Schulte Roth & Zabel

Distressed Investing: European Bank Debt and Claims — Before You Say "Done"

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1. About the Speakers

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David J. Karp is a special counsel in the New York and London offices 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 "Claims Traders Beware: More Risk Than You Bargained For!" for the *Bloomberg Bankruptcy Law Report*, "The Impact of Asymmetric Information, Trade Documentation, Form of Transfer and Additional Terms of Trade on Hedge Funds' Trade Risk in European Secondary Loans" and "Regulatory, Tax and Credit Documentation Factors Impacting Hedge Funds' Trade Risk in European Secondary Loans" for *The Hedge Fund Law Report*. He is also a frequent speaker on fixed-income trading and distressed investment strategies, recently speaking on compliance issues facing fixed-income traders and presenting "Basic Issues for Distressed Bank Debt Market Participants" at an SRZ event.

David is a member of the American Bankruptcy Institute, the Asia Pacific Loan Market Association, the Emerging Markets Trading Association, INSOL Europe, 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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Neil Robson, a senior associate in the London office of Schulte Roth & Zabel, has extensive experience providing regulatory advice to funds and managers regarding Financial Services Authority ("FSA") authorization and compliance matters; cross-border issues in the financial services sector, market abuse, anti-money laundering and regulatory capital requirements; formations and buyouts of financial services groups, and structuring and marketing of investment funds; agreements with customers, custodians and service providers; and outsourcing arrangements.

Neil is a sought-after speaker and author, recently co-authoring "The Impact of Asymmetric Information, Trade Documentation, Form of Transfer and Additional Terms of Trade on Hedge Funds' Trade Risk in European Secondary Loans" for *The Hedge Fund Law Report*, and "Proposed Changes to Europe's Derivatives Regulatory Structure: EMIR & MIFID II" for *Bloomberg Law Reports — UK Financial Services Law*. He discussed "EU Short Selling Legislation" at an *HFMWeek* UK Breakfast Briefing and participated in JP Morgan's MiFID Review — A Summary for Alternative Fund Managers webinar.

Neil received his LPC from BPP Law School, his M.A. and B.A. from University College London, and also has a Diploma from Birkbeck College, University of London.

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Roxanne Yanofsky is an associate in the London office of Schulte Roth & Zabel, where her practice primarily focuses on the secondary loan markets and providing advice on the legal issues relating to the purchase and sale of distressed assets, including trade claims. She also advises on all aspects of debt and claims trade transactions, including the review and analysis of syndicate loan documentation, security packages, transferability restrictions and confidentiality and disclosure requirements.

Roxanne routinely represents hedge funds, banks and other financial institutions in the drafting and negotiation of secondary trading documentation under the Loan Market Association regime, and is frequently involved in cross-border transactions throughout Europe, the United States and Asia. She recently co-authored "The Impact of Asymmetric Information, Trade Documentation, Form of Transfer and Additional Terms of Trade on Hedge Funds' Trade Risk in European Secondary Loans" and "Regulatory, Tax and Credit Documentation Factors Impacting Hedge Funds' Trade Risk in European Secondary Loans" for *The Hedge Fund Law Report*.

Roxanne received her LPC from BPP Law School, her LLB from University College of London, and her B.A. from McGill University.

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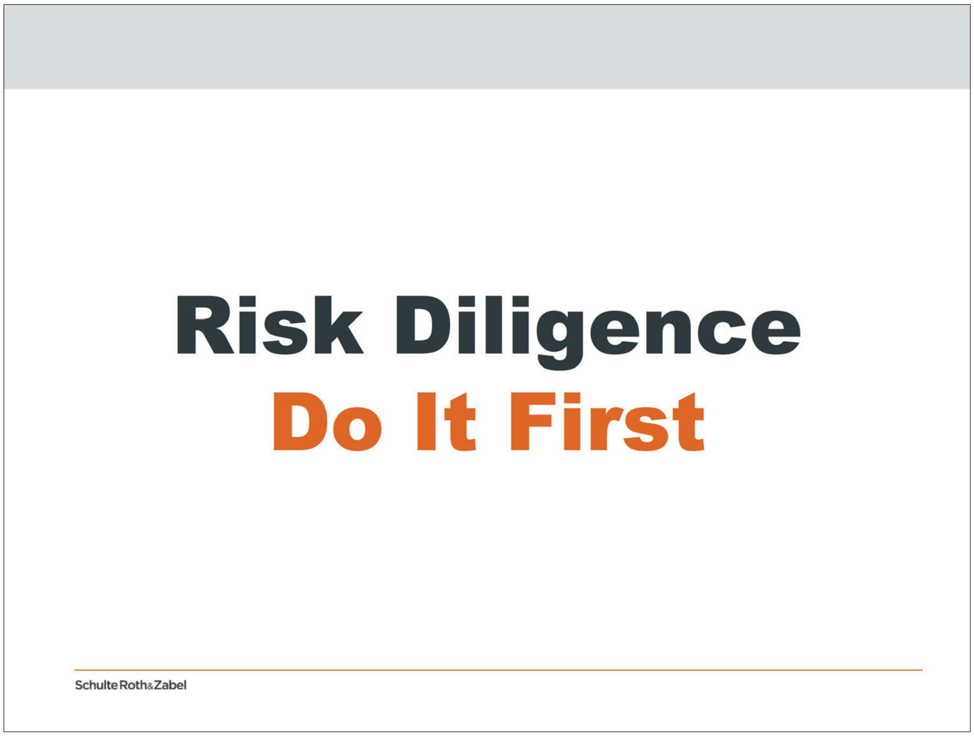
2. PowerPoint Presentation



Risk Diligence

Do It First

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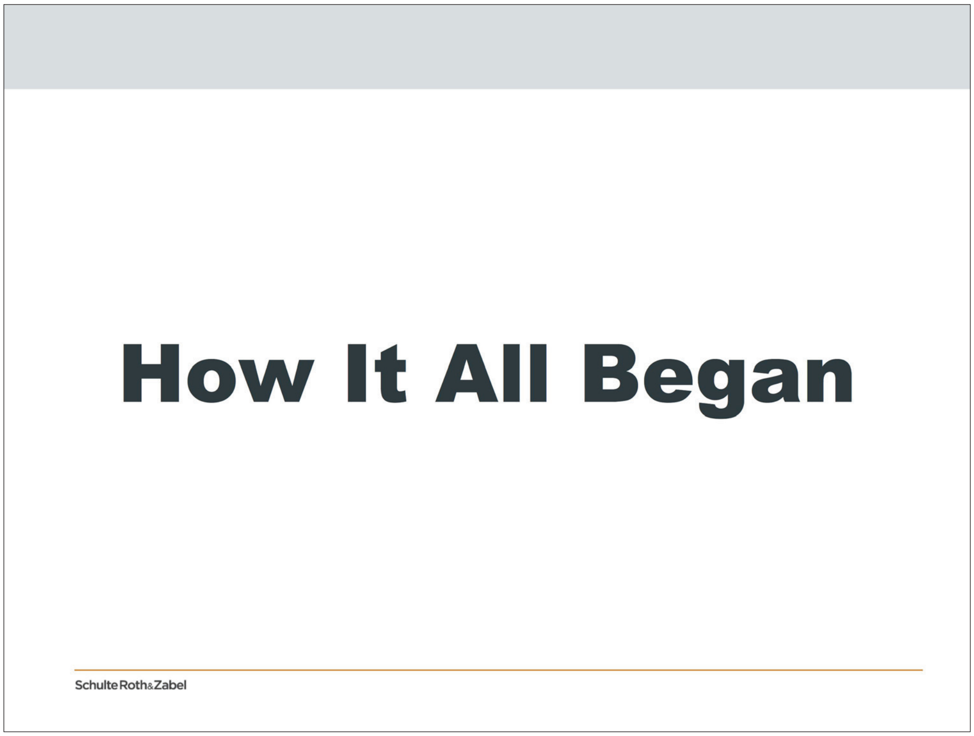

