool operators and commodity trading advisors, and provided ongoing advice to investment advisers on securities laws, rules, regulations and information. He has also represented clients in connection with the acquisition and sale of investment management firms or their assets.

A respected author and speaker, Steve has recently written "New Paradigm in Asset Manager M&A: Financial Institution Alliances with Hedge Fund Managers" and co-authored "Alternative Asset Manager Acquisitions: Addressing the Human Paradigm in the Integration Process," both of which appeared in *The Hedge Fund Journal*. He discussed "Alternative Asset Manager Acquisitions" at Goldman Sachs' 14th Annual Hedge Fund Conference, and presented on "Hedge Fund Challenges: The Hedge Fund Perspective" at the SIFMA Compliance & Legal Society Annual Seminar.

Steve has been listed in the *International Who's Who of Private Funds Lawyers, The Best Lawyers in America*, *IFLR Best of the Best USA* (Investment Funds), *Chambers USA*, *Chambers Global*, *IFLR Guide to the World's Leading Investment Funds Lawyers*, *IFLR Guide to the World's Leading Private Equity Lawyers*, *The Legal 500 United States* and *PLC Which Lawyer?*. Steve is a graduate of Georgetown University Law Center, where he was an editor of *Law and Policy in International Business*, and a graduate of Columbia University, where he was Phi Beta Kappa.

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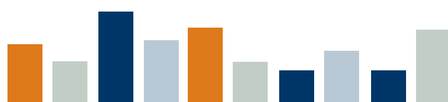

David J. Karp
919 Third Avenue
New York, NY 10022
+1 212.756.2175 | david.karp@srz.com

David J. Karp is a special counsel in the New York office of Schulte Roth & Zabel, where his practice focuses on corporate restructuring, special situations and distressed investments, distressed mergers and acquisitions, and the bankruptcy aspects of structured finance. David leads the firm's Distressed Debt and Claims Trading Group, which provides advice in connection with U.S., European and emerging market debt and claims trading matters.

David speaks and writes on distressed investing and related issues, recently co-authoring "Bankruptcy Claims Trading Orders: Who Is Watching," which appeared in *Bankruptcy Law360*, and "Claims Traders Beware: More Risk Than You Bargained For!" for the *Bloomberg Bankruptcy Law Report*. He discussed "Current Issues in Distressed Investing" at SRZ's 20th Annual Private Investment Funds Seminar and presented "Basic Issues for Distressed Bank Debt Market Participants" at SRZ's Distressed Investing: Capital Structure Analysis and Debt Trading seminar.

David is a member of the American Bankruptcy Institute, the Asia Pacific Loan Market Association, the Emerging Markets Trading Association, the International Swaps and Derivatives Association, the Loan Market Association, and the Loan Syndications and Trading Association. David obtained his B.S. from Cornell University and his J.D. from Fordham University School of Law.

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Richard J. Morvillo
1152 Fifteenth Street, NW, Suite 850
Washington, D.C. 20005
+1 202.729.7479 | richard.morvillo@srz.com

Richard J. Morvillo, a partner in the Washington, D.C. office of Schulte Roth & Zabel, has, for more than 30 years, made the focus of his practice SEC enforcement, related white-collar criminal matters and private securities litigation. A former branch chief with the SEC's Division of Enforcement, Rich represents corporations, corporate executives, brokerage firms, investment advisers, accounting firms, auditors, law firms, hedge funds and individual investors in connection with SEC, PCAOB, NYSE, FINRA, Congressional, state attorney general and grand jury investigations; SEC litigation; and complex securities cases. In addition to litigating to a successful judgment a number of SEC enforcement cases and defending numerous class actions and shareholder derivative suits in federal courts throughout the country, Rich has conducted many internal investigations for corporations, and advised members of numerous special committees of boards of directors as to their rights and obligations regarding the handling and evaluation of corporate transactions, internal investigations and shareholder litigation.

He is a frequent speaker at professional seminars and serves as the co-chair of two PLI annual programs: "Internal Investigations" and "Auditor Liability." He has served on the adjunct faculty of Georgetown University School of Law, teaching a course in "Professional Responsibility in Corporate and Securities Practice."

Chambers USA called Rich "one of the deans of the securities enforcement bar." He is also listed as a leading litigator in numerous other peer-review publications, including *Benchmark Litigation*, *The Best Lawyers in America*, *The Legal 500 United States*, *Ethisphere: Attorneys Who Matter*, *Washington DC Super Lawyers*, *The Legal Times*, which named him one of Washington's "Top 10 Securities Lawyers," and *Washingtonian Magazine*. Rich received his J.D. from Fordham University School of Law and his A.B. from Colgate University.

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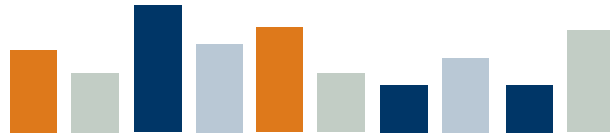
Schulte Roth & Zabel 

Investment Management Hot Topics

2. PowerPoint Presentation

Understanding when Fixed Income Instruments are Securities

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Investment Management Hot Topics

Notes:

Duties and Materiality

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Manipulative Trading Practices

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Ethical Walls and Other Compliance Considerations

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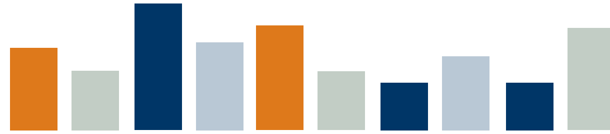

Investment Management Hot Topics

3. Outline

Current Issues in Trading Fixed Income Securities

I. Understanding When Fixed Income Instruments are Securities

A. Section 10(b) of the Exchange Act and Rule 10b-5 apply only "in connection with the purchase or sale of any security…or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act)." 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5

B. What are securities?

1. Exchange Act definition of a "security" is relatively straightforward:

   The term "security" means any note, stock, treasury stock, security future, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited. (Section 3(a)(10) of the Exchange Act, 15 U.S.C. § 78c)

2. Recent traditional debt securities insider trading cases:

   (a) *Alexandra Global Master Fund v. Ikon Office Solutions*, No. 06 Civ. 5383 (JGK), 2007 WL 2077153, (S.D.N.Y. June 20, 2007) (allegations concerning trading in convertible corporate bonds)

   (b) *R2Investments LDC v. Salomon Smith Barney, Inc.*, No. 01 Civ. 3598 (JES), 2005 WL 6194614 (S.D.N.Y. Jan. 13, 2005) (allegations concerning trading in high yield corporate bonds)

   (c) *SEC v. Barclays Bank PLC*, No. 07 Civ. 4427 (S.D.N.Y. filed May 30, 2007) (allegations concerning trading in distressed corporate bonds)

C. What are securities-based swap agreements?

1. Gramm-Leach Bliley Act § 206B defines "security-based swap agreement" as:

   "A swap agreement (as defined in Section 206A…) of which a material term is based on the price, yield, value, or volatility of any security or group of index securities, or any interest therein." 720 F. Supp. 2d at 404

2. Credit default swaps and the meaning of "based on":

   (a) In 2009, the SEC filed the first insider trading case involving credit default swaps in *SEC v. Rorech*

      (i) The complaint alleged that a salesman at Deutsche Bank and a then-portfolio manager at hedge fund investment adviser Millennium Partners LP engaged in insider trading in credit default swaps when the salesman misappropriated confidential information about a planned bond offering and provided it to the salesman in two cell phone calls

      (ii) The court ultimately ruled in favor of the defendants on the insider trading charge, but the important legal point was that the court found the SEC had antifraud jurisdiction over the credit default swaps at issue

   (b) In June 2010, the court in *SEC v. Rorech*, 720 F.Supp.2d 367 (S.D.N.Y. 2010) held that the CDS agreements in that case, which referenced a corporate debt security, were "securities-based swap agreements" for the purposes of Section 10(b)

      (i) Arguments

         (1) The SEC contended that the price term (or spread) of the two credit default swaps at issue was based on the price, yield, value or volatility of the underlying corporate bonds and, therefore, the credit default swaps were "securities-based swaps"