How It All Began

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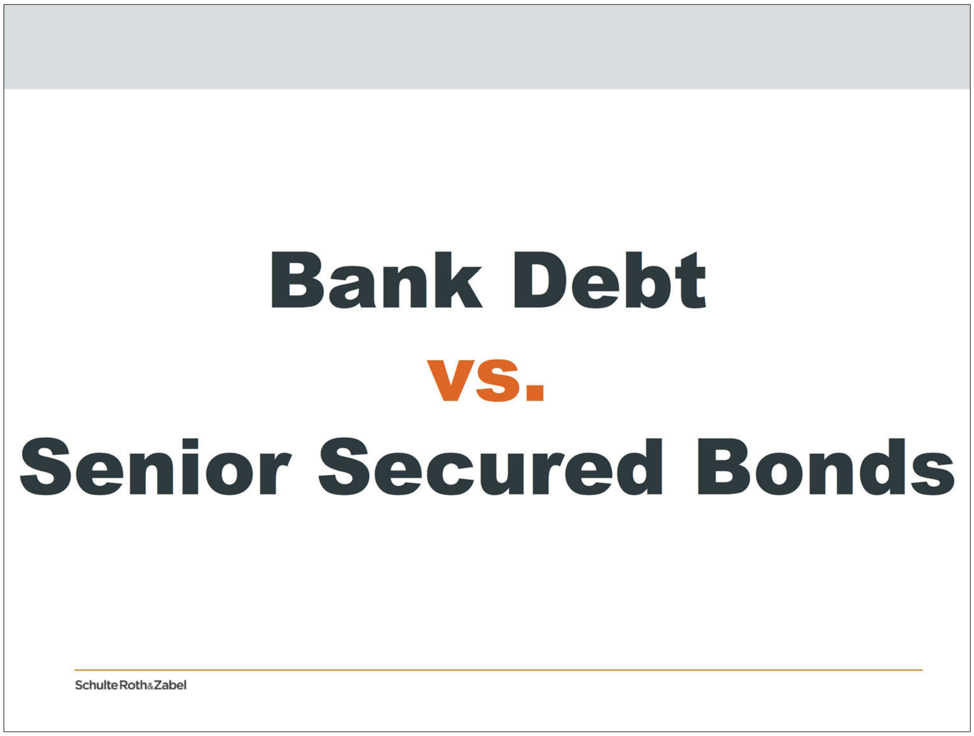

Bank Debt
vs.
Senior Secured Bonds

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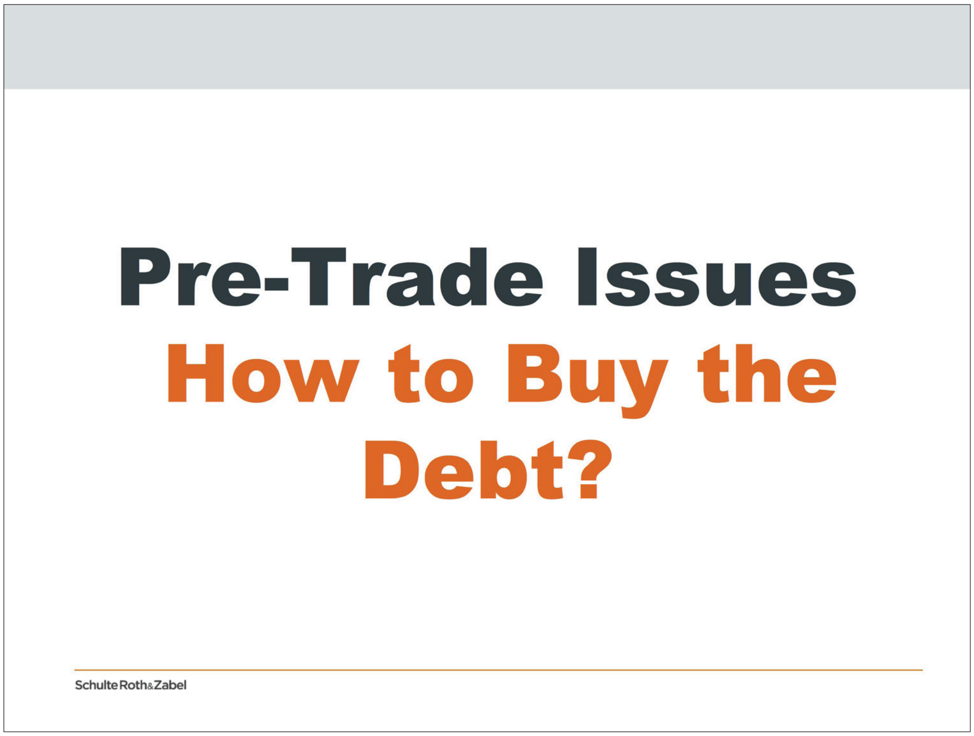

Pre-Trade Issues

How to Buy the Debt?

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Pre-Trade Issues

Will the Credit Agreement Accommodate the New Lender?

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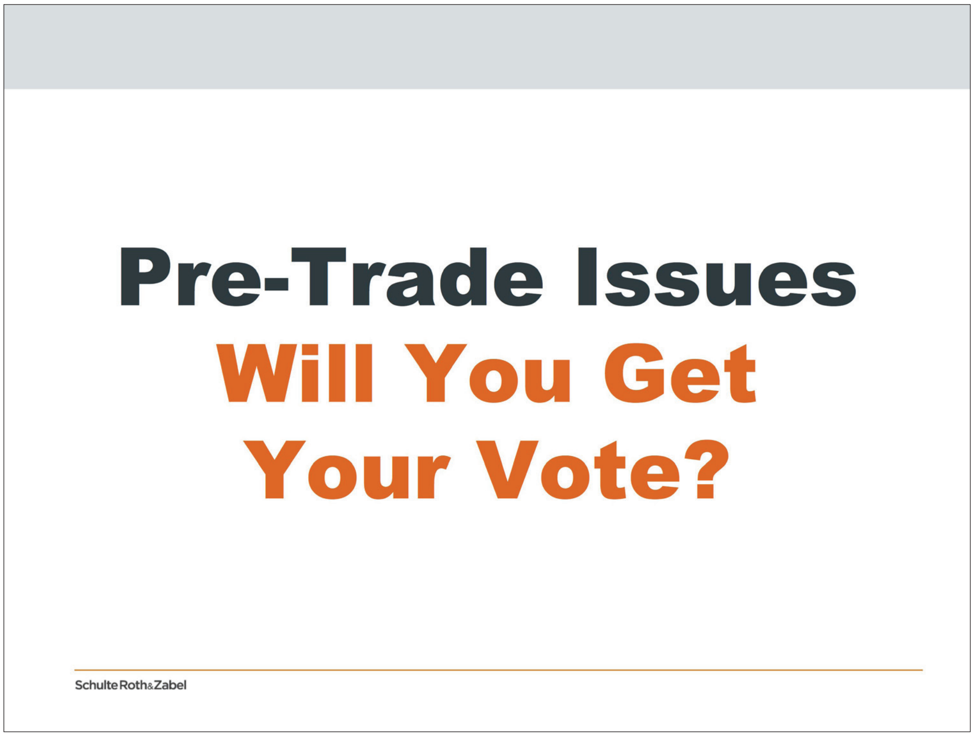

Pre-Trade Issues

Will You Get Your Vote?

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Pre-Trade Issues

Regulatory or Withholding Issues?

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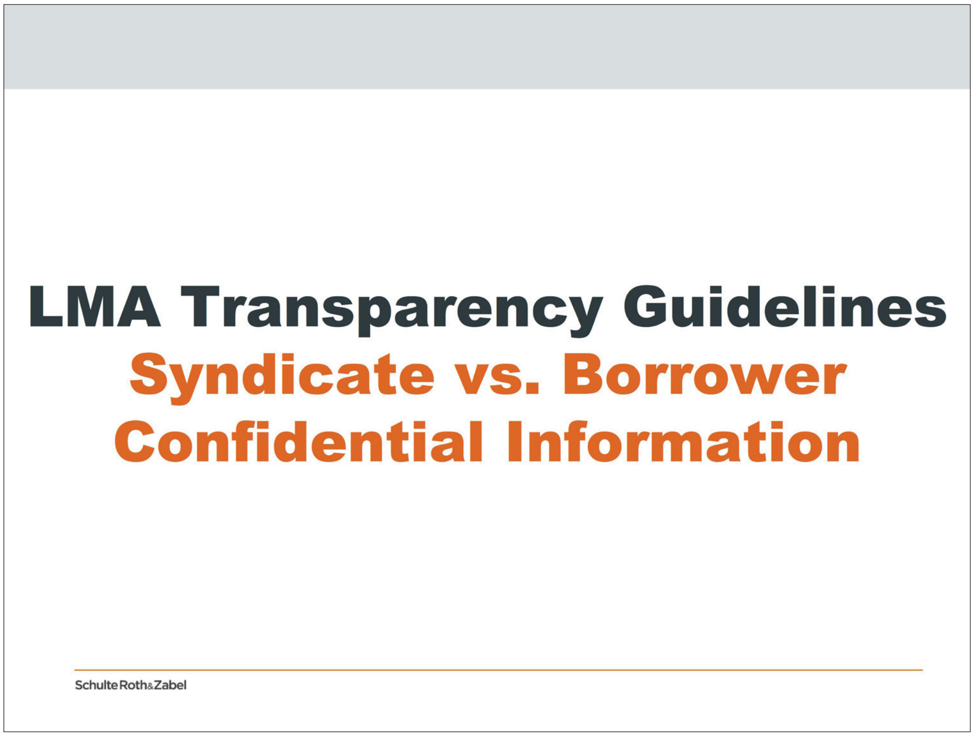

LMA Transparency Guidelines
Syndicate vs. Borrower Confidential Information

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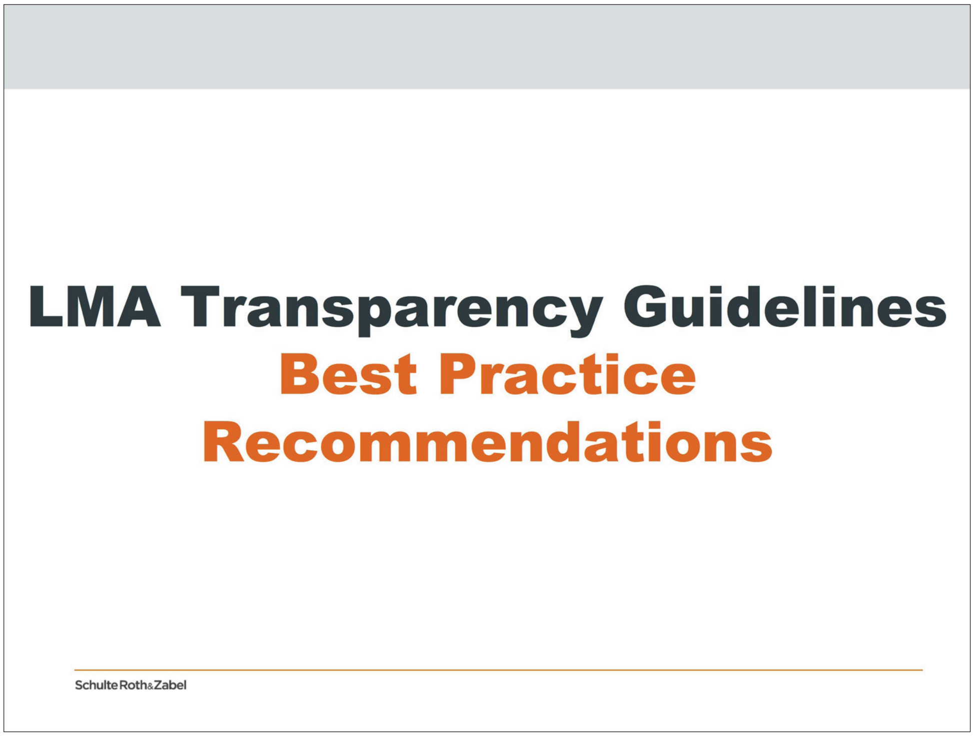

LMA Transparency Guidelines
Best Practice Recommendations

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LMA Transparency Guidelines
Do They Have Any Teeth?