         (2) The defendants contended that the price of the credit default swaps may have been related to the price, yield, value or volatility of the underlying bonds, but the price of the credit default swaps was not "based on" those characteristics of the bond. The defendants argued that the "based on" language in the statute requires a direct or exclusive dependence and that, in their case, the price of the credit default swaps was negotiated and affected by many factors, including the strength of the overall economy and the market's assessment of the company's credit risk

      (ii) Holding

         (1) The court held that the "based on" language does not require an exclusive relationship; rather, it means a fundamental part of the component

            - Plain and ordinary meaning of "based on" is a "principle component of," not an exclusive relationship

            - Other statutory interpretations of "based on" were consistent with that definition

            - The broad statutory scheme as a whole indicated that "based on" language was not intended to be narrowly interpreted

            - The legislative history of the Commodity Futures Modernization Act of 2000 expresses support for applying the SEC's enforcement authority to novel financial instruments like credit default swaps

II. Duties and Materiality

A. Two theories of insider trading:

1. Traditional theory: A person violates Rule 10b-5 when he trades in the securities of his corporation on the basis of material, nonpublic information and/or tips a corporate outsider to the material, nonpublic information for the purpose of trading securities. *United States v. O'Hagan*, 521 U.S. 642 (1997) (describing the traditional theory); *Dirks v. SEC*, 463 U.S. 646 (1983) (discussing tipper and tippee liability)

   (a) Trading constitutes a deception because "a relationship of trust and confidence [exists] between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation." *United States v. Falcone*, 257 F.3d 226, 229 (2d Cir. 2001) (quoting O'Hagan, 521 U.S. at 651-52)

   (b) That relationship gives rise to "a duty to disclose [or to abstain from trading] because of the necessity of preventing a corporate insider from…tak[ing] unfair advantage of…uninformed… stockholders." *Id*.

2. Misappropriation theory: A person violates Rule 10b-5 when he misappropriates material nonpublic information in breach of a fiduciary duty or similar relationship of trust and confidence and uses that information in a securities transaction. *United States v. Chestman*, 947 F.2d 551, 566 (2d Cir. 1991) (describing the misappropriation theory)

   The duty breached under the misappropriation theory is to the source of the nonpublic information. *Id.*

B. Materiality of information in debt securities cases

1. Standard is no different from insider trading in equity securities cases

   (a) *Alexandra Global Master Fund v. Ikon Office Solutions*, No. 06 Civ. 5383 (JGK), 2007 WL 2077153, *3 (S.D.N.Y. June 20, 2007) (holding that a defendant's intention to launch a private placement and use the proceeds to exercise its right to redeem outstanding convertible notes for 102% of their value was material because it "is unlikely that an investor seeking to liquidate securities would be uninterested in the fact that it could receive a significant premium by awaiting a redemption date rather than immediately negotiating an individualized repurchase price at or below the face value of the securities")

2. Information that is speculative and already in the marketplace is not material

   (a) *SEC v. Rorech and Negrin*, 720 F. Supp. 2d 367 (S.D.N.Y. June 25, 2010) (rejecting SEC's claim that information about a restructured bond offering and a customer's indication of interest in the offering was material because knowledge about a potential restructuring and the substantial investor demand for the restructured products was already in the market)

3. Knowledge gained by participating in creditors' committees and bankruptcy reorganization plans may be material

   (a) *In re Washington Mutual, Inc*., --- B.R. ----, 2011 WL 4090757 (Bankr. D. Del. Sept. 13, 2011) (knowledge that a settlement plan was being discussed and the relative stances of the negotiating parties may have been material even though there was no agreement in principle)

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C. **Duties in debt securities cases**

1. Between a corporation and its debt security holders

   (a) There is generally no fiduciary relationship between a corporation and their unsecured creditors; rather, the relationship is contractual

   (b) Convertible bondholders are not treated differently

      (i) *Alexandra Global Master Fund v. Ikon Office Solutions*, No. 06 Civ. 5383 (JGK), 2007 WL 2077153, (S.D.N.Y. June 20, 2007)

         (1) The plaintiff alleged that the defendant committed securities fraud when it repurchased convertible bonds at a negotiated price of 99.5% of their face value without disclosing that it was planning to launch a new private placement and use the proceeds to exercise its right to redeem all of the outstanding convertible bonds for 102% of their value

         (2) The court granted a motion to dismiss, holding that the defendant had no duty to disclose its intention to launch the private placement because corporations do not have a fiduciary relationship to their bondholders

         (3) The court noted that any fiduciary duty the defendant owed to the plaintiff as a result of the equity portion of the convertible bond did not matter because the plaintiff did not allege that the non-disclosure affected its conversion rights

2. Arising from a debt security holder's participation in a corporate bankruptcy

   (a) *In re Washington Mutual, Inc.*, --- B.R. ----, 2011 WL 4090757 (Bankr. D. Del. Sept. 13, 2011)

      (i) Objectors to a bankruptcy settlement plan argued that the settlement noteholders' claims should be disallowed and any distribution to which they would be entitled should be redistributed to other creditors and shareholders.

      (ii) The court held that the objectors stated a colorable claim under the traditional theory that the noteholders were temporary insiders as a result of their participation in the plan negotiations and, therefore, owed a fiduciary duty to other creditors and shareholders

   (b) *SEC v. Barclays Bank PLC*, No. 07 CV 4427 (S.D.N.Y. filed May 30, 2007)

      (i) The SEC filed a settled enforcement action alleging that Barclays and the head of its distressed debt desk engaged in insider trading by purchasing and selling millions of dollars of bond securities while aware of material nonpublic information received from the creditors' committee on which the individual defendant sat on behalf of Barclays

      (ii) The complaint alleged that as to three of the unofficial unsecured creditors' committees, Barclays owed fiduciary duties to all bondholders. The complaint was silent as to the duty arising from the three other creditors' committees

3. Between a debt trader and his employer and clients

   (a) *SEC v. Rorech and Negrin*, 720 F. Supp. 2d 367 (S.D.N.Y. June 25, 2010)

(i) The complaint alleged that a salesman at Deutsche Bank and a then-portfolio manager at hedge fund investment adviser Millennium Partners LP engaged in insider trading in credit default swaps when the salesman misappropriated confidential information about a planned bond offering and provided it to the salesman in two cell phone calls

(ii) The court held that the salesman did not breach any duty of confidentially owed to Deutsche Bank because Deutsche Bank expected the salesman to share his ideas and opinions with prospective customers and did not consider that information confidential

(iii) The court also held that the salesman did not breach any duty of confidentially owed to his customer who had placed an indication of interest because that customer had no expectation of confidentiality

III. Committee/Groups and Material Nonpublic Information in the Distressed Bank Debt and Claims Markets

A. Bank debt — generally not a "security"

1. As defined in I.B.1, the Exchange Act defines "securities" as any number of specific instruments, such as "any note, stock, treasury stock, bond, debenture, certificate of interest of participation in any profit-sharing agreement." Thus, while bonds are expressly included in the definition, bank debt is not. But it is also not expressly excluded

2. *In Reves v. Ernst & Young*, 494 U.S. 56 (1990), the Supreme Court adopted the "family resemblance" test to determine whether promissory notes should be deemed securities. Reves is a fact-specific inquiry into:

   (a) Whether the instrument is motivated by investment or commercial purposes;

   (b) The "plan of distribution" for the instrument;

   (c) The reasonable expectations of the public; and

   (d) Whether an alternative regulatory scheme or other risk-inducing factor renders application of the securities laws unnecessary. *Id*. at 66-67

   In *Reves*, the Supreme Court also identified seven types of notes that had previously not been identified as fitting within the definition of security:

   (a) Notes delivered in connection with consumer financing;

   (b) A note secured by a home mortgage;

   (c) Short-term notes to a small business secured by a business' assets;

   (d) Bank character loans;

   (e) Short-term notes secured by an assignment of accounts receivable;

   (f) A note formalizing an open account debt incurred in the ordinary course of business; and

   (g) Notes evidencing loans by commercial banks for current operations. *Id*. at 65

3. While general market practice currently does not treat bank debt as a security within the meaning of the Federal securities laws and existing case law, including *Reves*, there is no decision precisely

on point holding that bank debt is not a security. However, loan total return swaps and loan credit default swaps are considered securities based swaps. Loan indices may also fall within this category

4. Generally, trades of bank debt — and specifically the most frequently traded, leveraged loans — are not subject to the anti-fraud and anti-manipulation provisions of securities laws and are not regulated by the Securities and Exchange Commission

5. Material nonpublic information gleaned from bank debt trades (i.e., borrower confidential information or syndicate confidential information, further discussed below) and/or obtained from membership on an ad hoc committee may not be used to trade regulated securities (e.g., bonds, equity, etc.) as this would violate securities law

6. While, in limited circumstances, it may be possible to avoid securities law violations when trading bank debt with material nonpublic information, parties should utilize proper safeguards to minimize reputational risk and possible litigation risk from private counterparties

B. Investors in bank debt still face risk of common fraud litigation by private parties

1. The borrower may bring a breach of contract or breach of fiduciary duty claim in a bank debt trade, when the trader owes some other duty of trust or confidence to the borrower (i.e., confidentiality agreement with the borrower/debtor)

2. A counterparty may bring common law fraud litigation in bank debt trades for claims based on:

   (a) Fraud or misrepresentation, when the trader makes a material false representation intending to defraud the counterparty, who relies on the misrepresentation and suffers damages; or

   (b) Fraudulent concealment by the trader, if there was duty to disclose (e.g., New York common law's "peculiar knowledge" exception, where one party's superior knowledge of essential facts would render a transaction "inherently unfair")

C. Material nonpublic information in the leveraged loan secondary market — borrower confidential information and syndicate confidential information

1. Syndicate confidential information

   (a) Not confidential as between syndicate members

   (b) Readily available to brokers; can be disclosed to potential buyers of the debt who execute a confidentiality agreement

   (c) Syndicate information is confidential information about the borrower that is made available to lenders and potential lenders pursuant to a confidentiality agreement. Some syndicate information may contain material nonpublic information

   (d) Syndicate information is available to all members of the syndicate. Thus, a party would not be exposing itself to a fraud claim or violation of securities law claim if it traded bank debt with other existing or prospective lenders on the basis of material nonpublic information gleaned from syndicate information that was available to the existing or prospective lenders

2. Borrower confidential information

   (a) Borrower confidential information is confidential information that is not available to the entire

syndicate, but is confidential information, usually containing material nonpublic information, that has been made available to a lender because of its position on a steering committee or creditors' committee of the borrower

(b) Breach of duty owed to borrower or bankruptcy estate — if a party trades on the basis of material nonpublic information gleaned from borrower confidential information, without disclosing to the other party, it may face fraud claims by its counterparty. Even if it discloses the information to the counterparty in violation of a confidentiality agreement or other duty, it may be susceptible to allegations of breach of fiduciary duty it owes to the borrower, to the bankruptcy estate or to other creditors

D. Material nonpublic information in the bankruptcy context — official committees and ad hoc committees and groups

1. Official committees

(a) Official committees are appointed by the Office of the United States Trustee ("UST") under section 1102 of the Bankruptcy Code. An official committee is empowered to:

(i) Consult concerning the administration of the case;

(ii) Investigate the acts, conduct, assets, liabilities, and financial condition of the debtor;

(iii) Participate in the formulation of a plan; and

(iv) Request the appointment of a trustee or examiner under section 1104 of the Bankruptcy Code

(b) Members of official committees owe a fiduciary duty to the bankruptcy estate and to all similarly-situated constituents, and are subject to oversight by the bankruptcy court and the UST, including, in many large cases, trading restrictions

2. Ad hoc committees and groups

(a) Ad hoc groups or unofficial committees provide a mechanism by which creditors or equity interest holders with a common agenda can join together on an informal basis to pursue their interests in the reorganization process. Groups that form ad hoc committees include: bondholders; equity holders; trade creditors; unions; holders of tort claims against the estate; secured loan syndicates; landlords; and other groups of investors or financial institutions

(b) Importantly, unofficial committees are not appointed by the UST and traditionally do not owe fiduciary duties to any body of constituents, nor are they subject to oversight by the UST

(c) Recent case law has challenged this notion and ad hoc committee members should tread carefully in this evolving legal area. See *In re Washington Mut., Inc.*, --- B.R. ----, 2011 WL 4090757 (Bankr. D. Del. Sept. 13, 2011); *In re Northwest Airlines Corp*., 363 B.R. 704, 708-09 (Bankr. S.D.N.Y. 2007); *see also Official Comm. of Equity Sec. Holders of Mirant Corp. v. Wilson Law Firm, P.C. (In re Mirant Corp.)*, 334 BR. 787, 793 (Bankr. ND. Tex. 2005) (holding that attorney for an ad hoc committee of shareholders owed a duty to the entire class of shareholders, not just members of the ad hoc committee)

3. Rule 2019 disclosure

   (a) Current rule — broad disclosure requirements, but unclear by whom

      (i) Pursuant to current Bankruptcy Rule 2019:

         "Every entity of committee representing more than one creditor or equity security holder …shall file a verified statement setting forth (1) the name and address of the creditor or equity security holder; (2) the nature and amount of the claim or interests and the time of acquisition thereof…"

         Accordingly, if a bankruptcy court finds that a group is a "committee" within the meaning of Bankruptcy Rule 2019, then its members must disclose nature of the amount of debt/claims/equity securities they hold, when and at what price the claims/securities were acquired

      (ii) Current case law is divided on the issue of what constitutes a "committee" for purposes of current Bankruptcy Rule 2019. This distinction will no longer be relevant once the new rule 2019 (discussed below) goes into effect

   (b) New rule (effective Dec. 1, 2011)

      (i) The new rule submitted by the Supreme Court to Congress will become effective on Dec. 1, 2011, unless Congress blocks its effectiveness

      (ii) The new rule requires disclosure not just by committees, but also by "groups that consist of multiple creditors that are acting in concert to advance their common interest"

      (iii) The group must disclose of the circumstances concerning its formation, and each member of the group must disclose the nature and amount of each "disclosable economic interest" when the group first makes an appearance in the bankruptcy case. "Disclosable economic interest" is defined to mean "any claim, interest, pledge, lien, option, participation, derivative instrument, or any other right granting the holder an economic interest that is affected by the value, acquisition, or disposition of a claim or interest"

      (iv) Group members are not required to disclose the purchase price of their disclosable economic interests

E. Access to information — ad hoc committee members have to negotiate for access to information

1. Unlike the official creditors' committee, an ad hoc group does not have an absolute right to receive nonpublic information from the debtor

2. Ad hoc committees must negotiate with the debtor (and execute a confidentiality agreement) to gain access to nonpublic information. While not required by statute or rule, official committees and debtors will also often enter into confidentiality agreements out of an abundance of caution

   (a) Depending on the needs of the parties, confidentiality agreements can be executed between the debtor and:

      (i) The committee as a whole,

      (ii) Individual committee members, or

      (iii) Committee counsel

(b) If some members of an ad hoc committee wish to obtain confidential information and other members do not, it is possible to isolate members receiving confidential information from those who wish to remain unrestricted

3. As a result, an ad hoc committee member's ability to trade is only affected when that member elects to become "restricted" and receive nonpublic information from the debtor

4. Confidentiality agreement sunset provisions

   "Sunset provisions" in confidentiality agreements require the debtor, under certain circumstances or within a certain period, to publicly release the nonpublic information provided to the group. After publication (also referred to as "cleansing") the members of the group that had received the information, and were as a result restricted, are no longer restricted

5. Forced disclosure

   Restricted members may try to persuade or force the debtor to publicly disclose the confidential information, so that all of the ad hoc committee members may access that information. This is particularly true for information that is so important that it would clearly influence the committee's decision. Pressure from an ad hoc committee or its counsel to disclose information may create considerable tension in instances in which the debtor and the official committees in the case truly believe that the information is confidential, and that public disclosure of that information would harm the debtor

F. Information management

1. Investors in bank debt have several options with respect to information management. Investors can:

   (a) Stay exclusively on the "public" side, with no access to material nonpublic information

   (b) Stay exclusively on the "private" side, with access to material nonpublic information, but no ability to trade in the public markets

   (c) Set up an "information wall" or "ethical wall" between the public and private sides

2. Again, recent case law appears to have challenged traditional notions of when and on what information bank debt traders may trade