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Regulatory Position of Bank Debt

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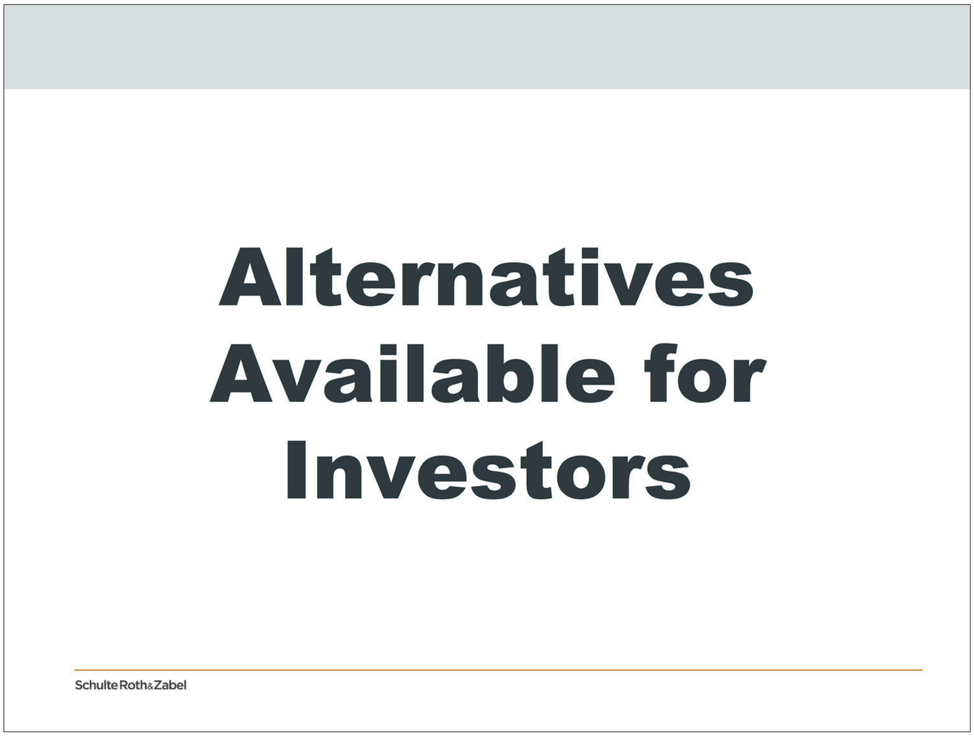

Alternatives Available for Investors

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Notes:

The Future of Europe

Are Claims the Way Forward?

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3. Outline

Distressed Investing: European Bank Debt and Claims — Before You Say “Done”

I. Pre-Trade Issues for Consideration by Investors

A. Distressed vs. Par Documentation

From Jan. 25, 2010, the Loan Market Association (“LMA”) combined its par and distressed documentation into one form of trade confirmation for both par and distressed trades (parties check a box identifying the nature of the trade). The LMA standard terms and conditions (“ST&C”) for par and distressed trade transactions (bank debt/claims) have also been combined. However, the LMA recognizes the increased credit risk a buyer faces in a distressed trade and two main differences under the LMA ST&C still exist:

1. Delayed settlement compensation (“DSC”): If parties agree to include DSC in a trade, this will be triggered at the trade date plus 10 days for par and the trade date plus 20 days for distressed; and
2. Additional representations and warranties to be given at time of trade by the seller to the buyer on the nature and status of the debt being sold.

In a par trade, the seller will give the following representations on behalf of itself and all of its predecessors-in-title (“PIT”):

1. The seller is the sole beneficial owner of the bank debt. Other than the credit agreement, there are no other documents executed by the seller or any of its PIT that would affect the buyer’s right to receive interest payments;
2. Neither the seller nor any of its PIT is in default of any obligations in relation to the traded debt;
3. The debt being traded is capable of being transferred to the buyer (subject to any third-party consents or credit agreement restrictions);
4. The settlement amount specified in the pricing letter is true and accurate;
5. The bank debt is not being sold pursuant to any employee benefit plan that is subject to the United States Employee Retirement Income Security Act 1974 (“ERISA”);
6. There are no limitations on the ancillary rights and claims assigned to the buyer;
7. The credit agreement has not been accelerated; and
8. The traded debt is free from set-off.

In a distressed trade, the seller will give the following representations on behalf of itself and all of its PIT:

1. 1–6, as set out above (7 and 8 are only given in a par context);
2. All credit documentation (as currently in force) has been delivered to the buyer (*this must be agreed upon by the parties at time of trade and referenced in Section 14 of the trade confirmation for this representation to apply*);
3. Neither the seller nor any of its PIT is “connected” to the borrower as per the Insolvency Act 1986 (the meaning of being “connected” is defined under Section 249 of the Insolvency Act 1986).
    a) A person is “connected” with a company if that person is either (i) a director or shadow director of the company in question or an associate of such a director or shadow director or (ii) an associate of the company.

        i. A person is generally considered an "associate" of a company if it can exercise control of more than one-third of the issued share capital of that company (Section 435 of the Insolvency Act 1986).

        ii. A "shadow director" is a person who is not a properly appointed director but on whose directions or instructions the board of directors of the company in question is accustomed to acting.

    b) Where a person is connected with a company, the period during which transactions between that person and the company may be challenged in any subsequent liquidation or administration is generally extended. The risk period during which a liquidator or administrator may challenge transactions between connected parties as a preference is two years from the date of the preference compared to six months before the onset of insolvency where the parties are not connected (Section 240 of the Insolvency Act 1986).

4. "No bad acts" have been committed by the seller or any PIT that would affect the buyer's right to receive payments relating to the purchased debt, and no set-off rights exist (the LMA intends this to be a "catch-all" representation and one of the most significant representations a buyer can receive);

5. Neither the seller nor any PIT has received notice that the traded bank debt is defective or impaired in any way;

6. The seller is not passing on any liabilities in relation to the purchased debt (other than agent expenses, contractual as per the credit, etc.); and

7. No litigation has been started against the seller or any PIT that would affect the buyer's rights under the credit agreement or right to receive interest payments in relation to the purchased debt.

In both par and distressed LMA trades, the seller gives representations and warranties not only on behalf of itself, but also on behalf of all of its PIT who held the asset before the seller. This creates a chain of contingent claims where recourse can be made by each buyer in the chain against each respective seller until the source of the breach is reached. As much as possible, investors should seek to match any terms it receives from its buy-in with terms it gives if it sells the debt position onward. Otherwise, an investor buying on a par basis and selling on a distressed basis will be giving its downstream buyer more representations on behalf of itself as well as all of its PIT than it would have received from its original seller when it purchased the debt (including the "no bad acts" representation). Therefore, and by way of example, if an investor purchases on a par basis, then sells onward on a distressed basis, and it subsequently turns out that the investor's *seller* had committed a bad act which affects the investor's buyer's right to receive payments in relation to the asset, the investor's buyer will have recourse against the investor, but the investor will have no recourse against its seller.

B. Form of Purchase

If an investor agrees to the fundamentals of a trade, either orally or via e-mail, this may be sufficient to trigger a valid contract between the parties *(Bear Stearns Bank PLC v Forum Global Equity Ltd [2007] EWHC 1576 (Comm))*.

Once a contract comes into existence and a trade is agreed upon, the LMA operates on the basis of mandatory settlement. Therefore, if a buyer agrees a trade on an "LMA basis" or using LMA documentation, and the buyer asks to buy the debt by legal transfer (assignment/novation), then the buyer is contractually agreeing to settle the trade even if the legal transfer cannot take place.

Under the LMA ST&C (incorporated into the trade confirmation), if a trade cannot settle by legal transfer (e.g., because a borrower withholds consent), the buyer and seller will then be obliged to settle by funded participation substantially in the LMA form of funded participation. If a funded participation cannot be effected (e.g., because the seller does not have the infrastructure in place for this set-up), the buyer and seller will be obliged to settle the trade by some alternative mechanism leading to the economic equivalent of the agreed upon trade ("legal transfer only"). The LMA does not elaborate on what "legal transfer only" means, but it could involve a cash settlement, swap transaction, or a buyer selling its position onward to a third party or back to the seller. Either way, the buyer is bound to settle and cannot walk away. (Condition 6.2 of the LMA ST&C.)