3. Information walls

   (a) Creditors who wish to continue trading while at the same time serving on a official creditors' committee should separate traders from recipients of borrower confidential information. If properly structured and observed, ethical walls may guard against trading that might harm the constituent creditors by interfering with the reorganization process, a potential fiduciary duty violation. In the context of a bankruptcy of the borrower, the bankruptcy court must approve information blocking procedures and retains discretion to permit trading, even upon the establishment of screening walls for members of official committees

   (b) Courts have approved trading orders with some of the following security methods in place:

      (i) Personnel with access to nonpublic information must execute a letter acknowledging awareness of the ethical wall;

      (ii) Committee members prohibited from sharing nonpublic information;

(iii) Files containing nonpublic information must be maintained separately;

(iv) Individuals serving as committee members are prohibited from receiving information regarding current securities trades in advance of such trades; and

(v) Compliance department required to confirm that trades are made consistent with the order

G. Big boy letters

1. The individualized nature of the bank debt markets makes so called big boy letters feasible in certain circumstances

2. Big boy letters allow parties to contract around private fraud claims when there is information asymmetry

(a) Big boy letters (or equivalent provisions in larger agreements) essentially are representations and warranties of the parties that acknowledge the information asymmetry and an indication by the party with inferior information that it still wishes to proceed with the trade. If the party later learns such additional information it will be a "big boy" and not seek recourse against the better-informed party

(b) While big boy letters cannot disclose the actual information possessed by the party with knowledge, they must be as detailed as possible in describing the information imbalance, and should note the sophistication of the parties and the voluntary nature of their trade, as well as the obligation of each party to conduct its own due diligence

(c) The keys to the enforceability of big boy letters are:

(i) The letter must be the product of negotiations between sophisticated parties;

(ii) The disclaimer should be specific as to the information that is not disclosed or the information withheld, i.e., business plans, earnings projections, or financial statements;

(iii) The letter should describe the party's relationships with the issuer, e.g., committee member, advisor, member of the board of directors;

(iv) The counterparty should acknowledge it has had the opportunity to conduct its own diligence;

(v) The counterparty should agree that, notwithstanding the acknowledged information asymmetry, the counterparty wishes to proceed with the trade; and

(vi) The counterparty should represent that any subsequent downstream purchaser will be required to acknowledge big boy language

(d) The limitations on enforceability of big boy letters are:

(i) Big boy letters are only enforceable between the parties to the relevant letter or agreement

(ii) Big boy letters do not protect against enforcement actions by the SEC

(iii) Big boy letters do not protect against third-party claims that may be brought for relief under the equitable powers of the bankruptcy court, e.g., equitable subordination, equitable disallowance, etc.

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3. Big boy letters and the Exchange Act's anti-waiver provision

   (a) Section 29(a) of the Exchange Act voids "[a]ny condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any rule of a self-regulatory organization." 15 U.S.C. § 78cc

   (b) Big boy letters may be such an unenforceable waiver in the context of a securities trade. See *AES Corp. v. Dow Chemical Co*., 325 F.3d (3d Cir. 2003); *Rogen v. Ilikon Corp*., 361 F2d 260 (1st Cir. 1966); but see *Harsco Corp. v. Segui*, 91 F3d 337 (2d Cir. 1996). However, the non-reliance language in big boy letters can have a limited use in defending fraud claims, in that it can undermine a plaintiff's argument that it relied on the statements or omissions of the other party in the trade

   (c) The SEC does not have an official position on the enforceability of big boy letters, but statements by SEC officials and actions in recent enforcement cases (i.e., SEC v. *Barclays Bank PLC*, No. 07 CV 4427 (S.D.N.Y. filed May 30, 2007) discussed above) indicate that the SEC does not believe big boy letters offer any protection in an enforcement action by the SEC

4. Sample big boy language

   Buyer acknowledges that (i) Seller currently may have, and later may come into possession of, information with respect to the Transferred Rights, the Assumed Obligations, Borrower, Obligors or any of their respective Affiliates that is not known to Buyer and that may be material to a decision to purchase the Transferred Rights and assume the Assumed Obligations ("Buyer Excluded Information"), (ii) Buyer has determined to purchase the Transferred Rights and assume the Assumed Obligations notwithstanding its lack of knowledge of the Buyer Excluded Information and (iii) Seller shall have no liability to Buyer or any Buyer Indemnitee, and Buyer waives and releases any claims that it might have against Seller or any Seller Indemnitee, whether under applicable securities laws or otherwise, with respect to the nondisclosure of the Buyer Excluded Information in connection with the Transaction; provided, however, that the Buyer Excluded Information shall not and does not affect the truth or accuracy of Seller's representations or warranties in this Agreement[1]

5. Efficacy of big boy letters

Breach of contract or fiduciary duty claim arising from purchase or sale of securities or non-securities when trader owes duty of trust or confidence to borrower (i.e., creditors' committee)	Ineffective
Defending government, civil or criminal proceedings arising from the purchase and sale of securities (i.e., distressed bonds)	Ineffective
Defending private third-party lawsuits for fraud arising from purchase and sale of securities (i.e., distressed bonds)	Uncertain effectiveness
Defending fraud case brought by counterparty arising from the purchase and sale of non-security (i.e., distressed bank debt)	Effective if drafted correctly (i.e., changes to the quoted language above may be necessary depending on the type and source of information)

[1] Section 5.1(h) of the Purchase and Sale Agreement for Distressed Trades — Standard Terms and Conditions as published by the Loan Syndication and Trading Association in September 2011. Section 4.1(o) contains the mirror representation by Seller.

IV. Conflicts of Interest — Investing at Different Levels of an Issuer's Capital Structure

A. Increased scrutiny

1. Regulatory

   (a) Examinations

      (i) The SEC often requests information relating to investment manager's identification of, assessment of and ongoing monitoring of conflicts and compliance risks, its Code of Ethics and its policies and procedures

   (b) Legislation

      (i) Enhanced disclosure requirements under Dodd-Frank and new Form ADV Part 2

      (ii) Connecticut proposed state legislation in 2010 that would require funds to disclose, at all times, any conflicts of interest

2. Investors

   (a) Due diligence and DDQ questions

      (i) "Describe any material conflicts of interest with respect to business matters"

      (ii) "Describe any current or potential conflicts of interest or any relationships which may threaten the organization's duty to its clients/investors or potentially breach applicable regulation"

      (iii) "Are any of the organization's key staff members involved in other businesses that may present a conflict of interest?"

      (iv) "Describe policies and procedures for identifying and addressing conflicts of interest"

      (v) "How are conflicts resolved?"

   (b) Insistence on advisory committees to address conflicts

3. Industry has provided recommendations and best practices

   (a) MFA's 2009 Sound Practices for Hedge Fund Managers

      (i) Adopt a compliance manual that addresses conflicts in a standardized and consistent way

      (ii) Create a conflicts committee

      (iii) Conduct annual reviews of compliance procedures

   (b) 2009 Report of the Asset Managers' Committee to the President's Working Group on Financial Markets

B. Nature of conflict

1. Investment manager may provide investment management services to one fund focusing on senior levels of issuers' debt and another fund focusing on junior levels

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2. Two issues typically arise:

   (a) In a reorganization of a portfolio company or a refinancing of its debt, the equity or lower ranking debt may be lost or its value significantly reduced in order to preserve value of holders of the higher-ranking debt

   (b) An investment manager holding debt of a portfolio company for one fund legitimately may become privy to material nonpublic information with respect to the portfolio company. As a result, all of the funds holding securities of the portfolio company, even if the securities are different, may be prohibited from trading in any securities of such issuer

3. Fiduciary duties

   (a) Delaware law imposes fiduciary duties with respect to both the fund and investors in the fund

   (b) Investment Advisers Act

      (i) Fiduciary duties to all funds

      (ii) Anti-fraud obligation with respect to investors in all funds pursuant to Rule 206(4)-8

C. Addressing conflicts

1. Establish processes for proactively identifying and managing conflicts of interest

   (a) Committee consisting of senior investment and non-investment professionals that, before a trade that may give rise to conflict is made, considers the likelihood of conflict arising and ways to mitigate conflict

   (b) If the committee determines that a material conflict is likely to occur, it should promptly provide the investment manager with a summary of the proposed investment, the nature of the conflict and the course of action the committee recommends