If a buyer can agree to the fall-back settlement mechanisms set out above and contemplated by the LMA then it is fine to agree to "legal transfer" at time of trade without anything further being said. The fall-back mechanisms will kick-in automatically if legal transfer cannot take place.

If a buyer agrees to being bound to settle the trade but wants to avoid a fall-back to funded participation in all circumstances, the buyer will have to specify "legal transfer only" at time of trade. To confirm, this will still oblige the buyer to settle the trade but will bypass the obligation to settle by funded participation.

If a buyer wishes to walk away from the trade if legal transfer cannot take place (e.g., if a borrower withholds consent), then this should be clearly specified at time of trade. Specifying "legal transfer only" will not suffice for the reasons set out above.

The ability to walk away from a trade is not common market practice for trading on an LMA basis, and certain counterparties may indicate resistance to trading on those terms. Most broker/dealers have matching open upstream trades and will not have agreed "walk away language" with the seller (as this is not the typical LMA approach). Whether or not this language can be included will ultimately depend on the bargaining power between the trading parties.

C. Voting Rights Between Trade Date and Settlement Date

The LMA does not account for how voting rights are allocated between the trade date ("TD") and the settlement date ("SD"). Therefore, any voting decisions within this time will remain with the seller unless the terms of the trade confirmation state otherwise. While it is good practice for the seller to confer with the buyer on any upcoming voting scenario after TD, the seller is under no contractual obligation to do so unless agreed at time of trade.

Where voting rights between TD and SD are agreed and documented in the trade confirmation, counterparties will often request certain carve-out language where they do not have to follow a buyer's voting direction in instances, where, for example: (i) the vote goes against a provision of the underlying credit agreement, (ii) the vote violates an existing law or regulation, or (iii) the vote causes reputational damage to the seller.

Additionally, if the seller is only selling a minority piece of its entire debt position to the buyer and cannot split the vote, it will vote in accordance with the majority holding.

Consequently, obtaining the benefit of voting rights from TD to SD does not guarantee that a buyer will have the seller vote in accordance with its instructions. The best way to ensure that a buyer is able to vote according to its preference is to facilitate a quick settlement so that it can become the lender of record.

D. Credit Agreement Restrictions

1. Eligibility requirements — an LMA-based credit agreement will not always expressly permit "funds" to accede as lenders of record. Some credit agreements will reference "financial institutions" as permitted eligible lenders. In England, the case of *Essar Steel Ltd. v The Argo Fund Ltd [2006] EWCA Civ 241* has provided a wide definition of what it means to be a "financial institution," and this generally supports an entity that is an investment fund, though this is not a guarantee. Other eligibility restrictions may include instances in which a buyer is seen as a "competitor" of the borrower whose debt they wish to purchase ("competitor" is usually defined as an entity that owns or holds a majority equity position in a company that operates in the same industry as the borrower).

Upon receipt of the credit agreement, a buyer should always ensure that the transfer provisions under the credit agreement permit a buyer to accede. If a buyer cannot accede under the credit agreement, it will be unable to hold the debt directly. Unless a buyer has negotiated walk away language in their trade confirmation with the seller, they will be required to settle the trade.

2. Borrower consent requirements — where borrower consent rights exist, this is usually the greatest hurdle for new lenders to overcome. Most LMA-based credit agreements will contain language stating that borrower consent cannot be "unreasonably withheld or delayed" — however, there is no case law outlining when the withholding of consent is "unreasonable." In 2008, UBS brought a litigation suit against Terra Firma Capital Partners, the private equity owners of Tank & Rast Holding GmbH (a German infrastructure group), in the High Court of Justice in England for a breach of contract under a loan agreement following the borrower's refusal to consent to a debt transfer — the underlying loan agreement provided that consent could not be unreasonably withheld. However, this case was ultimately settled in private so clarification from the court on what constitutes "unreasonable" grounds for withholding consent was never obtained.

   Recently, borrowers have started exercising their consent rights more frequently on the premise that in the current economic climate they have a genuine fear that the new lender may not be sympathetic to the company in the context of any future waiver or planned credit amendment. As there is no litigation precedent, it is hard to ascertain what the outcome would be if the refusal were eventually to be litigated.

   To overcome any potential consent issues, a buyer can ask the seller to reach out to the agent who can then notify the borrower to determine whether the borrower has any immediate objections. If achieved, this will give a good indication as to whether consent will be granted or withheld. Alternatively, the buyer can commit to buying a small piece of debt (usually the minimum transfer amount) to "test" whether the borrower will withhold its consent in the transfer.

3. Minimum hold requirements — a buyer should always verify whether there are any minimum hold amount restrictions under the credit agreement. This is equally relevant for a seller when selling its position. If a buyer allocates a trade to multiple funds, it should also verify whether the positions of all related funds can be aggregated for the purposes of meeting minimum hold restrictions.

4. Minimum transfer requirements — same with "minimum hold requirements" above. However, if there are inventory issues, one common way of bypassing these restrictions would be to effect an over-and-under with the counterparty (i.e., if a buyer is buying £500,000 but the minimum transfer amount is £1 million, the seller would transfer £1.5 million to the buyer, and the buyer simultaneously transfers £1 million back to the seller). There are two possible issues with this method of transfer: (i) a buyer would need to verify whether the seller had enough inventory to complete an over-and-under in the first instance, and (ii) a buyer would have to negotiate with the seller on how the additional transfer fee would be split between the parties.

II. LMA Transparency Guidelines

A. Overview of LMA Transparency Guidelines (the "Guidelines")

The Guidelines distinguish between two different types of information:

Syndicate Confidential Information — confidential information made available to the entire lending syndicate (generally subject to the execution of an LMA form of confidentiality agreement). This would include the credit documentation (loan agreement, intercreditor agreement, etc.) and quarterly, bi-annual and annual financial reports.

Borrower Confidential Information — confidential information made available to lenders within a syndicate who sit on a borrower's steering or restructuring committee. This would include, for example, proposed restructuring details or business forecasts and projections.

B. LMA "Best Practice" Recommendations

1. Market participants may trade on the basis of syndicate confidential information.

2. Market participants should not trade on the basis of borrower confidential information, even where the trading counterparty has access to the same information.

   There are exceptions to this recommendation where the trading parties make a judgment that trading is consistent with professional standards and fair dealings to trade with a counterparty that also has (or has the ability to receive) borrower confidential information, provided that the transaction "will not adversely affect other members of the syndicate or market."

3. Members on a steering/restructuring committee should disseminate borrower confidential information with the rest of the lending syndicate as quickly as possible.

4. Borrowers should disclose to a lending syndicate all material information prior to the syndication process or the "life of a transaction." Borrowers should also disclose any material loan purchase on the first business day following the trade.

C. Enforceability of the LMA Transparency Guidelines

The LMA is Europe's trade association for syndicated loan markets. One of its core activities is to establish market practice, but the LMA is not an arm of government and it has no authority as such. The LMA can issue guidelines, but they do not have any legislative force — they're not law. The views set out by the LMA, however, are highly persuasive in the syndicated loan market given that it currently has a corporate membership of over 455 members. Therefore, it is likely that the Guidelines will have an impact at least on the conduct and behavior of LMA participants.

D. Regulatory Position in the U.K. vis-à-vis Bank Debt

1. The Financial Services Authority ("FSA") in the U.K. regulates virtually any investment firm operating in the U.K.-regulated sector. Any activities conducted by such investment firm will have to be licensed by the FSA in advance.

2. Although not free from doubt, the agreed market consensus is that bank debt is currently an unregulated asset and is therefore outside the FSA's remit. Shares and listed bonds, on the other hand, do fall squarely within the FSA's remit, and also fall within the market abuse regime — as any investments listed on an European Union-regulated market are covered by the European Union regulatory regime.

3. At present there is no suggestion that bank debt will be drawn into the regulated sector. However, the Guidelines do appear to be suggestive of a more robust suite of guidance for conduct in this sector.

4. As the Guidelines have no force of law, any breach of the Guidelines is not considered an act of market abuse. However, a breach of the Guidelines by an FSA-authorized firm could, if it were brought to the FSA's attention, be considered a breach of one of the FSA's over-riding principles for U.K.-authorized firms — the core principle here being that firms should comply with proper standards of market conduct. If a particular U.K. firm gained a reputation for breaching the Guidelines or flagrantly ignoring them, and if there were enough complaints to the FSA, the FSA might start to investigate that firm's dealings in other markets — such as its securities practice, for example. So the damage could be reputational at best, and at worst, if the FSA were to find breaches of U.K. securities laws, they could fine the firm or, even more drastically, shut it down.

E. Alternatives Available for Investors

1. Inclusion of “big boy” language — in a scenario where a member of a coordinating committee sells bank debt to a party who is not a member of a coordinating committee, certain disclosures are made by the selling party, including a statement by the seller that it has more information about the company (including possible material inside information) than the buyer, but that the seller does not disclose this information nor accept any liability.

   Condition 20.5 of the LMA ST&C for par and distressed transactions (bank debt/claims) currently includes a version of “big boy” language:

   a) Material Information — the buyer and the seller acknowledge and agree that:

      ii. The other may possess material information not known to it; and

      iii. The other shall have no liability and no action or proceedings may be taken with respect to the non-disclosure of any such information except to the extent that such information renders inaccurate an express representation made pursuant to the agreed terms or these conditions by the party possessing such information.

      The markets typically deal with the issue of an imbalance of knowledge between the counterparties by including more specific “big boy” disclosure letters or provisions in a trade confirmation prior to a sale. These letters or provisions will often reference the fact that a seller is sitting on a steering committee and has come across information that may not be available to the rest of the syndicate. The more specific the disclosure, the more a seller protects itself against any common law fraudulent claim that may be brought against it by its buyer. However, it is important to note that a “big boy” letter may only be effective in connection with transfers of non-securities and may not be used to get out of compliance with securities regulation or a fiduciary duty.

2. Information Barriers

   Implementation of information barriers or “Chinese walls,” is one of the options suggested in the Guidelines by the LMA that would allow trading to take place when a lender is in possession of borrower confidential information. However, this option may not be practical or suitable for an investment firm, if, for example, the investment firm operates out of a small office or open-plan setting where it is difficult to implement measures that would stop information from leaking between different groups. If challenged, the onus will be on the firm to prove that Chinese walls were properly implemented. The only real test of the barrier will be once there is some suggestion from a regulator that it has been breached.

LMA GUIDELINES

Transparency and the use of information

As with all markets, participants in the secondary loan market base trading decisions on information that they have access to in relation to the loans, and those Borrowers whose loans are traded.

Participants are expected to behave with integrity towards the loan market. It is also noted that most participants in the loan market will be regulated entities, and therefore will be subject to regulatory principles and standards in both their handling of information as well as their wider activities in the loan market.

All market participants may trade loans on the basis of information that is available to the whole syndicate - Syndicate Confidential Information. This includes trading loans with counterparties who were entitled to receive such Syndicate Confidential Information but chose not to. Generally though, market participants should not trade on material information which has not been made available to the whole of a lending syndicate – Borrower Confidential Information. Information will typically be considered "material" where, if it were known to the entire syndicate, it would significantly impact the price of the relevant loan. This could, for example, include information arising from the running of a material amendment process by a participant's sales / trading desk on behalf of a Borrower, including the voting results or intentions of the members of the syndicate. It could also include information received as a result of membership of a steering committee.

This guidance only applies to the person within an institution who is making the decision to trade / effecting trades: it is perfectly acceptable for institutions to have access to such information and buy / sell if it is separated from trading decisions by an information barrier.

It is recognised that there are situations where, through different relationships in the context of a loan, some market participants will have access to information which is not available to other market participants. Where such information is not material it is acceptable to trade loans based on that information.

These guidelines seek to identify areas of best practice, but are not intended to be prescriptive as to how these are achieved. It is for individual participants to adopt the most appropriate measures in accordance with their own internal structures and policies.

These guidelines do not address issues concerning information relating to securities and the law on insider dealing / market abuse that applies to securities trading activities. However, it should be noted that participants in the loan market may receive information about Borrowers that would class as inside information in relation to the public securities market. Participants in the loan market will need to be sensitive to this and should deal with information that classes or could class as inside information in accordance with their internal policies on this issue.

The LMA notes that there will be participants in the loan market with three levels of information:

(1) Those who, subject to signing confidentiality undertakings with the Borrower, receive all Syndicate Confidential Information.

Examples of this may include but not be limited to -

- Financial reports
- Financial projections
- Covenant Compliance reports
- Plans to dispose of or acquire assets.

(2) Those who have taken a conscious decision, for example due to exposures to publicly traded securities issued by the Borrower, not to receive Syndicate Confidential Information; and

(3) Those who have material information that is not available to the whole syndicate – information referred to as Borrower Confidential Information. Examples of this may include but not be limited to -

- Material Information provided to a steering committee member / sounding group, unless passed on to the rest of the syndicate, thereby turning 'Borrower Confidential Information' into 'Syndicate Confidential Information'
- Material Information provided to a board member and / or shareholder, examples of which could arise from a debt-for-equity swap, or a related party sitting on the board
- Request for soundings on potential material amendments, waivers and re-financings
- Material information provided only to core lenders or a subgroup of the syndicate (for example on a proposed merger, acquisition or restructuring)
- Material Information provided to a related party which could affect the price of a traded loan.