   (c) The investment manager could complete internal questionnaires relating to consideration and mitigation of possible conflicts before making an investment, thereby documenting that the investment manager has addressed the conflict issue

   (d) Some policies provide that conflicts will be resolved by an independent manager

2. Disclosure

   (a) Disclose conflicts and policies for addressing them in PPM, Form ADV and investor letters

      (i) Investors should be aware of potential conflicts of interest at time of making investment

      (ii) If Fund B was established after Fund A, consider adopting a policy (and make appropriate disclosure thereof) that, if a conflict is not resolvable in an equitable manner, the investment manager will act in a manner that favors Fund A at the expense of Fund B, which could result in losses to Fund B

   (b) Disclose possibility that the investment manager may come into possession of material nonpublic information with respect to an issuer because, for Fund A, the investment manager is likely to sit on a creditors' committee. Explain that, should this occur, the investment manager

would be restricted from transacting in securities of the issuer in each of the funds that it manages until such time as the information becomes public or is no longer deemed material

V. Information Barriers and Compliance Considerations

A. Employees within a particular group (e.g., group that does private financings) may be exposed to material, nonpublic information (such employees being referred to as "restricted persons")

1. Before an employee exposes himself to inside information, he must inform the firm, which will consider whether to establish barrier. Even if separation (physical and technological) already exists, appropriate people (e.g., legal and compliance) must be informed so as to monitor the effectiveness of the wall

2. If a company is made subject to the information barrier restrictions (a "subject company"), all communications between restricted persons and other personnel (such other personnel being referred to as "unrestricted firm personnel") must comply with the information barrier policies

B. Policy

1. Physical and technological separation of groups, if possible

    (a) Separate, secure space

    (b) Restricted access to data

2. Restricted persons should have no authority to cause any accounts managed by the firm to trade in securities of the subject company

3. Restricted persons cannot discuss the subject company with unrestricted firm personnel

    (a) Avoid discussing the subject company in shared spaces

    (b) Conference calls regarding the subject company should be in closed spaces

4. If a member of unrestricted firm personnel wants to talk to a representative of the subject company, he must let the person he is talking to know that (a) the firm invests in the public securities markets and may invest in the subject company's securities, (b) the subject company representative should not provide material nonpublic information to the employee and (c) any information provided will not be kept confidential

5. Restricted persons must leave firm's investment committee meetings if subject company will be discussed

6. Any wall crossing must be pre-approved by legal and compliance

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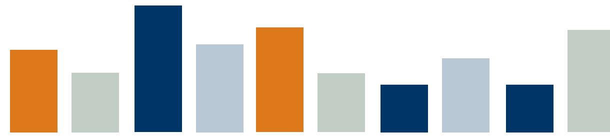

Investment Management Hot Topics

4. Additional Materials

Schulte Roth & Zabel

Distressed Debt & Claims Trading Developments

summer 2011

Debt Trading Clarity From the Authoritative Voice of the European Market

THE LOAN MARKET ASSOCIATION ("LMA") has announced updates to its secondary trading documentation, effective March 24, 2011, and, most recently, June 27, 2011. Notably, the LMA has responded to the growth of claims trading activity following the collapse of three of Iceland's major commercial banks in 2008, clarifying the scope of seller representations and confidentiality requests. The new updates are an improvement to the LMA documentation, which underwent significant changes in early 2010 through the consolidation of par and distressed trading documents.

see Key Changes to Secondary Trading Documentation on page 6

Roxanne Yanofsky Joins SRZ

THE DISTRESSED DEBT AND CLAIMS TRADING practice group at Schulte Roth & Zabel is pleased to announce that Roxanne Yanofsky has joined the firm as an associate in the Business Reorganization Group. Roxanne, who will be working in London, has in-depth experience representing both investment funds and broker/dealers in debt and claims trading transactions throughout Europe, the Middle East, Africa and Asia-Pacific regions. Roxanne has represented buyers and sellers of distressed debt instruments in all aspects of these trades, including negotiating and drafting terms of the transaction documents, advising on transferability restrictions, security documentation, recovery in any enforcement scenario, confidentiality agreements and acquisition of proceeds instruments. Roxanne was involved in establishing the market approach to trading claims against the defaulted Icelandic banks. "We are excited about adding Roxanne and expanding our debt and claims trading capabilities in our London office," said David Karp, who leads the firm's distressed debt and claims trading practice group. "Like many of our clients, we see the secondary market for EMEA distressed debt as an exciting growth area in the coming months and years." Roxanne can be reached at +44 (0) 20 7081 8013 or roxanne.yanofsky@srz.com.

Inside:

Debt Traders Settling Post-Reorganization Equity: In addition to the legal considerations related to trading and transferring post-reorganization equity and to the post-reorganization corporate governance of the reorganized debtor, there are many logistical considerations that can affect the settlement and liquidity of post-reorganization equity.

see Debt Traders Settling Post-Reorganization Equity on page 2

Pushing Unresponsive Counterparties to Settle: LSTA to Introduce "Buy In/Sell Out" for Distressed Trades: The Loan Syndications and Trading Association ("LSTA") is preparing to implement a trade termination mechanism for distressed trades, called "buy-in/sell-out" or "Distressed BISO," designed to give a performing party leverage over a non-performing party to move a stalled trade toward settlement.

see Pushing Unresponsive Counterparties to Settle on page 2

Bankruptcy Claims Trading Orders: Who Is Watching?: Bankruptcy courts have the ability to control the actual transfer mechanics if a trading order is issued. These orders are increasingly common in large bankruptcy cases and may restrict trading in the debtors' debt and equity securities and claims.

see Bankruptcy Claims Trading Orders on page 3

Debt Traders Settling Post-Reorganization Equity

DURING THE PAST YEAR, many investors in the distressed debt market have received post-reorganization private equity[1] either through a confirmed plan of reorganization or through participation in a rights offering. Unlike publicly traded equity, each new issuance of post-reorganization equity leaves recipients, issuers, and agents potentially facing uncharted territory in terms of how the instrument is to trade and settle. While there are many legal considerations related to trading and transferring post-reorganization equity and to the post-reorganization corporate governance of the reorganized debtor,[2] there are some logistical considerations that may affect the liquidity of post-reorganization securities and lead to significant settlement delays.

see Debt Traders Settling Post-Reorganization Equity continued on page 3

[1] E.g., Stallion Oilfield Services; Postmedia Networks Canada Corp.; HMH Holdings; Aleris International; MediaNews Group.

[2] For a more detailed analysis of the law regarding post-reorganization equity, e-mail us at SRZDebtTradingTeam@srz.com for a copy of our "Post Emergence Equity Trading and Post Emergence Equity Governance Outline."

Possible Causes of Delay

- Parties are unaccustomed to settling equity trades or are unfamiliar with the specific terms of the instrument being transferred;
- Lack of clear market consensus on how a post-reorganization equity instrument will trade, on what documents such equity will be traded, or even what rights need to travel with the shares. For instance, some issuers require an opinion of counsel for the selling party stating, among other things, that the transfer is not subject to securities laws, whereas some issuers require only a seller's certification to that effect, and some issuers require no opinion or certification; or
- The transfer agent and issuer may disagree on what form and type of documentation requirements and applicable procedures are to be followed to transfer the post-reorganization equity.

Pushing Unresponsive Counterparties to Settle: LSTA to Introduce "Buy In/Sell Out" for Distressed Trades

THE LOAN SYNDICATIONS and Trading Association ("LSTA") is preparing to implement a trade termination mechanism for distressed trades, called "buy-in/sell-out" or "Distressed BISO," designed to give a performing party leverage over a non-performing party to move a stalled trade toward settlement. BISO is already in place for par trades, but required substantial adaptation for use in distressed trades.[1]

The proposed Distressed BISO mechanism, which is expected to become effective in early September, sets forth a procedure by which a performing party can terminate a trade, proceed on a similar trade with a third party (the "cover trade"), and then potentially require the non-performing party or performing party to compensate the other party for any difference in purchase rate, as no party is intended to profit from Distressed BISO. Distressed BISO is drafted to put the parties in the same economic position as they would have been had the trade settled. As proposed, buyer and seller, by agreeing to use LSTA distressed trade documents, agree to be bound by the LSTA Standard Terms and Conditions, which will include the Distressed BISO once implemented.