The LMA considers that best practice includes the following:

- Market participants may trade loans based on Syndicate Confidential Information
- Steering committee members should share Borrower Confidential Information with the broader syndicate as quickly as possible
- Market participants should not generally trade loans based on Borrower Confidential Information. Market participants include the Borrower itself and its related parties
- This applies even where the counterparty to that trade has access to the same level of Borrower Confidential Information
- Notwithstanding the above, in order to facilitate restructurings and encourage the involvement of key major lenders, there may be circumstances where members of a steering committee or supporting lenders possessing Borrower Confidential Information may reasonably make a judgement (subject to applicable law) that it is consistent with appropriate standards of professional integrity and fair dealings to trade with a

counterparty also in possession of or having the ability to receive such Borrower Confidential Information where the transaction will not adversely affect other members of the syndicate / market

- Borrowers should undertake in writing to disclose promptly to lending syndicates all material information to all potential lenders prior to signing and / or during the syndication process and during the life of the transaction

- Borrowers and / or a related party should disclose any loan purchase which in the context of the relevant loan is material no later than close of business on the day following the trade(s).

Concerning syndicate lists, following the close of primary syndication, a lending syndicate's Agent should not pass details to any internal or external party of those entities that are currently lending / have lending exposure in relation to a given syndicated loan, unless requested by a Borrower or a syndicate member in certain limited circumstances, including:

  - In respect of a Borrower request, disclosure to a third party (but only to facilitate a refinancing or material amendment or waiver) or to the Borrower itself or another related party, who should comply with these guidelines

  - In the event of a lender filing for insolvency or being downgraded below investment grade, any syndicate member may enquire of the Agent to confirm whether such a lender is part of the syndicate and the amount of its commitment

  - Participation details can be provided among syndicate members who have agreed to share their commitment details with each other. All members of the syndicate should be given the opportunity, on request by the Agent, to agree or decline to share their details. If lenders holding over 15% of the Facility make such a request, then the Agent should approach the syndicate accordingly.

The LMA will engage with the ACT and other European corporate associations, along with the sponsor community regarding these proposals, including in respect of the impact on the ability of Borrowers and related parties to trade in loans.

These recommendations will be incorporated into future standard documentation where applicable. However, it is not intended that the guidelines regarding lender lists should impact legacy transactions and, therefore, Agents should take account of the provisions of the relevant facility agreement in respect of a legacy transactions in determining whether to disclose names of syndicate members other than at the request of the Borrower.

June 2011

Schulte Roth & Zabel

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

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*

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.

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[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."

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*

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[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

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[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]

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[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*

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[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.

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[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.

<table>
<tr><th colspan="2">Assignment Agreement (Distressed/Claims)</th></tr>
<tr><td>No Set-Off</td><td>The “no set-off” representation given by seller has been deleted as it is contained in the Standard Terms and Conditions.</td></tr>
<tr><th colspan="2">Confidentiality Letter</th></tr>
<tr><td>Expiration of Confidentiality Undertakings</td><td>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.</td></tr>
</table>

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Claims Traders Beware: More Risk Than You Bargained For!

Article contributed by Lawrence V. Gelber, David J. Karp, and Jamie Powell Schwartz of Schulte Roth & Zabel LLP

Introduction[1]

Bankruptcy claims trading was once largely dominated by trade creditors hoping to receive some value for their claims against a company in bankruptcy. For example, the plumber who was not paid for fixing the sink in an office building might sell his $300 claim against a debtor-building owner to an investment firm in exchange for an immediate pay-out of a fraction of the total claim amount. Over the past several years, however, the size, scope, and nature of the claims trading market has changed dramatically, as has the sophistication of market participants and the complexity of the underlying claims being traded. In many large bankruptcy cases, the small trade creditors have been joined by hedge funds and investment banks as unsecured creditors seeking to unlock liquidity with respect to swap, hedge, or structured financial product claims against large debtors such as Lehman Brothers and Enron. SecondMarket, a claims trading marketplace, has estimated that the potential market for bankruptcy claims is $500 billion, with an estimated $8 billion in claims traded in 2009[2] and $40 billion in estimated claims traded in 2010[3] demonstrating tremendous year over year and potential for growth in this asset class. Whether an investment fund looking for exposure to claims or a non-debtor counterparty looking for short term liquidity, parties must understand the potential risks of participation in this market.

Risks Associated with the Purchase and Sale of Bankruptcy Claims

Claims trading is largely unregulated, and the bankruptcy courts provide only limited oversight. Accordingly, it is incumbent upon purchasers and their counsel to be wary of the special risks attendant to investments in bankruptcy claims. In particular, purchasers of bankruptcy claims should be aware of three major categories of risk: (1) recovery risk; (2) notional amount risk; and (3) counterparty credit risk. Recovery risk is related to the distribution provided to a creditor pursuant to a debtor's plan of reorganization or liquidation and is beyond the scope of this article. Counterparty credit risk, as discussed below, is the risk that a seller may later become insolvent, creating potential difficulty in seeking damages for any breach of the claim sale documents. In many instances, the most significant risk to the value of a claim is the notional amount risk, i.e., the risk that the claim may be disallowed in whole or in part or that the face amount of the claim may otherwise be reduced or subordinated by the bankruptcy court, resulting in an impairment to the claims' validity or priority of payment in the bankruptcy case. Put simply, there is a risk that if Party A sells a claim to Party B for $100.00, then the bankruptcy court will not recognize or "allow" the claim in the amount of $100.00. If a claim is not recognized or allowed in its full face amount, it is

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said to be "impaired" (not to be confused with the term "impairment," as defined in 11 U.S.C. § 1124).[4]

Reasons for Impairment

Under the Bankruptcy Code, a claim is deemed allowed in the amount in which it is scheduled or filed, unless it is either disallowed or reduced or subordinated by a bankruptcy court order.[5] This is known in the claims trading market as claim impairment and can result from a successful attack by the debtor, creditors' committee, or other party-in-interest for a variety of reasons.

a) Bad Acts

A creditor's claim in a chapter 11 case may be reduced or subordinated if the creditor (particularly an insider-creditor) has committed "bad acts" that have benefited one creditor (usually the offending creditor) at the expense of others, such as purchasing claims to destroy a competitor, using one's insider status in a manner that causes harm to other creditors, or abusing the bankruptcy process. The practical effect of this subordination is that the bad actor's priority in right of payment may be subordinated to that of all other creditors, potentially diminishing the recovery percentage on the bad actor's claim. Instead of being first in line, a first priority secured claim holder could find his or her claim subordinated to all other secured and unsecured creditors and senior only to equity interests in the debtor.

b) Fraud/Insider Trading

A court also may subordinate a claim on the basis of: (1) fraud and other illegal acts; (2) non-arm's length transactions with the debtor; (3) an insider's breach of fiduciary duty; and (4) a creditor's use of the debtor as an alter-ego. Harm to the debtor's other creditors is an essential element of such an equitable subordination cause of action.

c) Non-Compliance with Procedural or Substantive Requirements

A claim may be challenged and reduced or disallowed on procedural or substantive grounds if, for example, the claim holder has failed to comply with requirements for asserting a claim as established by the bankruptcy court or cannot produce evidence to support the claim's validity. For instance, in most chapter 11 cases, the bankruptcy court sets a deadline (a "bar date") for filing proofs of claim against the debtor. Notice of the deadline must be given to all creditors and parties in interest in the case. Claims filed by a creditor after the bar date are subject to disallowance. Similarly, a claim may become subject to attack and ultimate reduction or disallowance for substantive deficiencies, such as those relating to adequacy of supporting documents and/or compliance with underlying documentation requirements relating to claim calculation.[6] For example, a debtor might challenge the calculation method utilized by a claim holder or might demand evidence demonstrating that the claim holder received the requisite number of market quotations in support of its calculation, pursuant to the underlying documents.

d) Preferential Transfer

A creditor's claim may also be challenged or disallowed if the creditor received a preferential payment[7] from the debtor within 90 days of the bankruptcy filing, even if it was unrelated to the bankruptcy claim being asserted.

Allocating Notional Amount Risk in Transfer Documents

If a claim becomes subject to one or more of the impairments described above, the purchaser's remedies against the seller will depend on the transfer documents used in the sale process. The market has generally settled upon four methods for allocating impairment risk, with language known as: (1) recourse; (2) non-recourse; (3) as-is; or (4) hold-back.

a) Recourse

A recourse agreement provides the purchaser with the strongest level of protection and generally enables a purchaser to focus on counterparty credit and recovery risks. If a claim is sold on a recourse basis, the purchaser will have the ability to force the seller to repurchase the claim, through the exercise of a contractual put right, if the claim becomes impaired.[8] Depending on the language used in the transfer documents, the seller may have a right to cure the impairment by a certain date rather than immediately repurchasing the claim. When a purchaser is allowed to exercise the contractual put right, the purchaser may be permitted to sell back the defective portion of the claim to the seller and also receive a negotiated amount of interest accruing from the date of the initial sale.

b) Non-Recourse

An assignment of claim agreement that does not contain a contractual put right but contains representations and warranties intended to protect the purchaser in the event of an impairment is generally labeled by the market as "non-recourse." In a non-recourse trade, subject to the representations, warranties, and indemnities in the assignment of claim agreement, the purchaser bears the risk of impairment because the purchased claim cannot be forcibly sold back to the seller, even if the claim subsequently becomes impaired. Depending on the wording in the transfer documents, however, a non-recourse purchaser may still be entitled to sue or seek indemnification from the seller, particularly if the impairment is related to a breach of the seller's covenants, representations, and warranties regarding the claim. For example, if a purchased claim is later disallowed but the transfer documents contained a representation that the claim was valid and an indemnity for any breach of the representation, the purchaser of the claim may still pursue contractual remedies against the seller despite the non-recourse nature of the claim.

The precise wording of the representations and warranties will determine whether impairment risk will be retained by the seller; as such, the term "non-recourse" may not accurately reflect the parties' relative risk positions. Although a non-recourse agreement contains no automatic purchaser right to recovery, carefully crafted representations, warranties, and indemnification provisions can shift impairment risk to such a degree that the trade may more accurately be categorized as recourse rather than non-recourse. In such an instance, a seller may need to consider whether the seller has retained any impairment risk and whether or not cash received from the purchaser is truly unencumbered and not subject to claw-back risk.

It is common for purchasers to try to force the seller to retain the notional amount risk. In some cases, when a purchaser negotiates a hold-back (discussed below) and offers to take the remainder of the claim on a non-recourse basis, the purchaser actually may expect to be covered for notional amount risk on the non-recourse portion of the claim by virtue of representations and warranties and attendant indemnification in the transfer documents. True non-recourse or "as-is" transactions are more rare.

c) As-Is

An "as-is" trade is exactly as it sounds - a trade with very limited representations and warranties, usually covering such things as due authorization and valid organization. An as-is trade thus transfers both the recovery risk and the notional amount risk to the purchaser. It follows logically that purchasers generally attach a significant discount to the value of the claim if they are willing to take it as-is and assume these risks.

d) Hold-Back

A hold-back occurs when the claims purchaser either escrows or withholds a portion of the purchase price until all or part of the purchased claim is allowed by final and non-appealable order of a bankruptcy court. In these situations, the parties generally negotiate the precise terms of any escrow arrangement and specifically delineate how the hold-back is to be released from escrow or otherwise funded by the seller.

Counterparty Credit Risk

If the seller of a claim itself becomes a chapter 11 debtor or otherwise becomes insolvent, the purchaser’s ability to exercise a recourse trade put right may be rendered worthless. Similarly, in the context of a non-recourse sale, the purchaser likely will not be able to obtain indemnification or sue to recover for breach of representations and warranties from an insolvent seller. When buying a bankruptcy claim, therefore, the purchaser is assuming certain risks with respect to the creditworthiness of the seller.

In addition to conducting diligence on the company in bankruptcy, a purchaser should carefully diligence its trade counterparty to ensure that the seller is solvent and can meet its obligations and potential liabilities listed in the claim trading documents. If a seller is insolvent or in financial distress, the value of any representations, warranties, or indemnities contained in the transfer documents may be severely compromised. If there is a question as to the seller’s creditworthiness, the purchaser should consider requiring a guaranty of the seller's obligations by a well-capitalized affiliate or insist upon a hold-back in an amount equal to a significant percentage of the purchase price until the claim is allowed by final order of a bankruptcy court.

Conclusion

At this time, claims trading is not subject to federal oversight either through bankruptcy courts or federal securities laws. Market participants are free to negotiate transfer documents to their advantage. Purchasers and their counsel must ensure that such documents contain appropriate protections against the various potential risks as to the ultimate value of the purchased claim. In the claims trading market, increasingly sophisticated investors, traders, and counsel must work in tandem to guard against documentation pitfalls and maximize returns.

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[1] For trade-specific advice, please consult with legal counsel. This article is for general informational purposes only and does not constitute, and should not be relied upon as, formal legal advice or a formal legal opinion.

[2] BCD News and Comment, "8 billion in unsecured claims traded in 2009," Vol. 52, No. 21 (March 16, 2010).

[3] SecondMarket, Claims Trading Monthly, December 2010.

[4] For the purposes of this article, the discussion of the concept of "impairment" in the context of trade claims should not be confused with the term "impairment," as defined in 11 U.S.C. § 1124 (which provides that "a class of claims or interests is impaired under a plan unless, with respect to each claim or interest of such class, the plan . . . leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest." *See* 11 U.S.C. § 1124(1)).

[5] 11 U.S.C. § 502(a).

[6] For example, a debtor might challenge the calculation method used by a claim holder or might demand evidence showing that the claim holder obtained the requisite number of market quotations in

support of its calculation, in accordance with the underlying documentation.

[7] The Bankruptcy Code defines a preferential payment as: (1) the transfer of an interest of the debtor in property; (2) to or for the benefit of a creditor; (3) for or on account of an antecedent debt owed by the debtor before such transfer was made; (4) made while the debtor was insolvent (the debtor being presumed to be insolvent within the 90 day period preceding the filing of a petition); and (5) made within 90 days before the filing of the bankruptcy petition (or within one year if the creditor was an insider); (6) that enables the creditor to receive more than such creditor would have received if the case were a chapter 7 liquidation proceeding. 11 U.S.C § 547. Such payments must be returned by creditors and are considered part of the bankruptcy estate - the rationale being that it is unfair for one creditor to be favored (or preferred) over another creditor on the eve of a debtor's bankruptcy filing.

[8] In many instances, the purchaser will be permitted to exercise its put right at the first sign that the claim may become subject to an impairment.

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