Although there are several iterations of the Distressed BISO timeline, depending on, for example, whether the buyer or seller is drafting the settlement documents, the general rule is that Distressed BISO becomes available fifty days after the trade date (the "trigger date"). The trigger date can be extended by up to ten or twenty days for a number of reasons, for example, if the seller delivers the upstreams to the drafting buyer within ten days of the trigger date.

see Pushing Unresponsive Counterparties to Settle on page 4

[1] The Loan Market Association, the European counterpart to the LSTA, also has a BISO mechanism for par trades but has yet to introduce plans for a distressed trade BISO.

Bankruptcy Claims Trading Orders: Who is Watching?

CURRENTLY, NEGOTIATION and documentation of claims trades remain largely unregulated, with only limited oversight from bankruptcy courts and the Securities and Exchange Commission. Generally, the bankruptcy court's, or the claims agent's, involvement in claims trading is ministerial, i.e., maintaining the claims register and recording transfers if the form complies with the rule. Only if there is an objection to a claims transfer does the bankruptcy court become involved in the substance of a transfer. Bankruptcy courts do, however, have the ability to control the actual transfer mechanics if a trading order is issued. These orders are increasingly common in large bankruptcy cases and may restrict trading in the debtors' debt and equity securities and claims.

From a trader's perspective, compliance with the trading order is a prerequisite to recognition and effectuation of transfers by the court and debtor. Once a trading order is entered, the bankruptcy court is the gatekeeper of claims transfers and traders need to ensure compliance. Failure to comply with a trading order can have severe results. Indeed, trading orders often specify that a purchase or sale of a claim not in compliance with the trading order is null and void.

From the debtor's perspective, one of the main objectives of a trading order is to allow the debtor to monitor the ownership of the claims so that it can protect itself from triggering a change in control that could jeopardize certain of the debtor's tax advantages such as net operating losses ("NOL") carryforwards under section 382 of the Internal Revenue Code. Given the growth in claims market participation and the valuable tax attributes often at stake, courts increasingly issue trading orders restricting trading in the debtor's equity, debt securities, and claims.

The consequences of not complying with a trading order can be harsh. For instance, in an early 2011 opinion in the Mesa Air bankruptcy case, the Bankruptcy Court for the Southern District of New York held that a claimholder's failure to comply with the trading order meant that the claimholder did not have standing to object to the confirmation of the debtor's plan.[1] The claimholder had sought to object to confirmation of the plan on various grounds, principally related to post-emergence governance. It argued that certain modifications to the plan after tabulation of the votes were material changes to the plan requiring resolicitation of votes.

*see **Bankruptcy Claims Trading Orders** on page 4*

[1] *In re Mesa Air Group, Inc.*, 2011 WL 320466 (Bankr. S.D.N.Y. Jan. 20, 2011).

Debt Traders Settling Post-Reorganization Equity

continued from page 2

The specifics of the terms of the equity security pursuant to the entity's governing documents (i.e., certificate of incorporation, by-laws, or stockholders' agreement) can also cause unexpected delays. For example, the recipients are often required to become a party to a stockholders' agreement, which may contain additional hurdles to future transfers by requiring, among other things, an opinion of counsel to the selling party and/or board consent to the proposed transfer, or by providing restrictions limiting the number of shares significant holders may transfer at one time without triggering tag-along rights for non-transferring holders.

In addition, as the post-reorganization equity will be issued only to record holders, the beneficial holder's receipt of the post-reorganization equity may be subject to the completion of intermediate trades between it and the record holder. It is possible for there to be multiple trades after the record date such that the actual beneficial holder could be several levels "downstream" from the record holder and, each transfer between intermediate trade parties can be delayed for myriad reasons.

In short, transfers of post-reorganization private equity often take longer than expected and, as with distressed loans and claims, consideration should be given to the potential for settlement delays and the distinction between trading liquidity and settlement liquidity.[3]

[3] In the distressed bank debt, claims and post-reorganization equity trading markets, the difference between the ability to enter into a binding agreement to transfer debt or equity risk ("trading liquidity") and the timing of closing and settling a trade ("settlement liquidity") can be significantly longer than for other asset classes, where instruments trade on an electronic basis and in many instances settle within 3 days of the trade date.

Pushing Unresponsive Counterparties to Settle

continued from page 2

To exercise its right to use Distressed BISO, the performing party sends the non-performing party a notice after the trigger date (the "BISO Notice"). To prevent the performing party from commencing a cover trade, the non-performing party then has twenty days to perform (the "cure period"). If the non-performing party does not comply with its obligations by the end of the cure period, the performing party has ten days from the end of the cure period to find an alternative party with which to enter the trade (the "cover period"), i.e., to "buy-in" or "sell-out." When the buyer enters a cover trade, the non-performing seller shall pay to the buyer the amount by which the cover price exceeds the price of the original trade or, if the cover price is less, the buyer shall pay the net amount to the seller. Conversely, when the seller enters a cover trade, the non-performing buyer shall pay to the seller the amount by which the cover price is less than the price of the original trade or, if the cover price is more, the seller shall pass on the difference to the buyer.

Below are a few other key features of the proposed Distressed BISO:

- Distressed BISO is only available for trades that are to settle by legal transfer, i.e., assignment, but not for trades that were to settle as participations on the trade date.
- Failing to execute and deliver a trade confirmation prior to the trigger date could give rise to a BISO Notice. The LSTA explains in footnote six to the exposure draft that a performing party should consider the appropriateness of using Distressed BISO if it has received written objection from the non-performing party as to a material term of the trade confirmation, the applicability of the LSTA Standard Terms and Conditions or the applicability of Distressed BISO to that trade.

*see **Pushing Unresponsive Counterparties to Settle** on page 5*

Bankruptcy Claims Trading Orders

continued from page 3

The Mesa Air trading order required any transferee to file a Notice of Intent to Purchase, Acquire or Otherwise Accumulate a Claim (a "Claim Acquisition Notice") if such transferee was, or would become as a result of the transfer, a holder of more than $25 million in claims. The trading order also imposed a 30-day period between the filing of the Claim Acquisition Notice and the effectiveness of the transfer, unless the 30-day period was waived by the debtor at its discretion. This requirement of the Claims Acquisition Notice was in addition to the requirements of rule 3001(e) of the Federal Rules of Bankruptcy Procedure, that transferees file evidence of a claims transfer with the court, a filing followed by a 21-day notice period during which either party or the debtor may object to the transfer. The transferee in the Mesa Air case filed the notice of transfer pursuant to rule 3001(e) only after the debtor raised the standing issue in its pretrial memorandum. The transferee, however, had not filed a Claim Acquisition Notice prior to the confirmation hearing, even though its claims purchase totaled $115 million. Because the 30-day period had not begun to run, the transfer was not yet effective in the eyes of the court, resulting in the court's denial of the transferee's standing. Although the court still considered and overruled the transferee's objections as a part of its independent analysis of whether the plan complied with the confirmation requirements as set out in section 1129 of the Bankruptcy Code, such independent analysis may not be appropriate for all issues and another court may not have considered the transferee's objections at all.

Bankruptcy courts have also used trading orders to protect those claimholders who may be perceived to be less sophisticated than more experienced claims-buying firms. For example, the trading order issued in the SIPA liquidation proceeding for Bernard L. Madoff Investment Securities LLC imposes a non-waivable 21-day notice period during which the transferor or transferee may object.[2]

*see **Bankruptcy Claims Trading Orders** on page 5*

[2] Order Granting Trustee's Motion for an Order Establishing Procedures for the Assignment of Allowed Claims, Securities Investor Protection Corp. v. Bernard L. Madoff Investment Securities LLC (In re Bernard L. Madoff), Ch. 7 Case No. 09-11893, Adv. Pro. No. 08-01789 (Bankr. S.D.N.Y. Nov. 10, 2011) (No. 3138).

Pushing Unresponsive Counterparties to Settle

continued from page 4

Key features of the proposed Distressed BISO continued:

- If a seller's non-performance is due to an upstream issue beyond the non-performing party's control, the seller, as non-performing party, might be eligible to "shield" itself from Distressed BISO by delivering to the buyer copies of the upstream confirmation, with rate and purchase price redacted, and certifying in writing that the upstream confirmation will not be used as inventory for another trade, that the seller will attempt to settle on the upstream confirmation, and that the seller will use Distressed BISO if the upstream counterparty is non-performing (the "upstream shield"). Upstreams confirmations used in the upstream shield must have trade dates not later than five business days after the trade date of the current trade at issue.
- If the performing party fails to effect a cover trade during the cover period, the performing party may not use Distressed BISO again for that trade.
- Although Distressed BISO is not intended to have any economic impact for either party, the non-performing party will be liable for up to $5,000 in legal fees associated with the trade.
- For drafts of documents to qualify a party as "performing," the drafts must be in "reasonably acceptable form." Documents can be in reasonably acceptable form even if they include blanks with respect to information to be provided by the non-drafting party. No further clarification on what is reasonably acceptable is provided in the Distressed BISO draft.
- If there is a dispute as to the reasonableness of the price of the cover trade, the dispute is referred to a three-member arbitration panel comprised of LSTA Board of Directors members for a binding determination.
- Currently under consideration, and the cause for the delayed effective date of Distressed BISO, is a proposal by LSTA board members that, once the parties have agreed on the settlement documents, the drafting party must deliver executed settlement documents within 10 days after the trigger date in order to maintain its performing party status and avoid a BISO Notice.

Given the added complexity of distressed trades, Distressed BISO will be more complicated than the BISO mechanism currently in place for par trades, and it may take time for the distressed debt market to fully understand and embrace Distressed BISO.

Bankruptcy Claims Trading Orders

continued from page 4

Typically, in claims transfers, the parties may waive the statutory 21-day notice period in the purchase documents and in the claim transfer notices and papers filed with the court. Instead of praising claims traders as providers of, perhaps, much-needed liquidity and facilitators of the transfer of risks that may not be suitable for an individual claimholder, the non-waivability of the notice period appears to be due to the Madoff court's view of claims traders as operating in a "bottom feeding area" and in need of a "big brother."[3]

Even accepting the reasonableness of the Madoff court's concern that more flexible trading procedures could lead to the Madoff claimholders being "victimized twice,"[4] the non-waivable notice period also applies to secondary trades between sophisticated claims traders. Notice periods, particularly non-waivable notice periods, require additional consideration when structuring back-to-back transfers because they can lead to delays in settlement.

[3] Transcript of Record at 19-20, Securities Investor Protection Corp. v. Bernard L. Madoff Investment Securities LLC (In re Bernard L. Madoff), Ch. 7 Case No. 09-11893, Adv. Pro. No. 08-01789 (Bankr. S.D.N.Y. Nov. 10, 2010) (No. 3194).

[4] *Id.* at 19.

Key Changes to Secondary Trading Documentation

Standard Terms and Conditions (Bank Debt/Claims)	
Definition of a Claim	The LMA has introduced a new definition of "Claim"; such definition to be included under the existing definition of "Purchased Assets." This new definition should prove particularly useful for market participants, as buyer and seller in each LMA claims trade will have a clear and consistent understanding of claim assets being assigned. Market participants currently trading Icelandic claims (namely, Glitnir banki hf., Kaupthing banki hf., and Landsbanki hf. claims) are immediate beneficiaries of this amendment, though this should help parties in any other future emerging claims market. Additionally, any distributions relating to an obligor's assets made on or after the trade date will be for the account of buyer at no additional cost and shall not be treated as a "Permanent Reduction" (as per Condition 12 of the Standard Terms and Conditions). This amendment matches current market treatment of an Icelandic claims trade.
Seller Representations	Whereas traditionally, trade parties would provide representations to one another on settlement date only, the LMA has revisited the time period for when certain representations under a debt trade or claims trade should be given, and has made the following amendments: Seller's representations under Condition 21.3, *Seller's representations — par trades*, and regarding "No acceleration or payment default" (paragraph a), and Seller's representations under Condition 21.4, *Seller's representations — distressed trades*, and regarding "No impairment" (paragraph d) and "No litigation" (paragraph f), will now be given by seller on the trade date only. The rationale for this amendment is that the matters upon which seller is representing are largely outside of its control. Seller's representations under Condition 21.2, *Seller's representations — all trades*, and regarding "No other documents" (paragraph b), "no default" (paragraph c), "alienability" (paragraph d), "Seller ERISA" (paragraph f), and "Ancillary Rights and Claims" (paragraph g), and Seller's representations under Condition 21.4, *Seller's representations — distressed trades*, and regarding "Provision of Credit Documentation" (paragraph a), "No connected parties" (paragraph b), "No bad acts" (paragraph c), and "No funding obligations" (paragraph e) will be given by seller to buyer on both the trade date and the settlement date. A new "no set-off" representation has been added as Condition 21.3(b), which seller will give to buyer in a par trade transaction on both the trade date and the settlement date (such representation is already given by seller in a distressed context under Condition 21.4(c)). Both of buyer's representations given to seller (regarding the use of information for any unlawful purpose and the use of ERISA funds) are now given by buyer on both the trade date and the settlement date.
Original Lender Designation	The "Original Lender" concept has been removed. To the extent seller is an original lender, it will have no predecessors-in-title. As such, the portion of any representation under the Standard Terms and Conditions given by seller including a representation on behalf of its predecessors-in-title will automatically be excluded.
PIK Interest	The LMA has added wording to clarify that PIK interest does not include cash pay interest on any deferred or capitalized amount. Cash pay interest shall follow the treatment chosen for cash pay interest under the relevant sections of the Standard Terms and Conditions.
Information Sharing	Seller is required to pass on to buyer any notices or other documents it receives in relation to the purchased assets, either in its capacity as a lender of record, or, as a result of the new updates, in its capacity as a prospective buyer.
Transfer Fees	Payment of any transfer fees to the agent in connection with the transaction defaults to buyer unless otherwise agreed in the trade confirmation. If the trade confirmation stipulates seller as the paying entity, then seller must transfer the appropriate amount to buyer on the date it is due under the credit agreement to match buyer's payment to agent.

Trade Confirmation (Bank Debt/Claims)	
Legal Transfer Only	The "Form of Purchase" in trade confirmations has been amended to clarify that where parties wish to settle a trade by legal transfer only, both the "Legal Transfer by Transfer Certificate/Assignment Agreement" and the "Legal Transfer only" boxes must be checked. Parties electing to settle via legal transfer only should agree to this method of settlement at the time of the trade, as this option will alter the LMA default position of settlement by funded participation (in the event a required third party's consent is not obtained or another transaction specific condition is not fulfilled) and will require parties to settle via some alternative method that produces the economic equivalent of the agreed upon trade.
Original Lender Designation	The "Original Lender" concept has been removed (*see above "Original Lender Designation – Standard Terms and Conditions (Bank Debt/Claims)*").
Funded Participation (Par/Distressed)	
Vote Timing	Where a voting decision is needed and a grantor has granted participations to multiple participants, it may set a reasonable timeframe in which the participants must vote.
Effective Date of Transfer	The transfer of an existing participant's rights and obligations to a new participant under a funded participation will become effective on the later to occur of: (i) the date specified in the transfer certificate (located in the annex of a funded participation agreement) or (ii) the date the grantor signs such transfer certificate.
Scope of Information Rights	Trade parties will recall that information rights under a funded participation are generally given by a grantor to a participant only in a distressed trade transaction (unless, and with respect to a par trade transaction, a participant owns a grantor's entire commitment under the relevant credit agreement). If information rights are granted in that context, the LMA has widened the scope of information rights given to include information a grantor receives as a lender of record in connection with an obligor's insolvency proceedings.
Funded Participation (Distressed/Claims)	
New Document	The new LMA Funded Participation (Distressed/Claims) is geared towards settlement of a claims trade where settlement via assignment is not possible or desirable between trade parties. The new document is based heavily on the recently revised Funded Participation (Par/Distressed), with references specific to a bank debt transaction having been removed (including references to loans, commitments, and collateral), and the following notable additions made: (i) Definition of "Claim" – with respect to a loan claim being participated, a grantor will grant to a participant a participation interest in its right to prove in the insolvency proceedings of the relevant obligor in respect of the credit documentation, together with (a) its rights, title, claims and interests in the underlying credit documentation (relating to the participated loan), (b) its rights relating to any proof of debt which has or will be filed by a grantor, (c) its rights relating to any proof of debt which has been filed by a grantor and admitted by the relevant insolvency officer, and (d) its rights to any distribution of the relevant obligor's assets as part of the insolvency proceedings; and (ii) A new representation by a grantor to a participant on the status of the claim being participated as at settlement date — this is akin to the representation seller gives buyer on the effective date of an assignment when assigning a claim. Immediate beneficiaries of this new document are market participants currently trading Icelandic claims, though this should also assist parties in any other future emerging claims market. The new document is designed specifically for loan claims, and parties wishing to use this form for settlement of a bond claim will have to modify the agreement accordingly.

Assignment Agreement (Distressed/Claims)	
No Set-Off	The "no set-off" representation given by seller has been deleted as it is contained in the Standard Terms and Conditions.
Confidentiality Letter	
Expiration of Confidentiality Undertakings	There is no longer a fixed long-stop date for the termination of confidentiality obligations under the confidentiality agreement. Confidentiality undertakings will now expire on the earliest to occur of: (i) the date the purchaser becomes a lender of record under the credit agreement, (ii) if the purchaser acquires an interest in the credit agreement other than by way of lender of record, until an agreed period of time after the document used to implement the purchaser's interest in the credit agreement has expired, or (iii) in all other cases, an agreed period of time after the purchaser last accessed confidential information. The consequences of this amendment are such that prospective purchasers will be required to be more pro-active in monitoring the flow of confidential information for each potential new bank debt acquisition.

For any questions or further guidance or assistance, please contact:

Lawrence V. Gelber is a partner in the New York office where his practice concentrates in the areas of distressed mergers & acquisitions, debtor-in-possession financing, corporate restructuring, creditors' rights and prime brokerage insolvency/counterparty risk.

+1212.756.2460 | lawrence.gelber@srz.com

David J. Karp is a special counsel in the New York office, where his practice focuses on corporate restructuring, special situations and distressed investments, distressed mergers and acquisitions, and the bankruptcy aspects of structured finance.

+1 212.756.2175 | david.karp@srz.com

Adam C. Harris is a partner in the New York office, where his practice includes corporate restructurings, workouts and creditors' rights litigation, with a particular focus on the representation of investment funds and financial institutions in distressed situations.

+1 212.756.2253 | adam.harris@srz.com

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Schulte Roth & Zabel

New York
Schulte Roth & Zabel LLP
919 Third Avenue
New York, NY 10022
+1 212.756.2000
+1 212.593.5955 fax

Washington, DC
Schulte Roth & Zabel LLP
152 Fifteenth Street, NW, Suite 850
Washington, DC 20005
+1 202.729.7470
+1 202.730.4520 fax

London
Schulte Roth & Zabel International LLP
Heathcoat House, 20 Savile Row
London W1S 3PR
+44 (0) 20 7081 8000
+44 (0) 20 7081 8010 fax

www.srz.com

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Alert

New Bankruptcy Rule 2019: Mandatory Disclosures for Ad Hoc Committee Members

June 21, 2011

The United States Supreme Court recently submitted to Congress an amendment to Bankruptcy Rule 2019 dealing with disclosure by groups of hedge funds and other distressed investors in reorganization cases. Unless Congress blocks its passage, which is unlikely, the amendment will become effective on Dec. 1, 2011.[1] As shown below, the new rule streamlines and clarifies what had become a frequently litigated disclosure process.

Background

Parties had often used federal Bankruptcy Rule 2019 in the past as a litigation tactic to compel members of ad hoc investor committees (e.g., creditors or shareholders) to disclose the nature of their investments, the prices paid and the timing of their acquisitions. When investors resisted disclosure of this commercially sensitive information, courts differed on whether Rule 2019 even applied to ad hoc committees.[2] As a practical matter, creditors and shareholders form ad hoc committees to advance their common interests and to enhance their leverage in reorganization cases.

The New Rule

A quick summary of the material terms of the amended rule (from the perspective of an investor) are set forth below:

Who Must Disclose?	Members of an informal committee and "*every group* or committee that consists of … multiple creditors or equity security holders that are … acting in concert to advance their common interests." The "committee" label is irrelevant.
Excluded Parties:	Indenture trustees, credit agreement agents and governmental units.

[1] The full text of the amended rule can be viewed at http://www.supremecourt.gov/orders/courtorders/frbk11.pdf.

[2] *Compare In re Philadelphia Newspapers LLC*, 422 B.R. 553, 555 n.1 (Bankr. E.D.Pa. 2010) (rule does not apply to informal groups); *In re Premier Int'l Holdings*, 423 B.R. 58, 60, 65 (Bankr. D.Del. 2010) (same) *with In re Washington Mutual, Inc.*, 419 B.R. 271 (Bankr. D.Del. 2009) (held, ad hoc committee and similar groups are bound by Rule 2019); *In re Northwest Airlines Corp.*, 363 B.R. 701 (Bankr. S.D.N.Y. 2007) (same).

What Must Be Disclosed?	"Pertinent facts and circumstances concerning": (i) the formation of the group, "including the name of each entity at whose instance the group … was formed …" and (ii) the "nature and amount of each *disclosable economic interest* held in relation to the debtor as of the date … the group or committee was formed."[3] The phrase "*disclosable economic interest*" means "any claim, interest, pledge, lien, option, participation, derivative instrument, or any other right or derivative right granting the holder an economic interest that is affected by the value, acquisition or disposition of a claim or interest." The disclosure must be made on a member-by-member basis, and not in the aggregate.
When Disclosure Must Be Made:	Whenever a group first appears in the case. The disclosure statement must be later supplemented to disclose material changes whenever the group "takes a position before the court or solicits votes on the confirmation of a plan."
What Need Not Be Disclosed:	Purchase prices paid for each investment; and precise date of acquisition (only the calendar quarter and year are required).
Consequences of Non-Disclosure:	The court may (i) refuse to permit the group to be heard; (ii) invalidate any "authority, acceptance, rejection or objection given, procured or received" by the group; or (iii) grant other appropriate relief.

The Compromise
Opponents of Rule 2019 argued that disclosure would chill the distressed debt market and discourage investors from serving on ad hoc committees, thereby harming the reorganization process. The amended rule, however, purports to strike a balance -- it requires disclosure, but *not* the disclosure of purchase prices.

Potential Litigation
Parties advancing competing strategies may continue to use Bankruptcy Rule 2019 as a weapon against an effective ad hoc committee. They may, for example, challenge the adequacy and timing of any disclosure made by an ad hoc group. More significant, a competing party may still seek disclosure of purchase prices and other trading information by relying on Bankruptcy Rule 2004 or, in appropriate cases, any other applicable discovery rules.[4]

Authored by Michael L. Cook and David M. Hillman.

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

[3] There are additional disclosure requirements if the group is *representing* other parties in addition to the members of the group or committee.

[4] According to the Advisory Committee note accompanying the new rule, "nothing in this rule precludes either the discovery of that information or its disclosure when ordered by the court pursuant to authority outside this rule."

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New York
Schulte Roth & Zabel LLP
919 Third Avenue
New York, NY 10022
+1 212.756.2000
+1 212.593.5955 fax

Washington, DC
Schulte Roth & Zabel LLP
1152 Fifteenth Street, NW, Suite 850
Washington, DC 20005
+1 202.729.7470
+1 202.730.4520 fax

London
Schulte Roth & Zabel International LLP
Heathcoat House, 20 Savile Row
London W1S 3PR
+44 (0) 20 7081 8000
+44 (0) 20 7081 8010 fax

www.srz.com

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Schulte Roth & Zabel

Schulte Roth & Zabel LLP
New York
919 Third Avenue
New York, NY 10022
+1 212.756.2000
+1 212.593.5955 fax

Schulte Roth & Zabel LLP
Washington, DC
1152 Fifteenth Street, NW, Suite 850
Washington, DC 20005
+1 202.729.7470
+1 202.730.4520 fax

Schulte Roth & Zabel International LLP
London
Heathcoat House, 20 Savile Row
London W1S 3PR
+44 (0) 20 7081 8000
+44 (0) 20 7081 8010 fax

www.srz.com